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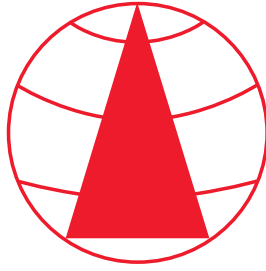
DIRECTORS IN THE TWILIGHT ZONE V



INSOL InternationalTM

International Association of Restructuring, Insolvency & Bankruptcy Professionals

Directors in the Twilight Zone V



INSOL International™

International Association of Restructuring, Insolvency & Bankruptcy Professionals

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President's Introduction

On behalf of INSOL International I am very proud to introduce the 5th edition of 'Directors in the Twilight Zone'. It ably addresses the risks faced by directors, managers, advisors and other third parties who trade companies in the twilight zone of insolvency. The name aptly describes the challenging period when a company runs into financial difficulty and it is not certain whether or not a formal insolvency will eventuate or whether some form of consensual solution can be agreed between the company, debt, equity, employees, government and other stakeholders.

The 5th edition not only updates and refreshes the existing country contributions, but also adds ten new countries to the list. It now covers 30 jurisdictions. The jurisdictions which have been added are the Bahamas, Belgium, Cayman Islands, Colombia, Estonia, Greece, Indonesia, Singapore, South Africa and UAE. The wording of the questions has been amended slightly to clarify them, but the information requested remains the same. We were keen to avoid drastically rewriting the questions as the formula works well and it enabled contributors to the previous edition to more readily update their chapters.

This is the first time that the Twilight series will be published in e-book format, considerably lowering costs and facilitating the addition of ten new chapters. In the future, the electronic format will allow the chapters to be updated as and when required.

Many INSOL members have generously given their time and expertise in writing about their jurisdictions. The project was led by Neil Cooper (Past President, INSOL International) and we would like to sincerely thank Neil for his continued interest and guidance and for bringing this publication to a conclusion that enables INSOL to provide our members with an excellent product which is highly functional, relevant, and of great assistance.

Finally, whilst I am privileged to be able to introduce this publication, I must acknowledge that much of the work was undertaken during Mark Robinson's Presidency of INSOL International, and I extend our thanks for his guidance and contribution.



Adam Harris
President, INSOL International
Bowmans

Foreword and Acknowledgement

This is the fifth edition of the directors in the Twilight zone publication. It has developed from the first edition which covered 13 countries and now covers 30 jurisdictions in more detail. In this edition, the questions have been revised to provide more specific answers and we hope that this will be of greater assistance to readers.

The original objective was to produce a comparative study of assistance to practitioners dealing with financially distressed companies operating in jurisdictions in addition to their own. It has never sought to be an alternative to specific legal advice, which will necessarily take account of the particular circumstances of the case with which the practitioner is dealing, but rather to provide an overview as to the approach of each particular country to this universally problematic question.

Since the first edition of this publication over fifteen years ago, a more enlightened non-punitive approach has seen many nations espousing the development of workable restructuring and reorganisation procedures that permit debtors' businesses to continue in the interests of all of the parties.

Despite the enthusiasm of reformers and sundry ministries, the principal obstacle in promoting reorganisation has been the reluctance of management to commence the procedure. The reforms frequently lack any incentive to the management to seek appropriate professional assistance while there is still an opportunity to restructure the business as a going concern. If the ability to reorganise the business is the carrot, where is the stick, which is also required to make the donkey move?

Most insolvency laws provide for the potential liability of directors: these have their genesis in the need to reinstate the bankruptcy estate because of the misdemeanours of directors and the language typically referred to fraudulent activity. These laws are of limited use to insolvency practitioners because the test to prove fraud is high with the burden of proof on the claimant.

Even now, the only laws relating to directors' obligations in many states are to be found in the civil codes and criminal offences of mismanagement with nothing in the insolvency laws.

The result is that despite all of the provisions outlined in this publication, there are still very few systems that impose material liabilities on directors that are sufficient deterrent to them continuing to trade, incurring losses and transferring assets beyond the reach of their creditors. Too many insolvencies result in creditors getting less than they should because of poor laws.

This is clearly inadequate from the points of view of the Ministries providing the opportunities for reorganisation, the creditors, the employees and the economies where the debtors' business was conducted. This situation is avoidable. More progressive systems adopting workable tests of when the directors incur liability for the losses can be used constructively to focus management on the need to seek professional advice on a timely basis. Even if management are unaware of the law, evidence has shown that when management seek advice from their lawyers, auditors or their lenders as to the action they should take to resolve their impending insolvency, they are likely to be advised of the potential liabilities that they will incur if they do not seek timely professional advice.

The cynic may well ask whether such laws have eliminated all wrongful trading by directors and the answer to this is obviously in the negative: the less - cynical realist, however, will be able to point to businesses that were wound up on a timely basis or were able to be restructured, simply because the directors sought timely advice from insolvency professionals to avoid the risk of personal liability. The cynic will also point out that wrongful trading provisions do not deal with directors deliberately defrauding creditors: quite simply that is a matter for criminal law.

Since the last edition of this guide, we have also seen guidance on this topic from the United Nations Commission on International Trade Law (UNCITRAL) in the form of the UNCITRAL Legislative Guide on Insolvency Law Part four: Directors' obligations in the period approaching insolvency. A summary of the legislative provisions in this guide is attached as an appendix to this foreword. The Legislative Guide is intended to be of assistance to nations considering the reform of laws relating to the management of an enterprise when that enterprise faces imminent insolvency. The work of UNCITRAL in connection with the directors of companies within economic interest groups continues and further guidance can be expected within the foreseeable future. INSOL hopes that this edition of the Twilight Zone may also be of assistance to such nations in providing details of laws extant in jurisdictions similar to their own.

We have decided to publish this work in electronic format to facilitate it being kept up-to-date and because the size of the publication with the additional nations that we are now including had resulted in a book that was no longer practical to slip into one's briefcase before jumping on the proverbial omnibus or aeroplane. We hope that members will find this useful and, as always, we welcome feedback and suggestions from our readers.



Neil Cooper
Past President, INSOL International



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Overview

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

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

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

- **Fraudulent trading**, i.e. the intentional or reckless incurring of debts when the director knows that there is no prospect of paying, so that this is a fraud. The difficulties of proof make this liability unusual in the countries which have the rule, mainly because of the equivalents of the "silver-lining" or "sunshine" or "light at the end of the tunnel" tests exemplified in an English 1960 unreported case in which the court held that the directors were not liable if they genuinely believed "that the clouds will roll away and the sunshine of prosperity will shine on them": *Re White & Osmond (Parkstone) Ltd*
- **Negligent trading**, i.e. incurring debts when objectively there is no reasonable prospect of paying them – a negligence standard on a balance of probabilities.
- **Compulsory stoppage on percentage loss of capital**, for example a duty to take appropriate action if there has been a 50% loss of capital or if the company is balance sheet insolvent or unable to pay its debts as they fall due.
- **Business misjudgements** leading to the insolvency e.g. borrowing beyond the capacity of the company to repay, committing the company to risky business ventures, inadequate budgeting, inadequate financial monitoring or supervision, inadequate insurance, unfunded capital investments, excessive dividends or imprudent investment in high risk securities or having too many employees.

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

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

Pros and cons of personal liability of directors

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

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

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

Other issues

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

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

International survey

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

- **High risk** - In France there is (or used to be) draconian personal liability of directors for serious business mistakes leading to the insolvency, e.g. risky ventures, imprudent borrowing, on failure to insure and often the bankruptcy of a major company has resulted in the near automatic bankruptcy of its directors.

It is said that the liability is high in Spain, Portugal and some South American countries – which impose a negligence standard but it would be necessary to meticulously compare the case laws.

- **Medium risk** - E.g. England, Ireland, Australia, New Zealand, Singapore, Hungary. Broadly, these countries adopt the principle of knowingly negligent liability for causing the insolvency. Thus, under Britain's Insolvency Act 1986, a director is personally liable if the company has gone into insolvent liquidation and the director "knew, or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation". The director has the deemed competence of a "reasonably diligent person" of his function e.g. finance director, and has a defence if he "took every step with a view to minimising the potential loss to the company's creditors that he ought to have taken" e.g. advice or a petition for an administration. The provisions in Australia and Ireland are to a very similar effect. English case law has mitigated the liability. There are broad equivalents in the Netherlands, Belgium and Japan by case law.
- **Low risk** - E.g. United States. The personal liability of officers and directors for deepening the insolvency is very rare in the US, apart from special legislation imposing tougher liabilities on directors of insured financial institutions. In Delaware for instance, the business judgment rule is protective of directors and there are no express statutory provisions imposing liabilities on directors for deepening the insolvency on the lines of those found in Europe and English-based jurisdictions. Case laws rejected the concept. Nevertheless, in the United States, class actions against directors for causing loss to shareholders and creditors under plaintiff-oriented litigation rules are quite common (the actions are usually settled) and it has been argued that, as a result, the liability of directors in the US is not greatly different from that elsewhere. On the whole, however, it is suggested that the US is protective of directors and applies a very tolerant business judgment rule. Canada is generally low risk.

Outside the above cases, one may note that the duty of directors to petition for insolvency proceedings or to notify the court or call a shareholders' meeting if one-third or one-half of the company's capital is lost is common in the Napoleonic and Roman Germanic jurisdictions, i.e. those outside the common law group. Indeed, Article 17 of the EU Second Company Law Directive imposes a duty on directors to call a meeting if more than one-half of the capital is lost: the UK does not prescribe civil liability for violation, but Belgium and Sweden (for example) do.

It seems to be a near universal rule that the failure of directors to account for taxes, e.g. deductions from employee wages, attracts personal liability: the moral is that directors should not borrow from the Revenue.

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

Conclusions

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

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

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

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ARGENTINA

QUESTION 1

1.1 How are directors identified / defined?

The election of board members is an essential aspect in the development and devolution of a company, the schemes for their election are considered essential and accordingly ruled by Argentinean General Companies Law¹ (AGCL), and, to the extent allowed by AGCL, the provisions included in each company's bylaws.

1.2 Board members may be elected under different circumstances.

- 1.2.1 Election of board members at the time of the company's creation. The First Board Members are elected at the time of the company's constitution, which may be performed in one act: the original contract (AGCL 166); or, in the case of constitution by public subscription (AGCL 168), at the founding assembly (art. AGCL 179).
- 1.2.2 Election of board members after the company's constitution:
- 1.2.2.1 The general principle is that, once the company has been constituted, directors are elected by the ordinary shareholders' meetings (AGCL 234.2 and 255) with quorum and majority requirements governed by law, and, to a certain extent by the company's bylaws (AGCL 243).
- 1.2.2.2 However, board member elections by ordinary shareholders' meetings through majority of votes have some exceptions: (a) when there are different classes of shares and the statute provides for each of them to choose one or more directors (AGCL 262); (b) when a shareholder chooses to use the cumulative voting scheme (AGCL 263); and, (c) when the bylaws provide for a "*Consejo de vigilancia*" explicitly entrusted with the ability to name members of the Board (AGCL 280 and 281.4).
- 1.2.2.3 Except for unanimous shareholder meetings, where publication may be waived according to AGCL 237, shareholders' meetings have legal requirements as to quorum and majorities. First call quorum requirements are of a majority of shares with voting rights (AGCL 243), a majority which is generally interpreted not to be modifiable by statute (by contrast to AGCL 244 referred to extraordinary meetings' quorum requirements). Second call quorum requirements provide for the meeting to be quorate regardless of the number of shareholders with voting rights actually present.
- 1.2.2.4 For validly appointing a director, the general principle is to require a simple or absolute majority ("*mayoría absoluta*", which means more than half) of present shares with voting rights at the time the ballot is taken (AGCL 243). However, bylaws may require a higher majority, though unanimity is rejected both by leading authors and judicial precedents. When the required majorities are not met, the candidacy is rejected.

¹ Argentina General Corporation Law 19,550 (AGCL) was sanctioned on 3 April 1972 and published at the *Boletín Oficial* number 22409 (Official Gazette) on 25 April 1972. Since then, it has been modified by numerous laws. The current text has been reordered by Decree 841/1984. A full Spanish version – for both the original and the updated version of AGCL – is currently available at the Ministry of Economy website: <http://www.infoleg.gov.ar/infolegInternet/verNorma.do?id=25553>.

The following is a summary of laws which have amended the original AGCL, as sanctioned by Law 19550 (laws are cited by law number, their publication date, and their Spanish short title):

Law 22315, 07 November 1980 (*Inspección General de Justicia. Ley Orgánica*).
Law 22903, 15 September 1983, (*Sociedades Comerciales. Su Modificación*).
Law 23576, 27 July 1988, (*Títulos. Creación de un nuevo título de deuda. Obligaciones negociables de sociedades anónimas*).
Law 23697, 25 September 1989, (*Emergencia económica. Estado de emergencia*).
Law 23962, 06 August 1991, (*Impuesto a las ganancias. Obligaciones negociables*).
Law 24076, 12 June 1992, (*Gas Natural. Marco Regulatorio. Privatización Gas del Estado*).
Law 24145, 06 November 1992. (*YPF. Privatización*).
Law 24435, 17 January 1995, (*Sociedades Comerciales. Modificaciones*).
Law 24522, 09 August 1995, (*Concursos y quiebras. Régimen legal*).
Law 26047, 03 August 2005, (*Registros Nacionales. Sociedades - Asociaciones - Fundaciones - Disposiciones*).
Law 26994, 08 October 2014. (*Aprobación del Código Civil y Comercial*).

1.2.3 Election of board members using candidate lists

AGCL does not provide rules for board member elections using candidate lists, instead of individual candidates, with individual and successive ballots. The validity of such scheme has been questioned based on its contradiction with general understanding that the AGCL is designed for individual voting (see AGCL 255, 234, 281, 256, 257, 258, 259 and 274); however, such scheme is not forbidden by law.

1.2.4 Election of board members by shareholders' classes (AGCL 262)

1.2.4.1 Since differentiation by shareholders' classes is permitted by AGCL 207, the law allows for statutory clauses to authorize share classes to enjoy different political and economic rights, though such rights must be homogeneous within the class or category. In such context, AGCL 262 permits bylaws / regulations allowing for each class to choose one or more director, with such statutory regulations being necessary for election by classes to be carried out.

1.2.4.2 Election of directors by shareholder classes requires either ballot at a special meeting for shareholders belonging to the class (AGCL 262 and 250), or by an independent ballot within the general shareholders' meeting, with proper quorum and majority requirements which are the same as those for shareholders' meetings, unless this is forbidden by the bylaws.

1.2.5 Election by cumulative voting

1.2.5.1 Election by cumulative voting provides for a scheme tending to provide minority representation at the Board. This scheme, which may not be applied when directors are chosen by the Supervisory Board (*Consejo de Vigilancia*) - (AGCL 280 and 281) or when the board is composed of less than three directors, needs to be activated in time by any shareholder with voting rights (AGCL 263), and may not be overridden by bylaws.

1.2.5.2 Shareholders with voting rights have the right to elect a third of the vacancies at the Board by the system of cumulative voting (AGCL 263). The system does not guarantee minority shareholders' representation at the Board, but, depending on vote distribution, it may provide for such a possibility. Simultaneous to cumulative voting, the other two thirds of board positions are chosen by shareholders using the ordinary system.

1.3 Timeframes that are applicable

1.3.1 The twilight period is the time period which runs between the judicially decided date of commencement of insolvency and the judicial pronouncement of bankruptcy or liquidation proceedings (as defined by Argentina Bankruptcy Law 24.522², ABL 116). Under Argentinean insolvency law, the twilight period is not applicable to reorganization proceedings. However, in the case of an indirect liquidation proceeding (*quiebra indirecta*) which arises due to the frustration of a reorganization proceeding, the twilight period is applied as explained in 1.6.2.

² Argentina Bankruptcy Law 24.522 (ABL) was sanctioned on 20 July 1995 and published at the *Boletín Oficial* (Official Gazette) number 28203 on 9 August 1995 (*Anales de Legislación Argentina* 1995 - D. 4381). Since then, it has been modified by numerous laws. They are hitherto cited by law number, publication date, and Spanish short title for each law:

Law 24587, 22 November 1995, (*Nominatividad de los títulos valores privados*).

Law 24760, 13 January 1997, (*Factura de crédito. Régimen legal - su aprobación*).

Law 25113, 21 July 1999, (*Contratos de maquila. Regulación legal*).

Law 25284, 02 August 2000, (*Entidades deportivas. Régimen especial de administración*).

Law 25374, 02 January 2001, (*Mutuales. Ley 20321 - modificación*).

Law 25563, 15 February 2002, (*Concursos y quiebras. Emergencia productiva y crediticia*).

Law 25589, 16 May 2002, (*Ley de concursos y quiebras. Leyes 24522 y 25563 - su modificación*).

Law 25640, 11 September 2002, (*Concursos y quiebras. Ley 25589 - prórroga*).

Law 25750, 07 July 2003, (*Preservación de bienes y patrimonios culturales. Bienes y patrimonios culturales - régimen*).

Law 25972, 17 December 2004, (*Emergencia pública. Ley 25561 - prórroga artículos*).

Law 26086, 11 April 2006, (*Concursos y quiebras. Ley 24.522 - modificación*).

Law 26684, 30 June 2011 (*Concursos y quiebras*).

Law 27170, 8/9/2015 (*Concursos y quiebras*).

A full Spanish version – for both the original and the updated version of ABL – is currently available at the Ministry of Economy website: <http://www.infoleg.gov.ar/infolegInternet/verNorma.do?id=25379>. For the texts of all modifying laws, refer to: <http://servicios.infoleg.gov.ar/infolegInternet/verVinculos.do;jsessionid=35E1DAB16F2F59CF5B6FDF07EC0F0D43?modo=2&id=25379>

- 1.3.2 The following transactions may be vulnerable to attack under ABL 118 and 119 if entered into during the two years prior to: (a) the pronouncement of the bankruptcy or liquidation proceeding (*quiebra*) or (b) the filing by the debtor of a then frustrated reorganization proceeding (*concurso preventivo*) (ABL 116):
- (a) gratuitous acts (ABL 118 1);
 - (b) the prepayment of debts payable only on the day of judicial pronouncement of bankruptcy or thereafter (ABL 118 2);
 - (c) any kind of security granted to secure an obligation not yet due (ABL 118 3); and
 - (d) acts which cause damage to creditors if the other party was aware of the debtor's insolvency at the time of the act (ABL 119).
- 1.3.3 Transactions entered into during the twilight period are vulnerable to attack by creditors. These attacks on the transactions' efficacy may come under general (civil) law principles, under insolvency law, or under corporate law.
- 1.3.4 Attacks based on general (civil) law do not depend on the existence of formal insolvency proceedings; they should be based on Argentina Civil and Commercial Code (ACCC), ACCC 338 to 342, or ACCC 333 to 337.³
- 1.3.5 Under insolvency law, personal liability on the part of directors or officers, for transactions entered into during the twilight period, may not be raised by creditors unless a formal insolvent liquidation procedure, and not a reorganization, follows.
- 1.3.6 Under corporate law, the directors may be held liable for claims by individual creditors on the grounds of damage suffered to individual creditors' personal estates (AGCL 19550, AGCL 59 and 279), irrespective of whether or not formal proceedings have been instituted.
- 1.3.7 Shareholders may also challenge transactions entered into during the twilight period, and this can give rise to personal liability on the part of directors, irrespective of whether or not formal proceedings have been instituted (AGCL 279).⁴

1.4 Does it depend on the nature of the transaction?

- 1.4.1 The length of the twilight period does not depend on the nature of the transaction. The objective of insolvency is to ensure fair (traditionally expressed as "equal") treatment between all stakeholders. Accordingly, transactions concluded during the twilight period which are of the nature described in 1.3.2 (a) to (d) are vulnerable to attack by creditors.
- 1.4.2 Transactions referred to in 1.3.2 (a) to (c) above are automatically void against creditors, the instigation of legal proceedings by creditors or the *síndico* (the judicially appointed trustee or insolvency administrator) is not necessary (ABL 118). Acts under 1.3.2 (d) require proceedings to be instigated by the *síndico* in order for a judicial decision to be reached declaring the act void *vis-à-vis* the creditors. The *síndico* must obtain previous authorization by the simple majority (more than a half) of the admitted unsecured liabilities (ABL 119). A creditor may also pursue the same action at its own cost and risk, but only after petitioning the *síndico* to do so, and waiting thirty days for the *síndico* to act (ABL 120). Under cases in ABL 118, 119 and 120, the result is that the transaction is void *vis-à-vis* the creditors, but remains valid between the parties. In addition, success in an action pursued by a creditor under ABL 120 results in the creditor obtaining reimbursement of its costs, and a priority being awarded to it, the priority is determined by the judge, and should be between a third and a tenth of the recovered assets value, with the limit on the creditor's claim against the estate.

³ Actions (*acción revocatoria*) based on ACC 338 aim at declaring void an act of the debtor in fraud (*fraude*) to its creditors. For this action's success, ACC 339 requires: (i) the debtor to be insolvent, though not necessarily under formal insolvency proceedings; (ii) prejudice to creditors to be caused by the transaction or that the debtor was insolvent prior to the transaction; and (iii) the action to be exercised by a creditor with a claim prior to the voidable transaction. For the purpose of this action, fraud may be defined as provocation or aggravation of the debtor's insolvency through acts or omissions, in prejudice to its creditors, deviating assets from its patrimony or estate.

Actions (*acción de simulación*) based on ACC 333 to 337 are directed towards declaring the transaction simulated, thus inopposable to creditors. This action may be instituted by creditors who are prejudiced or will suffer prejudice by the transaction, the insolvency of the debtor not being necessary.

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

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

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

1.5.2 Nevertheless, the relationship between the party to the transaction and the company may be significant in determining whether the related party may be held personally liable upon the formal liquidation proceeding of the company. In this case, liability does not merely imply the transaction's avoidance, but may, on occasions, result in the counterparty's declaration of bankruptcy (ABL 161).⁵

1.6 Will any other circumstances lengthen or shorten the twilight period?

1.6.1 The twilight period is extended under two circumstances they are:–

1.6.2 When the liquidation proceeding follows a frustrated reorganization proceeding, the two year limit (ABL 116) runs from the filing of the petition for the reorganization proceeding.⁶ In fact, this is not properly a case of lengthening the twilight period, but of beginning its counting earlier.

1.6.3 When considering the personal liability of directors or officers to creditors (ABL 173), the twilight period is extended back one further year prior to the date of the judicial pronouncement of insolvency (ABL 174), thus encompassing actions entered into by directors up to three years prior to the commencement of insolvency proceedings. The action against directors or officers requires proceedings to be instigated by the *síndico*, who must obtain previous authorization by a simple majority (more than a half) of the admitted unsecured liabilities (ABL 174 and 119). Creditors, at their own cost (ABL 120), have a subsidiary action in the event that the *síndico* does not seek or obtain authorization (ABL 176 and 120)⁷.

QUESTION 2

2. Actions potentially giving rise to liability for directors

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

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

(i) is the director's liability considered to be civil, criminal or both?

(ii) can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

(iii) will liability attach to all the directors or 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?

⁵. Refer to 2.2.4 below for further information.

⁶. Refer answer to 1.3.1.

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

2.1 General fiduciary duties

2.1.1 Directors are subject to certain general fiduciary duties imposed by statute. AGCL establishes that, in performing their functions, directors are required to act in good faith and with the diligence of a good businessman (*buen hombre de negocios*) (AGCL 59). This is understood to imply the duty of directors to administer the corporation, by performing a number of activities, being informed of the development of corporate trade, participating in board meetings, and raising objections to decisions by the board or by creditors' meetings which are contrary to AGCL or bylaws provisions. Thus, directors are not responsible for their administration's success, but for their loyalty and diligence in performing their duties. Their performance is assessed based on the circumstances at the time of their decision; the burden of proof is not on the director.

2.1.2 AGCL 59 is designed so that directors focus on the best interests of the company and its shareholders. However, the general fiduciary duty owed to the company and its shareholders becomes subject to an overriding duty to have regard to the interests of the company's creditors in the event that the company undertakes a reorganization proceeding (ABL 15 to 17). In such cases, ABL provides for the debtor's, and consequently its directors' and officers' duty to treat similarly situated pre-insolvency creditors in a similar fashion as regards their pre-insolvency claims. Such a duty may be seen as a consequence of the objective of insolvency proceedings to ensure fair treatment to stakeholders, in particular to pre-insolvency general creditors.⁸

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

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

2.2.1 Liability under Reorganization Proceedings (*concurso preventivo*).⁹ Where a company is subject to reorganization proceedings, failure to comply with the statutory provisions regarding the administration of the company and the treatment of creditors (ABL 15 and 16) may result in the separation of the debtor from the administration of the estate (ABL 17).^{10 11} Consequently, directors may be held liable for such actions. Statutory provisions provide a system of administration during reorganization proceedings according to the following principles: (a) freedom to enter into any transaction within the debtor's ordinary course of business¹² (*administración ordinaria de su giro comercial*); (b) requiring judicial authorization prior to entering transactions that exceed the debtor's ordinary course of business (ABL 16, third paragraph);¹³ and (c) prohibition on performing gratuitous acts or acts affecting the pre-insolvency standing of creditors *vis-à-vis* other pre-insolvency creditors (ABL 16, first paragraph).¹⁴

2.2.2 Liability under Liquidation Proceedings (*quiebra*). A director or officer may be held personally liable if, during the twilight period (see 1.5.3) he deliberately produces, facilitates, permits or aggravates the deterioration of the estate of the company or its insolvency. Liability is to compensate for the damage caused by the director or officer (ABL 173, first part). The action should be brought by the *síndico* within two years of the judicial pronouncement of the liquidation proceeding (ABL 174). Creditors only have a subsidiary or subordinated right to institute this action in circumstances where the *síndico* does not institute it (ABL 176 and 120)¹⁵. Requirements for liability are: (a) action by a person with capacity to represent the debtor¹⁶;

⁸. See 1.4.1.

⁹. It should be noted that, under a reorganization proceeding ruled by ABL (*concurso preventivo*), neither the *síndico* nor creditors may raise personal liability issues on the part of directors or officers, for transactions entered into by the company during the twilight period. However, creditors may file suits based on general (civil) law, which do not depend on the existence of formal insolvency proceedings. See 1.3.4. and 1.3.5.

¹⁰. Separation from administration of the estate does not impede the debtor's ability, and its directors and officers, to negotiate and eventually conclude a reorganization agreement with its creditors.

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

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

¹³. Though the general rule defines required judicial authorization prior to entering transactions when they exceed the debtor's ordinary course of business, a few examples where authorization is mandatory are provided by the statute, which include: transactions involving any registered asset (movable or immovable), issuance of bonds with a floating charge or other security right, and granting pledges of mortgages on any of the debtor's assets (ABL 16, third paragraph).

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

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

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

(b) entering transactions which: (1) produce, (2) facilitate, (3) permit, or (4) aggravate the company's economic or financial situation; (c) performing the action deliberately (with *dolo*);¹⁷ and (d) damage to the company or its creditors¹⁸.

- 2.2.3 A director or officer may also be held personally liable if, during the twilight period, or after a formal declaration of bankruptcy, he knowingly participates in acts directed to, and having the effect of diminishing the company's assets or increasing its liabilities. (ABL 173, second part) Requirements for liability are: (a) action by any person regardless of the person's capacity to represent the debtor¹⁹; (b) participating in actions tending to diminishing the debtor's assets or exaggerating its liabilities; (c) performing the action deliberately (with *dolo*);²⁰ and (d) damage to the company or its creditors²¹. The action should be brought by the *sindico* within two years of the judicial pronouncement of bankruptcy (ABL 174). Creditors only have a subsidiary or subordinated right to institute this action, when the *sindico* does not institute it (ABL 176 and 120)²². Liability extends to:
- (a) the restitution of goods still under the director's or officer's control;
 - (b) the obligation to compensate for the damage caused; and
 - (c) the loss of any right to claim against the insolvency estate (ABL 173, second part), which includes the director's or officer's right as a creditor of the company.
- 2.2.4 Extension of Liquidation Proceedings to Directors. ABL 161 refers to the extension of liquidation proceedings in cases of: (a) a person acting on behalf of the company but in his own interests, known as "*actuación en interés personal*" (ABL 161.1); (b) abuse of control committed by a controlling person, known as "*control indebido*" (ABL 161.2), and (c) a person having its assets and liabilities confused with those of the debtor under liquidation proceedings, known as "*confusion patrimonial inescindible*" (ABL 161.3).
- 2.2.4.1 Acting in the person's own interests is defined as: (1) any natural or legal person (2) appearing to act on behalf of the insolvent debtor (3) entering into transactions in his own interests and making dispositions of company's assets as if they were his own²³ (4) in order to defraud the insolvent debtor's creditors (ABL 161.1).
- 2.2.4.2 Abuse of control is defined by ABL as the unlawful deviation of the controlled company's interest, subjecting it to a unified direction in the controller's interest or in the group's interest (ABL 161.2)²⁴. A controller²⁵ is defined as: (a) any natural or legal person who directly or through another person has such participation in the debtor company with the necessary voting rights to dictate social decisions (ABL 161.2.a); and (b) each of the natural or legal persons that, acting jointly, have the participation described above (ABL 161.2.b).
- 2.2.4.3 Having assets and liabilities confused with those of the debtor under liquidation proceedings results in the extension of liquidation proceedings to: (1) any natural or legal person; (2) whose assets and liabilities, or the majority of them cannot be clearly divided from those of the insolvent debtor (ABL 161.3). The most frequent occurrence for this are cases of promiscuous or intermingled management of the aforementioned assets and liabilities.

¹⁷ *Dolo* is defined by art. 1724 of the ACCC as requiring both knowledge and intention to produce damage or evident indifference for a third party's interests.

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

¹⁹ It is generally understood that the debtor's directors and officers as well as members of a supervisory body and any third party are liable through ABL 173, second part.

²⁰ Defined as in ACC 1072. See previous footnote.

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

²² The creditor's success implies the consequences established under ABL 120, which have previously been described in footnote 8.

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

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

²⁵ AGCL 33 also defines control in its definition providing for both internal and external control. Definition of control by ABL 161.2 is considered to refer to internal control only. However, ABL 161.1 may be seen as encompassing cases of external control also. It should be noted that under Argentina law, control by itself does not imply liability, only abusive exercise of controlling power may bring about the controller's personal liability or, in some circumstances, its liquidation ("by extension").

2.2.4.4 The sanction for breach of these offences (2.2.4.1. to 2.2.4.3) is to extend the insolvency proceedings to include the declaration of the controlling party's own bankruptcy. Though the provision does not specifically mention directors as liable under it, directors and officers may be found liable if they meet the aforementioned criteria. In the case of control, it requires that: (1) the definition of control is applicable to them, and (2) they have abused such control.

2.2.4.5 In such cases, the liquidation proceeding may be extended by the Court, regardless of their personal solvency. This is known as "*quiebra refleja*" (as a "reflection" of the original bankruptcy) and may be either an independent insolvency proceeding with a separate estate²⁶ or the formation of a single estate with assets from the original bankruptcy and the second bankruptcy²⁷.

2.3 Liability under AGCL (Argentina's General Corporation Law 19.550)

2.3.1 AGCL does not provide specific regulations applicable to the actions of directors and officers in cases of insolvency. However, corporate actions, designed to be applied when the company is solvent, remain applicable during insolvency proceedings, regardless of whether such proceedings are reorganizations or liquidations. AGCL establishes a number of actions for which a director may be found liable for corporate wrongdoing. These actions, set out below and described in AGCL 276, 277 to 279, are actions based on liability, to which the general rules of the law of restitution apply. They may be brought or continued regardless of the existence of insolvency proceedings (ABL 175). The general rule established by AGCL art. 174 is that all directors will be held jointly and severally (*ilimitada y solidariamente*) liable to the corporation, shareholders, and third parties, for:

- (a) any fraudulent or wrongful performance of their duties (AGCL 59 and 274);
- (b) any violation of the law, the company's articles of incorporation or by laws (AGCL 274); and
- (c) any other damage caused deliberately or arising from an abuse of their position (AGCL 274).

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

2.3.2 These actions can be summarized as follows:

- (a) AGCL 276, first part, describes the action which may be brought against one or more directors of the corporation. It presupposes a detriment to the company's estate and must be approved at a shareholder's meeting. The decision of the shareholders has the effect of automatically removing the director from their position and requiring the appointment of a substitute. This action is brought on behalf of the corporation and by the corporation itself against the directors; but any shareholder may promote it if the action is not commenced by the appropriate corporate body within three months of the shareholder's meeting (AGCL 277). In a liquidation, this action must be filed or continued (*vis attractiva concursus*) before the bankruptcy Court (ABL 175 and 176). The *síndico* may continue the action (AGCL 278 and ABL 175) or it may be continued by any interested party, including the shareholders (ABL 176 *in fine*).
- (b) AGCL 276, second part, allows the above action to be brought by any shareholder who has objected to the approval of the directors' or officers' performance at the shareholders' meeting. Here again the action is brought on behalf of the corporation, but by a shareholder. As with the action in ACL 276, first part, in a liquidation, this action must be filed or continued (*vis attractiva concursus*) before the bankruptcy Court (ABL 175 and 176). The *síndico* may continue the action (AGCL 278 and ABL 175), or it may be continued by any interested party, including the shareholders (ABL 176 *in fine*).

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

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

- (c) AGCL 277 allows any shareholder, to file an action described in AGCL 276, first part, where the corporation has failed to do so and three months have expired since the approval of the shareholders was obtained²⁸. In this case, the shareholder acts in the place of the corporation.
- (d) AGCL 279 states that both the shareholders and third parties always have an individual right of action against directors. The damage for this action being personal to the plaintiff and not to the corporation²⁹; consequently the action is brought by the shareholder or third party under its own interest and not on behalf of the corporation³⁰. This right of action arises from any loss caused to the shareholder's estate³¹ or to the third party and does not depend on any previous corporate proceeding or decision having been brought. This right of action is not, therefore, affected by any approval of the directors' duty at the shareholders' meeting.
- (e) AGCL 54 refers to the liability for damages to the company committed by a controlling person³². Though it does not mention the controller's directors or officers as being liable, liability may be founded on the general principle of torts, under ACCC 1749 and 1751. There are two possibilities for actions under AGCL 54. Requirements for AGCL 54, first part to proceed are: (a) action by any controlling party, (b) which causes damage to the company, and (c) damage being the result of negligence or deliberation (*dolo*).³³ Requirement for AGCL 54, second part to proceed is the use by any controlling party of corporate funds or assets on the users of a third party's behalf. Restitution for this case implies restitution of the benefits obtained.³⁴

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

2.4.1 The APC describes the criminal offences that may be committed by directors³⁶ in the performance of their duties:

- (a) APC 173, Inc. 7: abusive, unfaithful, or fraudulent administration. Although this is not a specific provision aimed at corporate directors, since it applies to any person in charge of goods or economic interests other than his/her own, directors and officers may be charged with this offence and punished with imprisonment. The offence is either to impair the confided interests or to abusively obligate their owner, and requires the violation of the administrator's duties with the intention of causing damage or obtaining an undue advantage for him or a third party.
- (b) APC 300, inc. 3: the publication, certification, or authorization of false or incomplete corporate documents. Directors may be charged with this offence and punished with imprisonment. The offence must have been committed deliberately. The corporate documents to which this offence applies include balance sheets, inventories, and Board minutes.
- (c) APC 300, Inc. 3: providing false information or failing to provide adequate information as to the company's financial situation. This offence must have been committed deliberately but regardless of the reason, the false or inadequate information must have concerned important facts about the financial position of the corporation. It is punishable by imprisonment.
- (d) APC 301: directors deliberately consenting or participating in the performance of acts which are in violation of the law, articles of incorporation, and bylaws of the company, and which may cause damage. Punishable by imprisonment, the sanction is aggravated if the offence involves the issue of stock.

²⁸. See comment in 2.3.2. (a).

²⁹. Thus different from actions from AGCL 276 first and second parts. See 2.3.2.a. and 2.3.2.b.

³⁰. Contrary to actions from AGCL 276 first and second parts. See 2.3.2.a. and 2.3.2.b.

³¹. Here damage to the shareholder's estate is usually understood to mean damage to the value of shares.

³². This action is also applicable to damages caused to the company by its shareholders.

³³. See footnote 7.

³⁴. If there is loss, it is only suffered by the controlling party.

³⁵. APC 178, 300 and 301 were all ratified by Law 23.077, which ratified Law-decree 21.338. APC 173 was enacted under Law 11.221, and recuperated application with the enactment of Law 23.077.

³⁶. See discussion in 3.3. for applicability to officers, members of the Supervisory Board, private supervisors, liquidators, and corporate accountants.

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

2.5 Penal liability under other laws

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

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

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

- 3.1.1 The general rule³⁷ is that any person involved in the affairs of a company may be found liable, as if he were a director, under ABL 173, second part, for having knowingly participated in acts directed to and having the effect of diminishing the company's assets or increasing its liabilities (as set out in 2.2.3). Parties entering into contracts with the company, necessary participants and the like are considered included in this provision, as are members of the company's supervisory body.
- 3.1.2 A more specific case is provided for under ABL 173, first part. Any officer or person representing the corporation may be found liable, as if he were a director, under ABL 173, first part, for transactions entered into during the twilight period which deliberately produce, facilitate, permit or aggravate the deterioration of the estate of the company or its insolvency (as set out in 2.2.2). To be included under this case, the person must have the capacity to represent the corporation or administer some or part of its assets. Officers and agents of the corporation are considered included under this case, while members of supervisory boards are considered excluded.
- 3.1.3 A creditor who, whilst aware of the corporation's insolvency during a reorganization proceeding, has entered into a transaction in breach of the administration rules (ABL 15 to 17) is vulnerable to attack through actions of fraud, or simulation brought under civil law (ACCC 338 to 342 or ACCC 333 to 337).
- 3.1.4 ABL 161 refers to the extension of liquidation proceedings to cases of: (a) persons acting on behalf of the company but guided by their own interests (ABL 161.1),³⁸ (b) abuse of control (ABL 161.2),³⁹ and (c) a person having its assets and liabilities confused with those of the debtor under

³⁷. For a more specific case of liability for persons involved in a company's affairs, see 3.1.2.

³⁸. See discussion in 2.2.4.1.

³⁹. See discussion in 2.2.4.2.

insolvency proceedings (ABL 161.3).⁴⁰ Anybody who meets one of these criteria may suffer as a sanction the extension of the insolvency proceedings. This is again known as “*quiebra refleja*”,⁴¹ which means the declaration of bankruptcy of the person involved with the company’s affairs, regardless of the person’s solvency.

3.1.5 ABL does not have a concept of de facto directors.⁴² However, persons acting in such circumstances could be reached by the application of the principles in 3.1.

3.2 Liability under AGCL (Argentina’s General Corporation Law 19.550)

3.2.1 AGCL establishes a general rule about corporate officials (*gerentes*) with duties in the company’s administration or with the ability to represent the company. In the performance of their duties, they may be held liable on the same terms and to the same extent as directors,⁴³ but without in any way limiting the liability of the directors themselves (AGCL 270).

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

- (a) any fraudulent or wrongful performance of their duties (AGCL 59 and 274);
- (b) any violation of the law, the company’s articles of incorporation or bylaws (AGCL 274); and
- (c) any other damage caused deliberately or arising from an abuse of their position (AGCL 274).

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

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

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

3.3 Liability under APC (Argentina’s Penal Code)

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

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

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

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

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

⁴⁰ See discussion in 2.2.4.3.

⁴¹ See discussion in 2.2.4.4.

⁴² ACL does not provide such concept either. However, AGCL 34, second paragraph, asserts that the so called *de facto* shareholder (*socio oculto*) has unlimited and joint responsibility for corporate debts. Application of this concept in order to extend corporate insolvency proceedings to *de facto* shareholders under ABL 160 is debated by insolvency experts.

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

⁴⁴ See discussion in Section 4.

⁴⁵ It should be remembered that for the transaction to be void, it requires the act to cause damage to creditors. See also discussion in 1.3.2 and 1.4.2.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 General rule

- 4.1.1 The general rule for transactions entered into by the company during the twilight period is that they may be vulnerable to attack, under insolvency law, following commencement of liquidation proceedings (ABL 119).
- 4.1.2 A few transactions are automatically treated as void *vis-à-vis* creditors upon declaration of bankruptcy by the insolvency judge. In these cases, the judge may declare the transaction void without the need for a petition, and without any proceeding. Such declaration must be issued within three years of commencement of liquidation proceedings (ABL 124). Proceedings can also be brought by the *síndico* to challenge the specific transactions which will automatically be treated as void (i.e. not valid against creditors) upon a declaration of the insolvency judge.

Proceedings to challenge the transaction need not be brought by a third party. Rights of appeal exist. These transactions are:

- (a) gratuitous acts;
- (b) the early payment of debts which are not actually payable until the day of judicial pronouncement of bankruptcy or thereafter; and
- (c) granting security of any kind to secure an originally unsecured obligation which was not yet due (ABL 118).

4.2 Reviewable transactions

- 4.2.1 Any transaction may be subject to challenge under the general rule set out in 4.1.1 if it impairs creditors' interests and the other party is aware of the company's insolvency at the time of the transaction. Proceedings must be brought by the *síndico*, with the prior approval of the majority of the verified creditors (ABL 119). Actions need to be initiated within three years of commencement of liquidation proceedings (ABL 124). The insolvency judge's decision is subject to appeal by the injured party.
- 4.2.2 Proceedings challenging a transaction on this basis may be brought by creditors of the company once formal insolvent liquidation proceedings have been commenced (ABL 120). The successful creditor obtains reimbursement of its costs and a priority for its claim against the estate, as determined by the judge, which should be established at between a third and a tenth of the recovered value.
- 4.2.3 A creditor who, during the twilight period, was aware of the corporation's insolvency and entered into a transaction with the company, may not oppose the action by the *síndico* or the right of other creditors subsequently to challenge the transaction (See 1.3.2 (d)). The transaction will be challengeable if it caused damage to the creditors by reducing the value of the insolvency estate (ABL 119).

4.3 Defences

4.3.1 It will be a defence to any challenge, brought on the basis of the general rule that the interests of creditors have been impaired, to show that no damage to creditors has actually been caused. The onus of proving the absence of damage is on the creditor who entered into the transaction, knowing of the company's insolvency (ABL 119).

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

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

An unconnected third party providing credit to a company during the twilight period should take ABL 119⁴⁴ into account. If the third party knows that the company is insolvent though not legally declared as such, the provision of credit may be rendered void *vis-à-vis* the creditors in a future liquidation proceeding.⁴⁵

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 General rule

5.1.1 In the case of a company against whom liquidation proceedings (*quiebra*) have been commenced, the authority and powers of the directors are taken over by the *síndico*. (ABL 108 and 110) Consequently, in most cases, the power to bring actions against directors, officers, and others identified in question 3 lies in the hands of the *síndico*, who must obtain the authority of the majority of the verified creditors for that purpose (ABL 118 and 176).

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

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

5.2 Corporate proceedings

5.2.1 Corporate actions during insolvency proceedings

During insolvency liquidation proceedings (*quiebra*), actions against directors, officers and members of the Supervisory Board, based on AGCL 276 and 277,⁴⁶ may be brought by the *síndico* (ABL 175), though shareholders and third parties retain the right to claim for personal damage suffered by them (AGCL 279).⁴⁷

⁴⁶ See discussion in 2.3.1 and 2.3.2.

⁴⁷ See discussion in 2.3.2. (d).

⁴⁸ In these cases, commencement of liquidation proceedings (*quiebra*) "attracts" these suits to the insolvency Court (*vis attractiva concursus*).

⁴⁹ See discussion on footnote 2.

5.2.2 Pre-existing corporate actions during insolvency proceedings

ABL 175, second part, states that corporate actions commenced prior to the judicial pronouncement of insolvent liquidation proceedings may continue to be heard before the insolvency judge.⁴⁸ For pre-existing actions commenced by the corporation, the *síndico* must decide whether to continue the pre-existing proceeding or bring an action based on the insolvency law. For pre-existing actions commenced by a shareholder, the *síndico* must decide whether to cooperate in the pre-existing proceeding or bring an action based on the insolvency law.

5.3 Bankruptcy proceedings

5.3.1 It is the *síndico* in liquidation proceedings who may bring proceedings in relation to: reviewable transactions (ABL 119), director's liability (ABL 173, first and second parts), corporate officials' liability (ABL 173, first and second parts), liability of members of the Supervisory Board (ABL 173, second part), and others (ABL 173, second parts). The *síndico* must obtain the prior approval of the majority of verified creditors (ABL 120).

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

5.3.3 Actions based on Civil Law (*revocatoria ordinaria*), for a declaration of fraud in relation to a particular transaction (based on ACCC 338 to 342)⁴⁹ may only be commenced or continued by a creditor when the *síndico* has failed to act within thirty days of being required to do so by a creditor (ABL 120, second and third part).

5.3.4 Either the *síndico* or a creditor may bring an action to extend the ambit of the liquidation proceedings (ABL 163)⁵⁰ to:

- (a) persons who acted in their own interests and disposed of the debtor's assets while leading third parties / creditors to believe they were the insolvent debtor (ABL 161, 1);
- (b) any person who controls⁵¹ the insolvent debtor and who has guided its conduct towards interests other than those of the insolvent debtor; in the controller's favour or in favour of another member of the corporate group (ABL 161, 2); or
- (c) any person whose assets and liabilities (*patrimonio*) are so co-mingled with those of the insolvent debtor so that the determination of each person's assets and debts is impossible. (ABL 161, 3).

The application to extend the liquidation proceedings must be brought to the insolvency judge (ABL 162), within the time limit set out by ABL 163.

QUESTION 6

6. Remedies: orders available to the domestic Court

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

See response to question 2.

⁵⁰. See discussion in 2.2.4.

⁵¹. For the definition of control see 2.2.4.2.

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to cooperate with the insolvency office-holder's investigation into the company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Duty to co-operate

- 7.1.1 ABL 17, 102, 274 and 275 establish general rules of cooperation throughout insolvency proceedings.
- 7.1.2 In liquidation proceedings, the directors, corporate officials and representatives of the insolvent company are obliged to cooperate with the *síndico* (office holder) and with the Court, to provide information about the situation of the estate and / or the company's liabilities and assets. The Court has the power to enforce this duty to co-operate. Accordingly, any person failing to fulfil their duty to attend before the Court to provide information may be arrested (ABL 274 inc. 1 and 275 inc. 3). However, although the Court may enforce attendance, it may not force the director to incriminate himself (See description in 7.2.1.).
- 7.1.3 In reorganization proceedings, any director who fails to provide the information required by the Court and / or by the *síndico* (office holder) may be sanctioned by being removed from office by the Court (ABL 17). Such measure is appealable by the debtor.

7.2 Human rights

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

QUESTION 8

8. Appeals and limitation periods

- (a) What limitation period, if any, applies to the actions referred to above?

See answers to questions 1 and 2.

- (b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation periods

- 8.1.1 The limitation period for actions brought under ABL intending to declare certain acts void *vis-à-vis* the creditors⁵² is three years from the declaration of bankruptcy (ABL 124). Personal liability actions brought under ABL 173, first⁵³ and second part⁵⁴ have a limitation period of two years from the judicial pronouncement of liquidation proceedings (ABL 174). Actions brought under ABL 161

⁵² See discussion in 1.1. and 1.4.2.

⁵³ See discussion in 2.2.2.

⁵⁴ See discussion in 2.2.3.

have a limitation period equivalent to the time between the declaration of bankruptcy and six months following the general report⁵⁵ by the *síndico* (ABL 163).

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

8.2 Appeals

- 8.2.1 In civil and / or penal proceedings, an appeal is always available against the decision of a Court of first instance. In insolvency proceedings, the general rule is that decisions may not be appealed unless the statute explicitly provides otherwise (ABL 273.3).
- 8.2.2 Lower Court decisions in actions brought under insolvency law intending to declare certain acts void *vis-à-vis* the creditors under ABL 118, 119 and 120 are subject to appeal (ABL 124). Lower Court decisions on personal liability actions under ABL 173, first and second part may be subject to appeal depending on non-insolvency local procedural rules for ordinary proceedings (ABL 174). Lower Court decisions extending insolvency under ABL 161 are subject to appeal as any other declaration of bankruptcy (ABL 88).

QUESTION 9

9. Foreign corporations

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

9.1 General rule

- 9.1.1 The legal provisions outlined above apply to all companies subject to liquidation proceedings in Argentina.
- 9.1.2 AGCL 121 establishes that representatives of foreign companies have the same responsibilities and liabilities as directors and officers of domestic companies.

QUESTION 10

10. Insurance

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

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

The information provided in this country chapter is correct as at 15/02/2017

⁵⁵ The general report by the *síndico* (ABL 39) includes, among other legally required contents: a description of the causes leading to the debtor's financial situation; an inventory of its assets and an assessment of their value; an account of the debtor's liabilities; a report on the accounting books kept by the debtor; the *síndico's* opinion as regards the estimated date when the debtor became insolvent; and the list of transfers that may be voidable (ABL 118 and 119).

AUSTRALIA

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Identification and definition of directors

1.1.1 Under S 9 of the Corporations Act,¹ a director of a company or other body means:

(a) a person who:

- (i) is appointed to the position of a director; or
- (ii) is appointed to the position of an alternate director and is acting in that capacity, regardless of the name that is given to their position; and

(b) unless the contrary intention appears, a person who, although they are not validly appointed as a director, providing:

- (i) they act in the position of a director; or
- (ii) the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes.

1.1.2 Sub paragraph (b)(ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors or the company or body.

1.1.3 Additionally, under S 9 of the Corporations Act, a director of a company is captured under the definition of "officer".

1.2 Background

1.2.1 Division 2 of Part 5.7B of the Corporations Act (voidable transactions) deals with those 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.²

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

(a) Insolvent transactions

A transaction is an insolvent transaction if it is either an unfair preference given by the company or an uncommercial transaction, and either the company was insolvent at the time or became insolvent because of the transaction (S 588FC).³

¹ 2001 (Cth).

² See paragraph 1.3.4 below.

³ All references are to the Corporations Act 2001 (Cth). Note that other statutes in Australia also deal with the personal liability of directors (see, for example, s. 325 of the Co-Operatives Act 1992 (NSW); s. 188 of the Life Insurance Act 1995 (Cth); s. 144 of the Occupational Health and Safety Act 2004 (Vic)).

(b) Unfair preferences

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

(c) Uncommercial transactions

A transaction will be deemed “uncommercial” where a reasonable person in the company’s circumstances would not have entered into the transaction, having regard to the benefits and detriment to the company, and the benefits to other parties, of entering into the transaction (S 588FB).⁴

(d) Unfair loans

A loan to the company will be deemed “unfair” if the interest or charges were extortionate at the time the loan was made or have since become extortionate because of a variation (S 588FD).

(e) Unreasonable director-related transactions

A transaction where a company makes, or incurs an obligation to make, a payment, a transfer of company property, or an issue of the company’s securities to a director or a close associate of a director, is an unreasonable director-related transaction if a reasonable person in the company’s circumstances would not have entered into the transaction, having regard to the benefits and detriment to the company, and the benefits to other parties, of entering into the transaction (S 588FDA).

(f) Relation-back day

The time period in which transactions are vulnerable to attack is determined by reference to the “relation-back day”.⁵ 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.⁶

1.3 Time frames

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

1.3.2 S 588FE also provides the relevant time frames in which the transaction must have occurred in order for it to be voidable.⁷

⁴ 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.

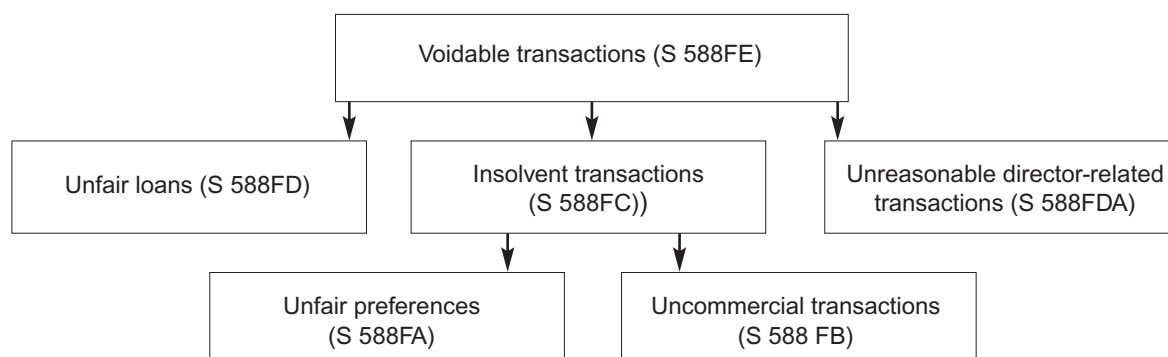
⁵ Defined in s. 9.

⁶ 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).

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

Type of transaction	Length of time prior to relation-back day	Section
Insolvent transaction (with non-related entity)	Six months (or after the relation-back day but on or before the day when the winding up began).	588FE(2)
Insolvent <i>and</i> uncommercial transaction (with non-related entity)	Two years	588FE(3)
Insolvent transaction to which a related entity ⁸ of the company is a party	Four years	588FE(4)
Insolvent transaction entered into for the purpose of defeating, delaying, or interfering with, the rights of any or all of the company’s creditors	Ten years	588FE(5)
Unfair loan	No time limit until start of winding up (which may be after the relation-back day).	588FE(6)
Unreasonable director-related transaction	Four years (or after the relation-back day but on or before the date when the winding up began).	588FE(6A)

1.3.3 The following diagram⁹ illustrates the meaning of “voidable transaction” in the Corporations Act.



1.3.4 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.¹⁰

⁸ 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.
⁹ Based on layout suggested by Andrew Keay.
¹⁰ 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).

Start and duration of twilight period	
No time limit until start of winding up	Unfair loan (S 588FE(6))
Ten years ending on the relation-back day	Insolvent transaction to defeat creditors (S 588FE(5)).
Four years ending on the relation-back day	Insolvent transaction with a related entity (S 588FE(4)); Unreasonable director-related transaction (S 588FE(6A)).
Two years ending on the relation-back day	Insolvent and uncommercial transaction(with non-related entity) (S 588FE(3)).
Six months ending on the relation-back day or the start of the winding up	Insolvent transaction (with non-related entity) day or amounting to an unfair preference (S 588FE(2)).
Relation-back day (see note in 1.3.5)	
Three years from the relation-back day or within such longer period as the Court orders on application by the liquidator within those three years (S 588FF(3)).	Proceedings brought in respect of voidable transactions pursuant to Ss 588FE and 588FF.
Six years after the start of the winding up	Actions against directors by the (Deputy) Commissioner of Taxation (S 588FGA), actions against directors for compensation for insolvent trading (S 588M), actions against persons (including directors) with respect to agreements or transactions entered into to avoid employee entitlements (S 596AB), an action against a holding company for loss resulting from insolvent trading (Ss 588V and 588W).

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

1.4 Circulating security interests

1.4.1 Any circulating security interest¹¹, which includes a floating charge on the property of the company which was created in the six months ending on the relation-back day (or after that day but on or before the day when the winding up began) is (with some exceptions - see 4.2.2) void against the company's liquidator unless the company was solvent immediately after the circulating security interest was created (S 588FJ).

¹¹ Defined in s. 51C.

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 the director?

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

- (i) Is the director's liability considered to be civil, criminal or both?**
- (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?**
- (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?**
- (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 consequences¹²

The following are the principal acts set out in the Corporations Act (there are others referred to in other legislation and the common law):¹³

- (a) failing to prevent the company from incurring a debt while insolvent (insolvent trading) (S 588G);¹⁴
- (b) failing to exercise powers and discharge duties with care and diligence (S 180);¹⁵
- (c) not acting in good faith (S 181);¹⁶
- (d) misuse of position (S 182);¹⁷
- (e) misuse of company information (S 183);¹⁸
- (f) entering into an agreement or transaction to prevent or significantly reduce the recovery of employee entitlements (S 596AB);¹⁹
- (g) causing or allowing the company to make a payment of money to the Commissioner of Taxation that is later found to be a voidable transaction under S 588FE (S 588FGA); and
- (h) falsification of books; false and misleading statements and information; obstructing or hindering the Australian Securities and Investments Commission (ASIC)²⁰ (Ss 1307-1310).²¹

¹² 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).

¹³ Note that liability for acts (b)-(f) and (h) arises even if the act is performed outside the twilight period.

¹⁴ The director may also contravene s. 596 by: (i) fraudulently obtaining credit for the company (596(1)(a)), (ii) with intent to defraud the company or its creditors, transferring or charging any property of the company (596(1)(b)) or concealing or removing any property of the company after or within two months before the date of any unsatisfied judgment against the company (596(1)(c)). These are criminal offences: s. 1311.

¹⁵ Liability is imposed on directors and other officers.

¹⁶ See above, footnote 15.

¹⁷ Liability is imposed on directors, other officers and employees.

¹⁸ See above, footnote 17. This duty continues after the person stops being an officer or employee of the company.

¹⁹ Liability is imposed on a "person", which includes a director.

²⁰ Australian Securities and Investments Commission – the corporate watchdog.

²¹ Liability is variously imposed on a "person" or an "officer", which includes a director. See also related offences in s. 590.

2.1.2 The Corporations Act (S 197) provides that where a trust deed of which a company is trustee excludes the trustee's right of indemnification from the trust assets, the directors of the corporate trustee have personal liability for the debts incurred by it.

2.2 Liability for insolvent trading under S 588G

2.1.1 (a) Liability of a director may be:

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

- a compensation order (S 1317H); or
- a civil pecuniary penalty order²² (S 1317G); or

(ii) criminal if dishonesty and suspicion of insolvency are involved (S 588G(3)).²³

There is to be no double recovery in actions for insolvent trading under S 588M (S 588N).²⁴

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

However, criminal proceedings may be taken after civil penalty proceedings regardless of outcome (S 1317P).

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

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

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

(iii) If the company²⁵ applies (under S 1317J), the director may be liable for the loss or damage to the company (including profits made by anyone as a result of insolvent trading) pursuant to a compensation order. In criminal proceedings, the compensation that the Court may require the director to pay to the company (under S 588K) is equal to the creditor's loss.

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

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

²² Certain contraventions of the Corporations Act involve breaches of "civil penalty provisions" for which a compensation order (S 1317H) and/or a civil penalty order (being payment of a fine to the Commonwealth of up to AU\$200,000: s. 1317G) is imposed. Such breaches are provable according to the civil standard, that is, on the balance of probabilities. Other contraventions of the Corporations Act are classed as "offences" and are effectively criminal breaches in the strict sense. They carry penalties of imprisonment or financial penalty and are provable according to the criminal standard of proof – i.e. beyond reasonable doubt (e.g. s. 588G(3) – insolvent trading to a criminal degree; s. 184 - lack of good faith, misuse of position or information to a criminal degree). Certain offences and contraventions of civil penalty provisions may also give rise to disqualification from managing a company and therefore holding the position of director (see sections 203B and 206A-206F).

²³ Possibly in conjunction with a compensation order under s. 588K.

²⁴ 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".

²⁵ Through the liquidator.

(e) The defences available are:²⁶

- (i) in relation to civil liability under Ss 588G(2) and 588M – expecting solvency on reasonable grounds, including reasonable reliance on a qualified person for advice; illness or other good reason preventing the director from managing the company at the time; or having reasonably tried to prevent the debt being incurred (S 588H);
- (ii) in relation to criminal liability – lack of dishonesty or lack of suspicion of insolvency, which, while not being explicit defences, would mean that essential elements of the offence are not satisfied (Ss 588G(3)(c) and 588G(3)(d)); and
- (iii) in relation to penal liability²⁷ – lack of material prejudice to the company or shareholders’ interests and to the company’s ability to pay its creditors, together with lack of seriousness of the contravention.²⁸ In addition, the above-mentioned defences available in civil proceedings (S 588H) apply here as well.²⁹

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

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

(f) However, the December 2015 Productivity Commission Report,³⁰ in conjunction with the Federal Government’s Innovation statement,³¹ recommended a “safe harbour” defence be introduced into Australian insolvency law to give directors of an insolvent company the ability to explore various restructuring options without personal liability for insolvent trading.

- (i) Presently, a director may be liable for insolvent trading if they are a director at the time the company incurs a debt, the company is insolvent at that time or becomes insolvent as a result of incurring that debt, and at the time of incurring the debt, there are reasonable grounds for suspecting the company is insolvent, or would become insolvent.³² There are two alternate proposals currently being considered, with a view to legislation being entered by mid-2017.³³
- (ii) Under the recommended safe harbour provisions³⁴ a defence to S 588G would be available to directors in circumstances where a director has engaged an appropriately qualified and experienced restructuring professional to provide advice on restructuring, and who remains of the opinion that the company can be returned to solvency within a reasonable period of time.³⁵
- (iii) Alternatively, a defence to S 588G is proposed if the debt was incurred as part of reasonable steps to maintain or return the company to solvency, and the person held the honest and reasonable belief that incurring the debt was in the best interest of the company and creditors, and incurring the debt does not materially increase the risk of serious loss to creditors.³⁶
- (iv) Importantly, the proposed safe harbour provisions only propose to act as a defence to the insolvent trading provisions contained in S 588G and directors remain subject to all other obligations under the Act, including the unreasonable director-related provisions discussed above.

²⁶ Note that the “business judgment rule” in s.180(2) does not provide a defence to an insolvent trading claim (see below, footnote 38 and accompanying text, and note to s. 180(2)).

²⁷ That is, liability which arises from a contravention of a civil penalty provision of the Corporations Act (see above, footnote 22).

²⁸ 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.

²⁹ 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).

³⁰ Productivity Commission 2015, *Business Set-Up, Transfer and Closure*, Final Report 75, Canberra.

³¹ Released 7 December 2015, accessible at www.innovation.gov.au/page/insolvency-laws-reform

³² See S 588G.

³³ See above footnote 30.

³⁴ Productivity Commission Report, see above footnote 28, Recommendation 14.2.

³⁵ Federal Government Innovation Statement, above footnote 31, proposal 2.2.

³⁶ Federal Government Innovation Statement, above footnote 31, proposal 2.3.

2.3 Failing to exercise care and diligence: S 180

- (a) Liability of a director may be both civil (S 1317H) and criminal (S 1311), and there is liability for a pecuniary penalty order under S 1317G.³⁷ Civil penalty proceedings are not to be taken, or are to be dismissed, if criminal proceedings resulted in a conviction: Ss 1317M and 1317N. However, criminal proceedings may be taken after civil penalty proceedings regardless of outcome (S 1317P).
- (b) A director can be made personally liable in respect of the whole of the loss caused to the company (including profits made by anyone as a result of insolvent trading). A director may also have to pay a fine to the Commonwealth.
- (c) Liability will attach to specific directors in the sense that it will be imposed on the particular director(s) in breach.
- (d) There is no specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director. Further, it is not necessary to show that the company was insolvent at the time.
- (e) The defences available to a director are:
 - (i) proper “business judgment”³⁸ had been exercised: S 180(2); and
 - (ii) 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).³⁹

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

- (a) Liability of a director may be both civil (S 1317H) and criminal (S 184), and there is liability for a pecuniary penalty order under S 1317G.⁴⁰ Civil penalty proceedings are not to be taken, or are to be dismissed, if criminal proceedings resulted in a conviction: Ss 1317M and 1317N. However, criminal proceedings may be taken after civil penalty proceedings regardless of outcome (S 1317P).
- (b) A director can be made personally liable in respect of the whole of the loss caused to the company (including profits made by anyone as a result of insolvent trading). A director may also have to pay a fine to the Commonwealth.
- (c) Liability will attach to specific directors in the sense that it will be imposed on the particular director(s) in breach.
- (d) There is no specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director, although the matter is covered by the general legislation, which imposes limitation periods. Further, it is not necessary to show that the company was insolvent at the time.
- (e) Reliance on proper delegation is a defence available to a director under S 190 (see also S 189 – reliance on information or advice provided by others).

³⁷ That is, a *quasi-penal* order.

³⁸ 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 best interests of the company (S 180(2) – the “business judgment rule”). Note that this defence is only available in proceedings under s. 180; in particular, it is not a defence to an insolvent trading claim (see note to s. 180(2)).

³⁹ See above, footnote 22.

⁴⁰ That is, a *quasi-penal* order.

In addition, in civil penalty proceedings, lack of material prejudice to the company's or shareholders' interests and to the company's ability to pay its creditors, together with lack of seriousness of the contravention, is the way in which the requirements of 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).⁴¹

2.5 Entering into an agreement or transaction to avoid employee entitlements in breach of S 596AB⁴²

(a) Liability of a director may be:

- (i) civil (S 596AC); and / or
- (ii) criminal (S 588G(3)⁴³ if insolvent trading to a criminal degree is also involved, or S 1311 otherwise).

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

(b) Whether the liquidator or an employee⁴⁴ 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 company under S 588K is equal to the creditor's loss.

- (c) Liability does not attach to individual directors in proportion to their specific involvement. Each director can be ordered to pay the whole amount, although an individual director may have a particular defence that lessens or absolves civil or criminal responsibility.
- (d) There is no specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director. Further, it is not necessary to show that the company was insolvent at the time.
- (e) Defences are only available if a linked contravention of S 588G is also present, and they are the same as for the breach of S 588G (see above, at 2.2).

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

- (a) Liability of a director is civil (S 588FGA).
- (b) The director can be made liable for the whole of the loss or damage suffered by the Commissioner as a result of the payment to the Commissioner being set aside under S 588FF.
- (c) Liability does not attach to individual directors in proportion to their specific involvement but attaches to all directors on the basis of joint and several liability (although a director may have a particular defence that lessens or absolves responsibility).

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

- (e) The defences available to a director are:
 - (i) expecting solvency on reasonable grounds, including reasonable reliance on a qualified person for advice (Ss 588FGB(3) and 588FGB(4));

⁴¹ See above, footnote 22.

⁴² 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).

⁴³ Possibly in conjunction with a compensation order under s. 588K.

⁴⁴ Under s. 596AC(3) as permitted by s. 596AF or s. 596AH (and not prevented by s. 596AI).

- (ii) illness or other good reason preventing director from managing the company at the time of payment to the Commissioner of Taxation (S 588FGB(5)); and
- (iii) reasonable steps taken to prevent the debt being incurred or the absence of reasonable steps that could have been taken (S 588FGB(6)).

See also S 588FG, which provides defences to the Commissioner of Taxation against an order setting aside the company's tax payment under S 588FF. 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; obstructing or hindering ASIC: Ss 1307-1310

- (a) Liability of a director is criminal (S 1311).
- (b) Since liability is criminal, the penalty does not depend on the damage caused.
- (c) Liability will attach to specific directors in the sense that it will be imposed on the particular director(s) in breach.
- (d) There is no specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director. Further, it is not necessary to show that the company was insolvent at the time.
- (e) Depending on the particular offence, the following defences may be available:
 - (i) lack of intention to falsify books (S 1307(3));⁴⁵
 - (ii) acting honestly;
 - (iii) acting with a lawful excuse;
 - (iv) lack of knowledge that information is false or misleading; and
 - (v) having taken reasonable steps to ensure the statement was not false or misleading.

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

⁴⁵ 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 Act specifies general duties of officers⁴⁶ of a company, which will apply to their conduct during the twilight period.⁴⁷ Employees may also be liable for misuse of their position or information during and outside the twilight period.⁴⁸

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

- (a) he or she acts in the position of a director; or
- (b) the directors of the company are accustomed to act in accordance with his or her instructions or wishes.⁴⁹

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

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 or is likely to suffer loss or damage (S 598).

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

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

3.1.6 Some sections of the Corporations Act create liability not only for those contravening a provision (e.g. directors if the provision imposes requirements on directors), but also for persons involved in the contravention.⁵⁰

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

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

3.2.1 A person who is deemed to be a director may be held liable for any of those acts identified in question 2 above, that is, acts which may give rise to personal liability on the part of directors.⁵¹

3.2.2 An officer of a company will be subject to the duties contained in Ss 180-183.⁵² An officer performing an act in contravention of those duties will therefore be liable. An officer will also be criminally liable for obtaining credit for the company by fraud (S 596(1)(a)), transferring company property with intention to defraud (S 596(1)(b)), concealing or removing any property of the company after or within two months before the date of any unsatisfied judgment against the company (S 596(1)(c)), various offences under S 590⁵³, falsification of books(S 1307⁵⁴) and furnishing misleading information (S 1309⁵⁵). 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 Ss 181, 182 or 183 (i.e. failure to act in good faith, misuse of position or misuse of information) is the same as it would be for that other person.

⁴⁶ 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.

⁴⁷ 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.

⁴⁸ Sections 182 and 183.

⁴⁹ Section 9 (definition of “director”) at 1.1.1 above.

⁵⁰ For example, see sections 181-183. The word “involved” is defined in s. 79.

⁵¹ That is, their liability will be the same as for a validly appointed director.

⁵² Sections 180-183 of the Corporations Act set out duties of care and diligence (S 180(1)), good faith (S 181), use of position (S 182) and use of information (S 183). Note that sections 182 and 183 also apply to employees of the company.

⁵³ Note that s. 590 also applies to employees of the company.

⁵⁴ Note that s. 1307 applies to officers, former officers, employees, former employees, members and former members.

⁵⁵ Note that s.1309 also applies to employees of the company.

- 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 voidable⁵⁶. The Court may make a variety of orders;⁵⁷ 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 (Ss 588V-588X) provides that a holding company can be liable to compensate loss or damage caused by the insolvent trading of a subsidiary.
- 3.2.7 A person managing a company while disqualified from acting as a director may become personally liable for the company's debt (S 588Z).

3.3 Limitation of liability

- 3.3.1 Whether liability will be limited to that resulting from involvement with a particular transaction, or relates more generally to the overall loss suffered by creditors, will depend upon the particular provision of the Corporations Act under consideration.
- 3.3.2 For example, a person who has received an unfair preference may be ordered to pay to the company an amount equal to some or all of the money that the company has paid under the transaction (S 588FF(1)(a)). The person's liability will then be limited under 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 Ss 180-183), liability pursuant to a compensation order is for an amount up to the loss or damage resulting from the particular contravention, including profits made by anyone as a result of the contravention (S 1317H).
- 3.3.4 In an action against a director (or a deemed director)⁵⁸ 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 Ss 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.

⁵⁶ Section 588FE provides that certain transactions are voidable (unfair preferences, uncommercial transactions, insolvent transactions and unfair loans to a company).

⁵⁷ Section 588FF.

⁵⁸ Because the definition of "director" in s. 9 includes deemed directors, the liability of a deemed director will always be the same as the liability of a validly appointed director in the same circumstances.

- 3.3.8 Liability (under S 598) of a person guilty of fraud, negligence, default, breach of trust or breach of duty is also within the Court's discretion. One of the possible orders is the order for repayment of the loss or damage suffered by the corporation as a result of the fraud, negligence, default or breach.
- 3.3.9 Where liability is criminal or a pecuniary penalty order is made, a fine is payable to the Commonwealth. At best, the loss resulting from the particular contravention may be indirectly taken into account when setting the amount of the fine.
- 3.3.10 Ss 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

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Transactions with the company in the twilight period that may be set aside

- 4.1.1 See 1.2.2 which lists the various transactions which may be deemed a voidable transaction under S 588FE, and the tables in 1.3, which stipulate the relevant time limits in respect of the voidable transactions.
- 4.1.2 In any of these cases the Court may make a range of orders under S 588FF, including the payment of money and the transfer of property.
- 4.1.3 The benefit of a voidable transaction that discharges a liability of a related entity can be recovered from that entity by the liquidator.⁵⁹
- 4.1.4 A circulating security interest⁶⁰ on the property of the company which was created within the six months ending on the relation-back day (or after that day but on or before the day the winding up began) is (with some exceptions – see 4.2.2) void against the company's liquidator, unless the company was solvent immediately after the circulating security interest was created (Ss 588FJ(1) and (3)).
- 4.1.5 A general law claim may be made against a counterparty where it received the benefit of a transaction undertaken by the directors of an insolvent or near insolvent company in breach of their duty to that company.

4.2 Available defences to a 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 non-party received no benefit, or the benefit was received in good faith and there were no reasonable grounds to suspect the company's insolvency; and

⁵⁹ Section 588FH.

⁶⁰ Defined in section 51C and includes a floating charge.

- (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.

4.2.2 Any circulating security interest is not void in so far as it secures any of the following (S 588FJ(2)):

- (a) an advance paid to the company, or at its direction, at or after the time the circulating security interest was created and as consideration for the circulating security interest;
- (b) interest on such advance;
- (c) the amount of a liability under a guarantee or other obligation undertaken at or after the creation of the circulating security interest on behalf of, or for the benefit of, the company;
- (d) an amount payable for property or services supplied to the company at or after the creation of the circulating security interest; or
- (e) interest on an amount so payable.

4.3 **Basis that directors and other persons involved with the company's affairs may incur further credit during the twilight period**

4.3.1 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 direction or instructions the directors are accustomed to act.

4.3.2 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.

4.3.3 In *Sandell v Porter*⁶¹ 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.⁶² 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.⁶³

4.3.4 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)).

⁶¹ (1966) 115 CLR 666.

⁶² Note that the Corporations Act defines a person to be "insolvent" when he or she is not solvent (S 95A(2)), and a person is defined to be solvent "if, and only if, the person is able to pay all the person's debts, as and when they become due and payable" (S 95A(1)).

⁶³ *Sandell v Porter* (1966) 115 CLR 666, per Barwick CJ at 370. See also *Hymix Concrete Pty Limited v Garrity* (1977) 13 ALR 321 where it was held that a company's whole financial position must be considered and a temporary lack of liquidity does not necessarily mean insolvency.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons 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 Act to bring proceedings in the name of the company.
- 5.1.2 The company is also the appropriate applicant for relief where the claim is in respect of a breach of the general law duty of directors of companies which are insolvent, near insolvent or of doubtful solvency to exercise their powers having regard to the interests of that company's creditors.⁶⁴
- 5.1.3 Finally, the company may apply for a compensation order if a civil penalty provision has been breached: (S 1317J(2)).

5.2 The liquidator

- 5.2.1 In the event that the Court exercises its power under S 474(2) to vest property of the company (including the company's claims, e.g. against the directors) in its liquidator, the liquidator may bring proceedings on account of the company's claims in the liquidator's own name.
- 5.2.2 It is the liquidator, rather than the company, who may bring a claim against a director for breach of the duty to prevent insolvent trading⁶⁵ and for causing the company to undertake a transaction which has the purpose of defeating claims by employees to their entitlements.⁶⁶
- 5.2.3 The liquidator also has a statutory right to make an application to the Court against those guilty of fraud, negligence, default, breach of duty or breach of trust in relation to the company.⁶⁷
- 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.⁶⁸

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*.⁶⁹ No relevant exception to the rule applies in the particular circumstance of a breach of duty by a director of the company, or some other person concerned in its management, during the twilight period in circumstances where a liquidator or other external administrator has been appointed to the company.

⁶⁴ See above, footnote 12.

⁶⁵ Section 588M(2).

⁶⁶ Section 596AC(2).

⁶⁷ Section 598(2). See also definition of "eligible applicant" in s. 9.

⁶⁸ Section 588FH.

⁶⁹ (1843) 67 ER 189.

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.⁷⁰
- 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.⁷¹
- 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:⁷²
- (a) a failure by the company to remit the amount of taxes which it has deducted from payments made by the company (group tax) or the superannuation guarantee charge;
 - (b) the service upon the directors of the company of notices requiring them to either remedy that default or take other prescribed action, including putting the company into some form of insolvency administration; and
 - (c) a failure on the part of the directors to comply with that notice within 21 days.

However, where three months has lapsed after the due date for payment of those tax liabilities, the directors are unable to avoid personal liability for the company's unpaid debts as the director penalty cannot be remitted by the administration or winding up of the company.⁷³

- 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 for a declaration of contravention, a pecuniary penalty order or a compensation order.⁷⁴ ASIC may also make an application to the Court against those guilty of fraud, negligence, default, breach of duty or breach of trust in relation to the company.⁷⁵

⁷⁰ Sections 588R, 588S, 588T and 588U.

⁷¹ Sections 596AF, 596AG, 596AH and 596AI.

⁷² See Division 269 of Schedule 1 to the *Taxation Administration Act 1953*.

⁷³ See the Tax Laws Amendment (2012 Measures No. 2) Act 2012.

⁷⁴ Under s. 1317J.

⁷⁵ Section 598. See also definition of "eligible applicant" in s. 9.

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.⁷⁶

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?

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 company⁷⁷ (S 1317J); recovery from a related entity (S 588FH(2)), a holding company (S 588W) and a person managing the corporation while disqualified (S 588Z); recovery from a chargee where a void circulating security interest⁷⁸ 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))⁷⁹; and
- (d) for the ASIC - compensation equal to the loss or damage (ss 588J and 1317J), a pecuniary penalty (S 1317J), a declaration of contravention of a civil penalty provision (S 1317J) or a disqualification order (S 206C).

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

ASIC or the Director of Public Prosecutions may lay charges where a criminal offence is alleged. Remedies are generally fines and/or imprisonment.⁸⁰

⁷⁶ Section 1313.

⁷⁷ The liquidator must be suing in the name of the company.

⁷⁸ Defined in section 51C.

⁷⁹ Pursuant to ss. 596AF and 596AG.

⁸⁰ A criminal Court may also order a director to pay compensation to the company (section 588K). Alternatively, where the alleged offence is minor, ASIC may issue (under s. 1313) a penalty notice requiring the alleged offender, within a specified time of at least 21 days, to pay the penalty and (if applicable) stop committing the offence. If the recipient complies with the notice, no criminal proceedings are instituted.

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors (and other persons identified in question 3 above) obliged to co-operate with the insolvency office holder’s investigation into the company’s affairs
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Extent to which directors are obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs

- 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.⁸¹
- 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.⁸²
- 7.1.3 Whilst a breach of those obligations is punishable as an offence (S 1311), as a matter of practice, if a liquidator wishes to pursue information, she or he will rely upon the examination provisions of the Corporations Act which allow a Court to summon a person for examination about a company’s affairs.⁸³
- 7.1.4 Where a prosecution in respect of an offence under the Corporations Act has been instituted against a person, ASIC may require any person who is or was a partner, employee or agent of the defendant to assist in the prosecution by giving “all assistance in connection with the prosecution that the person is reasonably able to give” (S 1317(1), and see also S 1317R, which applies both to criminal and quasi-penal proceedings, and imposes requirements on a wider range of persons).
- 7.1.5 Where ASIC believes that a person can give information relevant to a matter it is investigating or is to investigate, ASIC may require that person to attend an examination on oath or affirmation and give all reasonable assistance to ASIC.⁸⁴ ASIC may also require a person to produce specified books.⁸⁵
- 7.1.6 Finally, S 1310 prohibits a person from obstructing or hindering (without lawful excuse) ASIC or anyone else in the performance or exercise of a function or power under the Corporations Act.

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 Art. 14.3(g) of the ICCPR, a person charged with a criminal offence shall not “be compelled to testify against himself or to confess guilt”. This right may be relied upon by directors under question during investigation of the company. The ICCPR, “while having no force [as law] in the Australian municipal law, nevertheless provides an important influence on the development of Australian common law”.⁸⁶

⁸¹ Section 475.

⁸² Section 530A.

⁸³ Sections 596A and 596B.

⁸⁴ Section 19 of the Australian Securities and Investments Commission Act 2001.

⁸⁵ Section 33 of the Australian Securities and Investments Commission Act 2001.

⁸⁶ *Environmental Protection Authority v Caltex Refining Co Pty Ltd* (1993) 178 CLR 477.

- 7.2.3 Under Australian law the privilege against self-incrimination is not considered to be merely rule of evidence governing the admissibility of evidence in judicial or quasi-judicial proceedings. In the words of Mason CJ and Toohey J in *Environmental Protection Authority v Caltex Refining Co Pty Ltd* (1993) 178 CLR 477:
- “The privilege in its modern form is in the nature of a human right, designed to protect individuals from oppressive methods of obtaining evidence of their guilt for use against them.”*
- 7.2.4 The privilege does not apply during ASIC investigations, and a person cannot rely on it in refusing to provide information or a document. However, where the person claims privilege in respect of any incriminating information or document before providing it to ASIC at the investigation, the information or document is not admissible as evidence against the person in a criminal proceeding or a proceeding for the imposition of a penalty⁸⁷ (except for proceedings concerned with the falsity of such information or document).⁸⁸
- 7.2.5 Similar rules apply in relation to examining a person about a corporation under S 597. Examinees are obliged to answer any question put to them in the context of such examinations notwithstanding that the answers may tend to incriminate them (S 597(12)). However, for so long as privilege is claimed in relation to any such answers, those answers may not be used in criminal proceedings (or proceedings for the imposition of a penalty) against the examinee other than proceedings concerned with the falsity of any such answer (S 597(12A)).⁸⁹
- 7.2.6 It is settled law in Australia that the privilege is not available to artificial entities such as corporations.⁹⁰

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation periods applying to actions brought against directors

- 8.1.1 Any proceeding brought with respect to voidable transactions pursuant to S 588FF must be commenced before the later of three years after the relation-back day or 12 months after the first appointment of a liquidator in relation to the winding up of the company or within such longer period as the Court orders on an application by the liquidator within that period (S 588FF(3)).
- 8.1.2 It appears that actions against the directors by the Commissioner of Taxation pursuant to S 588FGA (action for a debt) must be commenced within six 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 six 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 six years after the beginning of the winding up (S 596AC(4)).

⁸⁷ Section 1349.

⁸⁸ 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.

⁸⁹ Note that the protection does not apply in civil proceedings.

⁹⁰ See above, footnote 85. See also s. 1316A.

- 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 six years after the beginning of the winding up (S 588W(2)).
- 8.1.6 If a civil penalty provision is breached, proceedings for a pecuniary penalty order or a compensation order may only be started within six years after the contravention (S 1317K).
- 8.1.7 Criminal proceedings may be instituted within five years after the act or omission said to constitute the alleged offence or at any later time with the consent of the Minister (S 1316). Penalty notices for alleged contraventions of minor offences⁹¹ must also be issued within this time (S 1313(2)(b)).

8.2 Appeal from the decision of lower Courts

- 8.2.1 The Corporations Act does not provide any time limits for appeals in penal, civil, criminal or disqualification proceedings.
- 8.2.2 The Court in which the proceeding is decided will be determined by reference to the particular section of the Corporations Act pursuant to which the proceeding is brought. For example, where the relevant section of the Corporations Act refers to Court with a capital "C", that Court is defined in the Corporations Act (S 58AA) as meaning any Federal Court, Supreme Court or Family Court (i.e. superior Court). Where the relevant section of the Corporations Act refers to Court with a small "c", that court means any Court.⁹²
- 8.2.3 If a matter is decided in the Supreme Court of a particular State or Territory, the time limit for any appeal would be governed by the rules of that particular Court. For example, in New South Wales a party has 28 days after the date of a Supreme Court decision to file a Notice of Appeal, subject to leave requirements, unless the Court of Appeal orders otherwise.⁹³
- 8.2.4 In the Federal Court, a party has 21 days after the date on which the judgment was pronounced, or alternatively the date on which leave to appeal was granted, or such further time as the Court may allow, to file and serve a notice of appeal.⁹⁴
- 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.⁹⁵

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 period⁹⁶ apply to both foreign and domestic companies.⁹⁷
- 9.2 A "foreign company" (as defined in S 9) must not carry on business in Australia unless it is registered or has applied to be registered (S 601CD), but if a foreign company does carry on business in Australia, it is liable to be wound up by order of the Australian Courts (S 583).

⁹¹ See above, footnote 68.

⁹² Section 58AA(1) of the Corporations Act and see also the Corporations Rules. Please note that the use of the words "Court" and "court" in this response to questionnaire does not necessarily adopt this distinction.

⁹³ Rule 51.16 of the Uniform Civil Procedure Rules 2005.

⁹⁴ Rule 36.03 of the Federal Court Rules 2011.

⁹⁵ Section 206G of the Corporations Act.

⁹⁶ This encompasses all the provisions of the Corporations Act considered above, but may not necessarily include relevant provisions from other legislation.

⁹⁷ See definitions of "corporation" (S 57A), "company" and "foreign company" (S 9).

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 that may arise in connection with the issues raised in questions 1-9 above?

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.

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):⁹⁸

- (a) a liability owed to the company (which may arise due to breaches of other duties);
- (b) conduct resulting in a pecuniary penalty or compensatory order;⁹⁹
- (c) conduct not in good faith;
- (d) wilful breaches of duty in relation to the company; and
- (e) conduct involving improper use of position or information.¹⁰⁰

Indemnity or insurance covering any of the above items is void (S 199C).

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)).¹⁰¹ Directors may pay their own premiums to insure themselves against those liabilities against which the company is unable to insure.

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.

⁹⁸ Sections 199A and 199B of the Corporations Act.

⁹⁹ Such penalties and orders are provided for in sections 1317G and 1317H of the Corporations Act.

¹⁰⁰ Such conduct is prohibited by sections 182 and 183 of the Corporations Act.

¹⁰¹ See also s. 212(2)(c)(ii).

APPENDIX

Summary of Australian insolvency procedures and commercial issues

1. Summary of the insolvency regime in Australia

1.1 The insolvency regime in Australia is divided into:

- (a) Insolvency of natural persons – see Bankruptcy Act; and
- (b) Insolvency of corporations – see Corporations Act.

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

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

1.4 Summary of insolvency procedures for corporations

1.4.1 Voluntary administration

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

- (a) enter into a deed of company arrangement with the creditors of the company, which may allow the continued operation of the company and provide scope for considerable flexibility in allowing the company to restructure its affairs;
- (b) be wound up (also known as “liquidation”); or
- (c) return control of the company to the directors (this is rare).

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

1.4.2 Liquidation of the company

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

1.4.3 Receivership

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

1.5 Insolvency Law Reform Act 2016 (Cth)

- (a) The *Insolvency Law Reform Act 2016* (Cth) (ILRA) was assented to on 29 February 2016 and Parts 1 and 2 of the Insolvency Practice Schedule (IPS) which are primarily concerned with registration and disciplinary matters, and Schedule 3 of the ILRA which relates to matters such as payments for property and the contravention and termination of a Deed of Company Arrangement commenced on 1 March 2017. Part 3 of the IPS, which relates to general and procedural rules regarding external administrations and bankruptcies is expected to commence September 2017.¹⁰²
- (b) The ILRA makes a number of changes to the Bankruptcy Act and the Corporations Act, which are designed to streamline personal and corporate insolvency law through the imposition of a common set of rules for the conduct of insolvency administrations. The aim of the ILRA is to improve efficiency and increase confidence in the insolvency profession.
- (c) The ILRA will be supplemented with the Insolvency Practice Rules (Corporations) 2016 and Insolvency Practice Rules (Bankruptcy) 2016 (“IPRs”), however, at the time of publication, the Bankruptcy IPRs have not yet been released.¹⁰³

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 funding 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 funding 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.

¹⁰² The Hon. Kelly O'Dwyer MP: Media Release, “Insolvency Law Reform Act”, dated 23 August 2016 and available at <http://kmo.ministers.treasury.gov.au/media-release/076-2016/>

¹⁰³ Australian Restructuring Insolvency & Turnaround Association media release dated 19 December 2016 (accessible at [http://www.arita.com.au/news-item/2016/12/19/final-insolvency-practice-rules-\(and-related-regulations\)-released](http://www.arita.com.au/news-item/2016/12/19/final-insolvency-practice-rules-(and-related-regulations)-released))

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.

The information provided in this country chapter is correct as at 01/03/2017

BAHAMAS

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Overview

1.1.1 The term ‘director’ although frequently used in the Bahamian Companies (Winding Up Amendment) Act, 2011 (CWAA), is not specifically defined in the legislation¹. A director for all purposes is a person who has been appointed pursuant to the provisions of the Articles of Association. However, the lack of a definition of ‘director’ in the CWAA and the context in which the word is used in the legislation, particularly with regard to acts performed in the twilight period or in an insolvency context, may invite a submission that ‘director’ includes what is known as a *de facto* director or a person who has been invalidly appointed as a director and has assumed the responsibilities of a director.²

1.1.2 A ‘shadow director’ is included in the definition of ‘officer’ in the CWAA in relation to the following: obligations to submit the company’s statement of affairs,³ defrauding creditors⁴, fraud in anticipation of winding up,⁵ misconduct in the course of winding up,⁶ material omissions from the statement of affairs,⁷ and insolvent trading.⁸ Unlike the term ‘director’, ‘shadow director’ is defined in the CWAA. In relation to a company, it refers to any person in accordance with whose directions or instructions the directors of the company are accustomed to act. However, the person is not deemed to be a shadow director by reason only that the directors act on advice given by him in a professional capacity.

1.1.3 Between the date when a company becomes insolvent and formal insolvency proceedings are commenced (namely, the twilight period), transactions entered into by the directors or others managing the company may be vulnerable to attack or may give rise to personal liability on the part of the directors or others managing the company.

1.1.4 A company is insolvent when either of two situations arise:

(a) when the company is unable to pay its debts as they fall due; or

(b) when the value of the company’s liabilities exceeds its assets.

1.1.5 In a situation where a company is solvent, directors usually owe their duties to the company. However, in circumstances where the company is insolvent, they owe their duties to the creditors of the company.

1.2 Periods of vulnerability for Bahamian law clawbacks

1.2.1 Prior to the formal commencement of insolvency,⁹ transactions may be vulnerable to clawbacks during the following periods:

¹ The CWAA, the Companies Act 1992 (as amended) and the International Business Companies Act 2000 (as amended) (IBCA).

² Per Lord Collins in *HMRC v Holland* [2010] 1 WLR 2793. Authorities such as *Re Lo-Line Electric Motors Limited* [1988] Ch 477 may add to the argument also, as it established the meaning of ‘director’ depended on the context in which it was found in legislation. See also *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180.

³ Section 196, CWAA.

⁴ Section 229, CWAA.

⁵ Section 228, CWAA.

⁶ Section 230, CWAA.

⁷ Section 231, CWAA.

⁸ Section 244, CWAA.

⁹ There are other acts of misconduct or fraud for which a director or officer can bear criminal responsibility which are beyond the twilight period, that is, after a winding up order is made. Amongst these are transactions in fraud of creditors (s. 229, CWAA) and misconduct in the course of winding up (s. 230, CWAA).

- (a) For voidable preferences, 6 months (S 241, CWAA);
- (b) For fraud in anticipation of winding up, 12 months (S 228, CWAA);
- (c) For dispositions at an undervalue, 2 years (S 242, CWAA);
- (d) For fraudulent trading, no time limit (S 243, CWAA); and
- (e) For insolvent trading, no time limit (S 244, CWAA).¹⁰

QUESTION 2

2. Actions potentially giving rise to liability for directors

- (a) In respect of which acts during the twilight period may a director be held personally liable or which may otherwise have adverse consequences for the director?
- (b) In relation to each act identified in (a) above:
 - (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?
 - (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 trading¹¹

- (a) Insolvent trading applies to directors who at any time before the commencement of the winding up of the company knew or ought to have known that there was no reasonable prospect that the company would avoid being wound up by reason of insolvency.
- (b) (i) Liability is civil.
 - (ii) The Court has a wide discretion to order the person concerned to make such contribution, if any, to the company's assets as it deems proper.
 - (iii) Where more than one director is involved, the Court has a wide discretion to order any person concerned to make such contribution, if any, to the company's assets as it deems proper.
 - (iv) There is no specified period.

¹⁰ This wrongdoing is marked by the time at which a person who, at any time before the winding up commences, is or has been a director of the company, knew or ought to have concluded that there was no reasonable prospect that the company would avoid being wound up by reason of insolvency and he was a director of the company at the time.

¹¹ Section 244 of CWAA.

- (v) The Court will not make an order against any person if it is satisfied that after he first knew, or ought to have concluded, that there was no reasonable prospect that the company would avoid being wound up by reason of insolvency he took every reasonable step open to him to minimise the loss to the company's creditors.

2.2 Fraudulent trading¹²

- (a) Fraudulent trading applies to directors who at any time before the commencement of the winding up carried out business with the intent to defraud creditors of the company or creditors of any other company or for any fraudulent purpose.
- (b) (i) Liability is civil.
- (ii) The Court has a wide discretion to order the person concerned to make such contribution, if any, to the company's assets as it deems proper.
- (iii) Where more than one director is involved the Court has a wide discretion to order any person concerned to make such contribution, if any, to the company's assets as it deems proper.
- (iv) There is no specified period.
- (v) The director may state that he honestly relied on information that he thought was true and correct from persons with appropriate expertise in the fields concerned. Further, a director may, in appropriate circumstances, argue that the board delegated its powers to appropriately qualified persons to carry out the functions.

2.3 Fraud in anticipation of winding up¹³

- (a) Personal liability will attach to a director who has:
 - (i) concealed any part of the company's property to the value of Bahamian dollars (B\$)10,000 or more or concealed any debt due to or from the company;
 - (ii) removed any part of the company's property to the value of B\$10,000 or more;
 - (iii) concealed, destroyed, mutilated or falsified any documents affecting or relating to the company's property or affairs;
 - (iv) made any false entry in any documents affecting or relating to the company's property or affairs;
 - (v) parted with, altered or made any omission in any document affecting or relating to the company's property or affairs; or
 - (vi) pawned, pledged or disposed of any property of the company which has been obtained on credit and has not been paid for (unless the pawning, pledging or disposal was in the ordinary course of the company's business).
- (b) (i) Liability is criminal.
- (ii) A director found guilty of this offence is liable on summary conviction to a fine of B\$20,000 or to imprisonment for five years or both.
- (iii) The amount of the fine or length of time of imprisonment or both will depend on the circumstances of the case.

¹² Section 243 of CWAA.

¹³ Section 228 of CWAA.

(iv) The acts in question must have occurred after the commencement of the winding up or in the 12 months immediately prior thereto.

(v) That the directors had no intent to defraud or conceal is a defence.

2.4 Transactions in fraud on creditors¹⁴

(a) A director will be liable if he or she 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 has concealed or removed any part of the company's property with the intent to defraud the company's creditors or contributories.

(b) (i) Liability is criminal.

(ii) A director guilty of this offence is liable on summary conviction to a fine of B\$20,000 or to imprisonment for five years or both.

(iii) No intention to defraud is a defence.

2.5 Misconduct in the course of winding up¹⁵

(a) A director will commit an offence if he:

(a) does not to the best of his knowledge and belief fully and truly disclose to the liquidator:

(i) all the company's property (except such part as has been disposed of in the ordinary course of the company's business);

(ii) the date on which and manner in which the company's property or any part thereof was disposed of;

(iii) the persons to whom any property was transferred; or

(iv) the consideration paid for any property that was disposed of.

(b) does not deliver up to the liquidator or does not deliver up in accordance with the directions of the liquidator any of the company's property which 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 does not deliver up, in accordance with the directions of the liquidator, all documents in his custody or under his control which belong to the company and which he is required by law to deliver up;

(d) knows or believes that a false debt has been proved by any person in the winding up and fails to inform the liquidator of such knowledge or belief as soon as practicable;

(e) prevents the production of any document affecting or relating to the company's property or affairs; or

(f) 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.

(b) (i) Liability is criminal.

(ii) That the directors had no intent to defraud or to conceal the state of affairs of the company or to defeat the law is a defence.

¹⁴ Section 229 of CWAA.

¹⁵ Section 230 of CWAA.

2.6 Material omission from statement relating to company's affairs¹⁶

- (a) A director of the company commits an offence when he makes any material omission in any statement relating to the company's affairs, with intent to defraud the company's creditors or contributories.
- (b) (i) Liability is criminal.
- (ii) This offence applies to statements made when a company is being wound up.
- (iii) No intent to defraud the company's creditors or contributories is a defence.

2.7 Fiduciary duties owed to a company

- (a) Every director and officer of a company in exercising his powers and discharging his duties has a duty to act - (a) act honestly and in good faith with a view to the best interests of the company; and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.¹⁷ A director also owes numerous common law duties to a company.
- (b) (i) Liability is civil.
- (ii) Liability for all loss to the company occasioned by the breach of duty is subject to the usual rules of causation and remoteness.
- (iii) Liability for breach of fiduciary duty is joint and several subject to any allocation of contribution the Court may make.
- (iv) A claim should be brought within six years of any breach or from when the breach was or could have been reasonably discovered.

The Court may decline to find against the director wholly or in part if it is found that the director acted honestly and according to the standards expected of a reasonably competent director in the circumstances.

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

¹⁶ Section 231 of CWAA.

¹⁷ See Section 81 of CA.

3.1 Other persons who may become liable for actions performed during the twilight period

3.1.1 There are numerous persons other than directors who may become liable in relation to their actions performed in management of the company's affairs during the twilight period. It is recognised by Bahamian law that directors are not the only persons who are involved in managing the company's affairs during this period of vulnerability and as such are not the only persons who may bear legal responsibility for performing prohibited actions.

3.1.2 Officers of the company including 'shadow directors'¹⁸ are persons who fall into the category of those who may be liable for actions performed during the twilight period. In addition, managers and professional service providers may also be liable. According to the CWAA, a professional service provider is a person who contracts to provide general managerial or administrative services to a company on an annual or continuing basis.¹⁹ Additionally, voluntary liquidators or receivers of the company may be liable for certain acts committed during the twilight period.

Another category of persons which may be liable to repay property of the company are third parties who received such property as a result of a disposition at an undervalue. A lack of bad faith will provide some protection to the transferee of such property. A third party could also be liable to repay the company's property or pay compensation for the dissipation of the same where he has knowingly received the company's property as a result of fraud or has dishonestly assisted with its transfer.

3.2 Acts for which others may be held liable

3.2.1 In relation to fraud in anticipation of winding up, an officer, professional service provider, voluntary liquidator or receiver of a company who committed a prohibited act during the relevant period preceding the commencement of the winding up may be held liable by the Court. Specifically, such persons may be liable for:

- (a) concealing or removing any part of the company's property up to the value of B\$10,000 or concealing any debt due to or from the company within 12 months preceding the start of the winding up;
- (b) hiding, destroying, mutilating or falsifying documents relating to the company's property or affairs;
- (c) making false entries in any document relating to the company's property or affairs;
- (d) parting with, altering or making any omission in any document affecting or relating to the company's property or affairs; or
- (e) pawning, pledging or disposing of any property of the company that has been obtained on credit and has not been paid for (unless the pawning, pledging or disposal was in the ordinary way of the company's business).

In order to be properly constituted for the purposes of a prosecution, any of the foregoing acts that comprise fraud in anticipation of winding up must have been performed by the person with intent to defraud the company's creditors or contributories. These persons, other than directors²⁰ (for a director's liability in relation to fraud in anticipation of winding up see 2.3 above), if found guilty of fraud in anticipation of winding up, shall be liable on summary conviction to a fine of B\$20,000 or to imprisonment for five years or to both.

3.2.2 In relation to fraudulent trading,²¹ any person who carries on the company's business with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose may be liable.

¹⁸ This term is defined in 1.1.2 above.

¹⁹ Section 183, CWAA.

²⁰ 'Directors' for these purposes are not 'officers' who are defined to include shadow directors.

²¹ Section 243, CWAA.

- 3.2.3 Insolvent trading is aimed at the actions of directors who, before the commencement of the winding up of the company, knew or ought to have concluded that there were no reasonable prospects that the company would avoid being wound up by reason of the insolvency. These provisions do not expressly state that this wrongful act applies to others, but this may be implied from a reference at the end of the provision that states that in the section, officer means also a shadow director.²²
- 3.2.4 In relation to transactions in fraud of creditors, an officer or professional service provider may be liable upon conviction to a fine of B\$20,000 or to imprisonment for five years or to both. This offence is committed when an officer or professional service provider 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 has concealed or removed any part of the company's property with intent to defraud the company's creditors or contributories. The wrongful act is committed in the context of the passing of a resolution for a voluntary winding up or making of a winding up order by the Court.
- 3.2.5 There is also a recognized offence for misconduct during the course of winding up. Although this may take place after the twilight period, once a winding up order is made, questionable actions performed between the date of the filing of the petition or passing of the resolution for a voluntary liquidation and the date of the issuance of the Court order to wind up the company will be amongst those that are scrutinized. This offence is directed at directors, officers and professional service providers of the company and may attract a similar fine of B\$20,000 or imprisonment for two years or both.
- 3.2.6 In relation to dispositions at an undervalue, the provisions of S 242, CWAA, apply equally to directors as to any other persons who make an offending disposition. All such persons and any bad faith transferee of the company's property may have the property disgorged and sent back to the company at the behest of the liquidator.
- 3.3 Personal liability for company's losses**
- 3.3.1 For fraudulent trading (addressed in 3.2.3 above) any person who commits such an act may be liable to make such contribution to the company's assets as the Court considers proper.
- 3.3.2 For insolvent trading, directors may be liable to make such contribution, if any, to the company's assets as the Court considers proper.

²² Section 244, CWAA).

3.4 Summary

Persons other than directors may be liable for the following acts of wrongdoing:

Wrongful act	Persons liable	Extent of liability
Fraud in anticipation of winding up (S 288, CWAA)	Any officer, professional service provider, voluntary liquidator or receiver who performs the prohibited act.	B\$20,000 fine on summary conviction and/or five years' imprisonment. (Directors not named in S 228).
Fraudulent trading (S 243, CWAA)	Any person who carries on the business of the company with intent to defraud its creditors or creditors of any other person, or for any fraudulent purpose.	Same as for director.
Insolvent trading (S 244, CWAA)	Officer including shadow director referred to at end of S 244, CWAA.	Same as for director.
Transactions in fraud of creditors (S 229, CWAA)	Any officer including shadow director and professional service provider who commits the wrongful act.	B\$20,000 fine on summary conviction and/or five years' imprisonment. (Directors not named in S 229).
Misconduct during the course of winding up (S 230, CWAA)	Any officer including shadow director or professional service provider who commits the offence.	Same as for director.
Dispositions at an undervalue (S 242, CWAA)	Any person who makes a disposition at an undervalue which offends S 242 and any third party who (in bad faith) is a transferee of such property.	Same as for director.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company’s affairs properly incur further credit during the twilight period?

4.1 Summary of heads of challenge

4.1.1 The potential heads of challenge which may lead to a transaction being set aside relate to transactions which:

- (a) are at an undervalue;
- (b) are preferences;
- (c) are in breach of a director’s fiduciary duties;

4.2 Transactions at undervalue²³

4.2.1 Every disposition of property made at an undervalue by or on behalf of a company with intent to defraud its creditors shall be voidable at the instance of the official liquidator. Undervalue is defined as:

- (a) the provision of no consideration for the disposition; or
- (b) a consideration for the disposition the value of which in money or money’s worth is significantly less than the value of the property which is the subject of the disposition.

Defences

- 4.2.2 The Court will not make an order under this provision if there was no intention to wilfully defeat an obligation owed to a creditor.²⁴
- 4.2.3 The Court will not make an order under this provision if the date of the relevant disposition is more than two years old.²⁵ This two-year period is measured from the date of the relevant disposition to the commencement of an action or proceedings by the liquidator against the alleged wrongdoer.
- 4.2.4 The Court will also not make an order that will prejudice certain purchasers who have acted in good faith.²⁶

4.3 Voidable preference²⁷

4.3.1 Every conveyance or transfer of property, or charge thereon, and every payment obligation and judicial proceeding, made, incurred, taken or suffered by any company in favour of any creditor at a time when the company is unable to pay its debts (as defined) with a view to giving such creditor a preference over the other creditors shall be invalid if made, incurred, taken or suffered within six months immediately preceding the commencement of a liquidation.

²³ Section 242 of CWAA.

²⁴ Section 242 of CWAA.

²⁵ Section 242 (4) of CWAA.

²⁶ Section 242 (5) of CWAA.

²⁷ Section 241 of CWAA.

Defences

- 4.3.2 The Court will not make an order that a transaction constitutes a voidable preference if the preference given was not made with the intention of giving the receiving creditor a preference. This is a question of fact.

4.4 Breach of fiduciary duties

- 4.4.1 If a director causes a company to enter into a transaction that is detrimental to the company, knowing it to be detrimental, or being recklessly indifferent, such transaction could be in breach of his duties owed to the company and the director could be liable to compensate the company for any loss. Moreover, if the contracting party is put on notice of any irregularity it may be liable to restore the company's property or pay damages. This is not an insolvency specific issue but applies whether the company is insolvent or not.

4.5 Properly incurring further credit in the twilight period

- 4.5.1 In the Bahamas, in circumstances where twilight period transactions made by directors and others on behalf of the company are being scrutinized by a liquidator, a key issue that may arise is whether or not entering into further credit transactions was justifiable or alternatively could be classified as insolvent trading under S 244 of the CWAA.

The provision provides some protection for directors and others whose actions are being examined in this context. Such protection applies in circumstances where the Court is satisfied that after the director or other person first knew, or ought to have known, that there was no reasonable prospect that the company would avoid being wound up by reason of insolvency, such person took every step reasonably open to him to minimise the loss to the company's creditors. At times, such steps may include obtaining further credit, e.g. to protect a valuable asset for the creditors which would have lost value or would have been lost entirely without some quick action and borrowing on the part of the directors or others managing the company.

In assessing the reasonableness of the actions of a director and/or other person in this regard, a standard is defined in the Bahamian legislation. A person ought to know facts, reach conclusions and take steps that a reasonably diligent person would have known, reached or taken. The reasonably diligent person has:

- (a) general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company; and
- (b) the general knowledge, skill and experience of that particular director.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Actions brought against directors and other persons

- 5.1.1 The liquidator by S 197 is empowered to investigate if the company has failed, the causes of the failure, and generally, the promotion, business, dealings and affairs of the company. In doing so, the liquidator may discover such wrongdoing as must be reported to the company's creditors and contributories.²⁸ The findings upon investigation may also warrant that liquidator bringing proceedings to recover compensation for loss and damage for the benefit of the creditors. In appropriate circumstances, the liquidator may also be obliged to lodge criminal complaints against persons whose actions both in and outside of the twilight period warrant prosecution.

²⁸ Section 205(1)(a).

- 5.1.2 Fraud in anticipation of winding up, transactions in fraud of creditors and misconduct in the course of winding up are criminal offences. As such, they will involve a prosecution. The liquidator has the power to bring or defend any action or other legal proceedings in the name and on behalf of the company. He can therefore bring a complaint insofar as criminal acts must be prosecuted or bring civil proceedings insofar as civil redress must be had in order to get in or protect the assets of the company for the benefit of the creditors. There is scope in relation to misconduct in the course of winding up for the liquidator to make a complaint which gives rise to a charge on information,²⁹ or alternatively, on summary conviction.³⁰
- 5.1.3 Likewise, for fraudulent trading and insolvent trading which will attract the civil remedies of personal liability of wrongdoers to repay funds to the company or to make a contribution to its assets, the liquidator may bring an action against those responsible for the wrong.
- 5.1.4 In relation to bringing an action for avoidance of a disposition made at an undervalue, there is specific provision in the CWAA to the effect that the liquidator may bring this action and that it shall not be brought more than two years after the date of the relevant disposition.

²⁹ A formal criminal charge which leads to a prosecution in the criminal courts.

³⁰ Summary convictions relate to minor offences.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Wrongful act	Remedy
Fraudulent trading	The Court may require the director to make such contribution to the company's assets as the Court considers proper.
Insolvent trading	The Court may compel the director to make such contribution to the company's assets as the Court considers proper.
Fraud in anticipation of winding up	If prosecuted, the director is liable on summary conviction to a fine of B\$20,000 or to imprisonment for five years or to both.
Transaction in fraud of creditors	If prosecuted, the director is liable on summary conviction to a fine of B\$20,000 or to imprisonment for five years or to both.
Misconduct in winding up	If prosecuted, the director is liable on conviction on information to a fine of B\$50,000 or to imprisonment for five years or both or on summary conviction to a fine of B\$20,000 or to imprisonment for two years or to both.
Material omission from statement relating to the company's affairs	If prosecuted, the director is liable on summary conviction to a fine of B\$20,000 or to imprisonment for two years or to both.
Fiduciary duties	The director may be ordered to compensate the company for all loss and damage caused by breach of his 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	The Court may order disqualification for a period not exceeding five years under the Companies Act (CA). There is no financial penalty.
Transactions at undervalue and preferences	The Court may make an order setting aside the transaction so as to restore the company to the position it would have been in had it not entered into the transaction. However, if the transferee has not acted in bad faith the Court may make provision to protect its rights.

QUESTION 7

7. Duty to co-operate

- (a) **To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

7.1 Obligation to co-operate

- 7.1.1 In the Bahamas, the key provisions of the CWAA which give the liquidator enforceable investigatory powers are those governing his ability to require directors to lodge the company’s statement of affairs,³¹ to implement investigations,³² and to require the co-operation of relevant persons and their private examination, if necessary.³³
- 7.1.2 In relation to the company’s statement of affairs, the liquidator may require directors, officers, prior liquidators, professional service providers, or employees of the company who have been employed for a period of one year immediately preceding the commencement of the winding up or appointment of a provisional liquidator, where applicable, to prepare and submit to him a statement concerning the affairs of the company. Such statement may include particulars of the company’s assets and liabilities, names and addresses of persons who have the company’s assets, what assets are held by those persons, names and addresses of the creditors and the securities held by them, dates when the securities were given and any further information required. Persons who have been asked to produce a statement by the liquidator must comply with such request within 21 days after being notified of the request. Release of the obligation to comply and extensions of time may be granted by the liquidator. However, if any person who is obligated to comply, without reasonable excuse, fails to co-operate, he shall be liable to a civil penalty.³⁴
- 7.1.3 As stated above, a liquidator may investigate causes of failure of a company and generally look into its affairs. The liquidator can also:
- (a) assist a relevant regulator and the Royal Bahamas Police Force to investigate the conduct of directors, officers, liquidators, professional service providers and employees; and
- (b) assist the Attorney-General relative to the instituting and conduct of a criminal prosecution of any offence in relation to the company committed by any of the persons referred to in 7.1.3(a).
- 7.1.4 A somewhat unusual provision in the Bahamian CWAA is the ability of the liquidator to use the assets of the company to fund all or part of the costs of an investigation and prosecution under this section.³⁵ To do so in a situation where the company is insolvent, the Bahamian liquidator must obtain the approval of the company’s creditors. In the event that the company is solvent, the liquidator must obtain the consent of the contributories to utilize this funding mechanism.

³¹ Section 196, CWAA.

³² Section 197, CWAA.

³³ Section 198, CWAA.

³⁴ Such civil penalty is not specified in the relevant provision Section 196(7), CWAA.

³⁵ Section 197(3), CWAA.

- 7.1.5 The liquidator may compel, by Court order, the co-operation and private examination of anyone who has made or agreed with the statement of affairs, including any director or officer (including shadow director), any professional service provider, a receiver, advisor or liquidator of the company or its property or any person who has taken part in the promotion or management of the company. The liquidator may also apply for any of such persons to deliver up to him any property or documents belonging or connected to the company. The liquidator may also seize such documents or property from such persons until the Court makes an order. A creditor or contributory of the company may participate in the oral examination of the relevant person to be privately examined. The Court has the power to compel a person's examination whether he is resident in the Bahamas or not. The Court may also issue a letter of request for the purpose of seeking the assistance of a foreign Court in obtaining the evidence of a relevant person resident outside the jurisdiction.
- 7.1.6 An examined person may decline to answers to investigatory or examination questions on grounds of avoiding self-incrimination or legal professional privilege. Otherwise, an examinee must answer all questions put to him or her, which are within their knowledge or means of knowledge regarding any matter within the scope of the order. The examinee may be compelled to give the names and addresses of all persons who might reasonably be expected to have knowledge or means of knowledge regarding any matter with in the scope of the order.³⁶

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation periods

8.1.1 Limitation period for criminal proceedings

No limitation period applies to the criminal proceedings identified above.

8.1.2 Limitation period for civil proceedings.

In relation to liabilities arising under the CWAA, the limitation period is six years from the date on which the cause of action accrued. Further, this six-year period applies to a director's common law duties.

In relation to a claim for breach of a director's fiduciary duty, the limitation period is six years from when the cause of action accrued. No limitation period applies in the case of a fraudulent breach of trust. In the case of fraud or concealment, the limitation period does not start to run until the plaintiff discovered it or could with reasonable diligence have discovered it.

8.2 Appeals

8.2.1 The Supreme Court exercises jurisdiction over most matters in relation to directors. An appeal from a judge of the Supreme Court is heard by the Court of Appeal. Interlocutory rulings require leave from either the Supreme Court or if refused, the Court of Appeal. An appeal from the Court of Appeal lies to the Privy Council in London. Parties may appeal to the Privy Council as of right from a final decision when the subject matter of the dispute is worth more than B\$4,000. If the value of the subject-matter is less, or the ruling is interlocutory, leave may be obtained from the Court of Appeal or the Privy Council only when the matter is of general public importance or for some other reason ought to be submitted to the Privy Council for directions.

³⁶ Order 7, r. 3(11), Companies Liquidation Rules, 2012.

QUESTION 9

9. Foreign corporations

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

- 9.1** The Court, by the provisions of the CWAA, has assumed the jurisdiction to make winding up orders in respect of existing companies, those registered under the CA and the IBCA, and in relation to foreign companies.
- 9.1.1 The conditions that must be satisfied if the Court is to assume the jurisdiction to make a winding up order in relation to a foreign company are:
- (a) the company incorporated under the law of another jurisdiction or foreign company must have property located in the Bahamas;
 - (b) the company must be carrying business in the Bahamas; or
 - (c) the company must be a registered company under Part VI of the CA.

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 that may arise in connection with the issues raised in Questions 1-9 above?

Directors' and officers' (D&O) liability insurance is available in the Bahamas. S 59 of the IBCA and 117 of the CA specifically permits a company to purchase and maintain insurance for directors.

D&O insurance will normally cover liability arising out of 'wrongful acts' and omissions. This generally includes claims for breach of contract, torts and breaches of statutory duties. Claims for breaches of fiduciary duties are covered in certain circumstances. However, claims brought by the company against a director are generally not covered under these policies.

D&O insurance will generally not cover claims involving fraud, dishonesty and criminal acts. Also, under the CA, a company is not obligated to indemnify a director against liability for breach of duties owed to the company.³⁷

The information provided in this country chapter is correct as at 15/02/2017

³⁷ Section 113.

BELGIUM

QUESTION 1

1. The directors and the start and duration of the “twilight” period

(a) How are directors identified / defined?

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

1.1 Start and duration of the twilight period

A director is appointed by the shareholders of the company or, under certain circumstances, co-opted by the existing board of directors. The role of a director is defined in the Belgian Companies Code, the Articles of Incorporation and in the implementing documents of the company. The relationship between the company and the individual director is a contractual agency agreement. In principle, a separate liability rule applies although established case law has confirmed that directors acting in concert can be held jointly liable. In a company limited by shares (“*naamloze vennootschap/ société anonyme*”) the board of directors is a collegial organ. The individual directors are not organs of the company. This means that a decision by the board can lead under certain circumstances provided by law to the joint liability of all directors, even those who did not agree. In a private limited company (“*besloten vennootschap met beperkte aansprakelijkheid/ société à responsabilité limitée*”) one director can commit the company even if a board has been constituted. The board of directors can appoint managing directors to handle the daily management of the company. The company law provisions on directors’ liability in the Companies Code are also applicable to members of the executive committee, and it is assumed by most scholars that the other grounds of directors’ liability can also be invoked, *mutatis mutandis*, against members of the executive committee, even though members of the executive committee are not necessarily directors.^{1 2}

Apart from individuals, a legal person is allowed to be a *de jure* director of a company, but has to appoint a permanent representative from its shareholders, directors, or employees: this representative is charged with performing the assignment in the name and on behalf of the legal person. This permanent representative is civilly and criminally liable as if he were performing the assignment in his own name and on his own behalf, notwithstanding the joint and several liability of the legal person. In other words, the permanent representative is liable as if he were a formally appointed director (Art. 61§ 2 Companies Code).

1.2 Identification and definition of directors

The twilight zone ends when the company enters into formal insolvency procedures. Under Belgian law the directors of the company have to file an insolvency declaration with the commercial court within one month of the company being in a state of “*cessation de paiements*”, *i.e.* being unable to pay debts (Art. 9 of the Bankruptcy Act of August 8, 1997, as amended (“the Bankruptcy Act”)³).

A company can be only declared insolvent when the following requirements are met cumulatively: (1) the company has a commercial objective, (2) the company has ceased to make payments on a permanent basis, and (3) is no longer able to obtain further credit. The judge has discretionary powers to decide whether these requirements have been met, taking into account the various circumstances and the fact that no further income can be expected (Art. 2 of the Bankruptcy Act).

The cessation of payment (a condition for declaring a company bankrupt) is deemed to occur on the date of the bankruptcy declaration or, if the objective circumstances unequivocally indicate that cessation of payment occurred earlier, an earlier date, can be established provided that this is not more than six months before the judgment (Art. 12 Bankruptcy Act).

¹ Article 527 of the Companies Code.

² Belgian report, Joris Latui and Eddy Wymeersch (Jan Ronse Instituut), p. 42- 43, in Study on Directors’ Duties and Liability, prepared for the European Commission DG Markt by: Carsten Gerner –Beuerle, Philipp Paech and Edmund Philipp Schuster, (Department of Law, London School of Economics), London, April 2013.

³ A new draft insolvency law has been prepared and reviewed by the (Conseil d’ Etat- Raad van State) but not available for public consultation. <http://www.presscenter.org/nl/pressrelease/20161223/modernisering-van-het-insolventierecht-van-ondernemingen>

One remark must be made with a reference to the so-called “alarm bell procedure” when the net assets of the company drop below half of the share capital of the company. In case the directors of the company fail to convene an extraordinary general shareholders’ meeting either proposing certain remediation measures or to go into liquidation, the directors can be held liable in the event that a creditor can prove that he suffered losses because of the neglect by the directors. In practice, very often companies continue to operate with this balance sheet insolvency for years; therefore, the actual liability under this specific clause goes way beyond the six months provided in article 12 of the Bankruptcy Act.

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 the director?
- (b) In relation to each act identified in (a) above:
 - (i) Is the director’s liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or 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 Actions potentially giving rise to liability for directors

The general directors’ liability rules continue to apply in the twilight zone in addition to the liability for continuing an obviously bankrupt enterprise. The relation between these two liabilities is not always clear, although it is likely that the latter will be used to hold a director liable in the event that the company ceased to pay its debts more than six months prior to the date when the Court declared a company bankrupt. In the UNAC case,⁴ it was held that, where it is clear that the company will only accumulate additional losses without a serious chance of recovery, this is both a fault in the exercise of a director’s management (Art. 527 Companies Code) and a breach of his general duty of care owed to any affected party and to the company’s creditors in particular (Art. 1382 Civil Code). In certain circumstances, although not automatically, this will be an obvious serious fault contributing to the bankruptcy, if the company is eventually declared bankrupt (Art. 530 Companies Code). Additionally, when a director enters into a transaction, while this was no longer reasonably justifiable in the light of the impending bankruptcy, he commits a pre-contractual fault for which he will be liable (Art.1382 Civil Code).⁵

In Belgium there is also a specific procedure referred to as the “alarm bell procedure”, whereby the directors incur a liability if they fail to convene an extraordinary general meeting when as a result of the losses incurred, the net assets of the company have dropped below half of the company’s share capital. During that meeting the shareholders will either need to liquidate the company or take other measures e.g. increase the share capital (Art. 332, 333, 633 and 634 of the Companies Code). Such a meeting must be convened no later than two months after the losses are

⁴ Commercial Court of Charleroi, 12 October 1976, [1976], *Revue Pratique des Sociétés*, 143.

⁵ Belgian report, Joris Latui and Eddy Wymeersch (Jan Ronse Instituut), p. 60 - 61, in *Study on Directors’ Duties and Liability*, prepared for the European Commission DG Markt by : Carsten Gerner –Beuerle, Philipp Paech and Edmund Philipp Schuster, (Department of Law, London School of Economics), London, April 2013.

established unless the company's articles of incorporation provide for stricter terms. The directors have to provide a special report to the shareholders 15 days prior to the extraordinary general shareholders' meeting.

2.2 Liability for insolvency trading

- (i) Articles 530 § 1, 265, 2° and 409, 2° of the Companies Code create a special liability regime for directors (and *de facto* directors) of a bankrupt company. An exception exists for medium size companies with an average turnover during the last three years of 620,000 euro and a balance sheet of less than 370,000 euro. The liability is in principle civil but can under specific laws become criminal e.g. abuse of company's goods (Art.492 bis Criminal Code).

This claim can only be brought if, on the one hand, bankruptcy has been declared; and, on the other hand, the assets of the bankrupt company have proven insufficient to meet all the liabilities. Article 530 Companies Code, contrary to general law, allows individual creditors to sue for their proportionate share in the collective loss on bankruptcy. While under general law even the slightest fault constitutes a fault for liability purposes, article 530 § 1 Companies Code requires an obviously serious fault, which has been defined as "inexcusable recklessness verging on fraud". "Obviously" in this context implies that "every reasonable man" must deem the fault serious. Under the law of September 4, 2002 amending the Bankruptcy Act 1997, an obviously serious fault will be irrefutably presumed in cases of "serious and organized tax fraud", giving the tax authorities a special right of action against the directors. For the purpose of Art 530 Companies Code, it is sufficient for a serious fault to have contributed to the loss. In addition, the judge can allocate the loss at his discretion. The judge is also free to decide whether to hold directors who committed a serious fault jointly and severally liable. The only limit to his discretion is that the directors cannot be liable for an amount in excess of the insufficiency of the assets (in respect of the debts). Article 530 § 2 Companies Code contains additional rules in favour of the Belgian Social Security Service ('BSSS'), if upon bankruptcy, social security contributions and related claims remain unpaid. In these circumstances, the directors who committed a serious fault that is at the root of the bankruptcy may be held jointly and severally liable as a result of a claim by the BSSS or the trustee in bankruptcy.⁶

- (ii) The late declaration of the bankruptcy or continuing an obviously insolvent enterprise does not in itself constitute a breach of the Companies Code and or the articles of incorporation, therefore there will be no joint and several liability on that basis alone. However, the Courts can impose joint and several liability or in solidum liability for common and concurrent managerial errors respectively; something which the Courts are likely to do since all directors are deemed to be aware of the financial situation of the company. Also, it is possible that there will be accompanying breaches which violate the Companies Code or the articles of association and could thus trigger the joint and several liability of article 528 of the Companies Code, for example failing to file the annual accounts (Art. 92 Companies Code) or failing to call the extraordinary general meeting within two months after it ought to have been established that the company's net assets have fallen below half of the company's registered capital (Art. 332, 333, 633 and 634 of the Companies Code).
- (iii) A director who is not in agreement with a policy decision should inform his co-directors and have his opposition recorded in the minutes of the board meeting. If the director has reasonable grounds for absence from a meeting at which a wrongful decision was taken, he will not be liable but should consult the meeting minutes and have his opposition minuted at the subsequent board meeting. He can also explain this dissenting opinion in a registered mail to bolster his defence. The director can also subsequently resign if he feels that the course of action taken by the board of directors is inappropriate. However, he should avoid his resignation being considered as 'desertion', i.e. by not bringing the disputed matters to the attention of a general shareholders' meeting. In addition, such a resignation is only enforceable vis-à-vis third parties from the moment the board acceptance of the resignation is published in the Belgian Official Gazette.

⁶ Belgian report, Joris Latui and Eddy Wymeersch (Jan Ronse Instituut), p. 53 - 55 , in Study on Directors' Duties and Liability, prepared for the European Commission DG Markt by: Carsten Gerner – Beuerle, Philipp Paech and Edmund Philipp Schuster, (Department of Law, London School of Economics), London, April 2013.

- (iv) In addition, it must be noted that on the basis of his mandate (Art. 2000 of the Belgian Civil Code) a director can hold the company liable for all damages that he suffered in the course of his mandate as company director, where these damages are not the result of his own negligence.

QUESTION 3

3. Other persons involved with the company's affairs, who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

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

The person responsible for the daily management of the company does not necessarily have to be a director (Art. 525 Companies Code), i.e. officer of the company and member of the board. Such a daily manager does not have a director's role in the company, and his liability will therefore be contractual only and like that of a director, unless the law expressly provides the contrary. For liability purposes, daily managers are only mentioned in article 527 Companies Code, which prescribes a director's liability to the company for errors committed in the exercise of management based on general law. The liability in their capacity as daily managers will be regulated by the legal regime applicable to their appointment, for example employment law if the daily manager is an employee.⁷

The *de facto* and shadow directors exercising the role of director expose themselves to the same liability as their formally appointed counterparts. This applies to both to the civil and criminal liability. In the light of this, it's surprising that the Companies Code fails to define the term *de facto* director. Only article 530 of the Companies Code explicitly refers to *de facto* director, if that person performs positive, independent acts of management. Controversy remains as to whether merely influencing a director, as opposed to actually performing the act of management suffices to qualify someone as a *de facto* director, but mere advice or suggestions seem insufficient.

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

As mentioned under point 3 (a) the *de facto* directors are only mentioned in article 530 of the Companies Code concerning serious fault contributing to bankruptcy and in article 492 *bis* Criminal Code regarding abuse of company goods, so their liability is mostly based on general law principles. Depending on the contractual relationship with the company, the general law principles on which to base a claim in liability will be confined to tort law (Art. 1382 Civil Code).⁸ Qualification as a *de facto* director implies interference with the management of the company without a legal or contractual basis. In summary, where a breach of a general duty of care (Art.1382 Civil Code) or when article 530 Companies Code or 492 *bis* Criminal Code applies, *de facto* directors can be held liable. As regards other directors' liabilities under the Companies Code and articles of incorporation

⁷ Belgian report, Joris Latui and Eddy Wymeersch (Jan Ronse Instituut), p. 44, in Study on Directors' Duties and Liability, prepared for the European Commission DG Markt by: Carsten Gerner –Beuerle, Philipp Paech and Edmund Philipp Schuster, (Department of Law, London School of Economics), London, April 2013.

⁸ Matthias Vandenbogaerde, Aansprakelijkheid van vennootschapsbestuurders, Antwerpen, Intersentia, 2009 p.13, n° 16.

(Art. 527 up to Art. 529 Civil Code), it remains doubtful whether they also apply to *de facto* directors. This has been contested by scholars and case law has not yet been able to decide on this matter.⁹

3.3 Limitation of liability

De facto and shadow directors exercising the role of director expose themselves to the same liability as their formally appointed counterparts. This applies to both to the civil and criminal liability. See point 2.2 (ii).

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Basis for setting aside transactions

All transactions entered into with a company in financial difficulties prior to the initiation of any insolvency proceeding remain, in principle, valid during such a subsequent insolvency procedure. Belgian bankruptcy law specifically provides that certain transactions entered into with a bankrupt company during the so-called hardening period may be declared unenforceable vis à vis the bankrupt estate. The actions entered into during the hardening period, which may be declared unenforceable vis-à-vis the bankrupt estate are as follows:

- (i) Transactions without consideration or at extremely beneficial terms;
- (ii) Payment other than in money of debts due or payments of debts that are not due; and
- (iii) Security interests provided for debts existing prior to the granting of security.

All other payment of outstanding debts and all acts for valuable consideration that took place during the hardening period can be declared unenforceable by the Commercial Court if the beneficiary knew of the suspension of payment.

Moreover, acts or payments at any time made by the debtor with the intention to cause damage to creditors are unenforceable. Transactions within the scope of the abuse of companies' assets would fall within this ambit of the law.

4.2 Available defenses

As mentioned under 4.1, good faith transactions at arm's length by a contracting party, who was not aware that the debtor has stopped making payments, are more difficult to challenge or reverse.

4.3 Credit during the twilight period

During the twilight period, only the availability of additional collateral and third party guarantees will allow companies to obtain further credit. In on-going finance transactions these measures can be very effective: for example, under cash pooling arrangements where the credit provider literally takes over the cash management of the company.

⁹ Belgian report, Joris Latui and Eddy Wymeersch (Jan Ronse Instituut), p. 48, in Study on Directors' Duties and Liability, prepared for the European Commission DG Markt by: Carsten Gerner – Beuerle, Philipp Paech and Edmund Philipp Schuster, (Department of Law, London School of Economics), London, April 2013.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 The following parties are entitled to bring actions against directors:

- (i) Shareholders and third party creditors on the basis of tort (Art. 1382 of the Belgian Civil Code) or an infringement of the Articles of incorporation or the Companies Code (Art.517 to Art.529 of the Belgian Companies Code).

A minority group of shareholders with 10% of voting rights can sue on the basis of mismanagement or breach of duty.

- (iii) Employees (for example in a case of collective dismissal) - on the basis of tort and breach of the Articles of Association or the Companies Code, specific employment and social security laws.

Belgian law provides for specific information and consultation with the employee representatives in the case of important events that may impact the employment. On the other hand, in case of collective dismissal, the employers must inform the employee representatives (works council, unions, or if these bodies do not exist, the employees) in writing beforehand. The various stages of the procedure must be followed. Explicit penalties are provided for non-compliance. The employees may have to be re-hired or receive additional compensation if the dismissal procedure is not strictly complied with. There are various criminal sanctions, which will apply if certain of the provisions relating to notification of information and consultation are breached. A term of imprisonment of between 8 days and 1 month and / or a fine between EUR 143 x 5,5 and EUR 2,750 x 5,5 per employee with a maximum of EUR 275,000 x 5,5 may be imposed.

- (iii) Third parties ('external liability') - If the company is in breach of contract, the third party will have no recourse to the director personally by claiming he has a contractual relationship with him.¹⁰ This is nothing more than a logical application of the "organ theory" described above. Furthermore, the private law doctrine of "quasi-immunity for execution agents," which has been held to be applicable to directors, prevents a contracting party from claiming against a director who commits a tort in the course of the execution of a contract, unless certain stringent conditions apply. These imply that the breach of contract is also a breach of the general duty of care; and, secondly, this breach caused harm that is distinct from the harm caused by the wrongful execution of the contract. These conditions are unlikely to be fulfilled unless the director's tortious conduct also constitutes a criminal offence. The doctrine of quasi-immunity, as it has recently been confirmed by the Supreme Court, will not shield a director from a pre-contractual liability claim arising out of the negotiations leading to a contract (*culpa in contrahendo*) because these claims, by definition, do not arise during the execution of a contract and are to be brought under the principles of general tort law.

With respect to tort based claims i.e. the claimant has to prove the fault, the damages and the causal link between the fault and the damages. Claiming that one had a contractual relationship with the director (Art. 1382 Civil Code) will be the most likely course of action for a third party. Liability in tort can be established for breaches of the general duty of care (Art. 1382 Civil Cod),¹¹ which includes statutory breaches, no matter how light the breach is. This is tempered by the fact that breaches of the general duty of care are assessed in a similar way to breaches of obligations of means, namely whether a reasonable and careful director, placed in the same circumstances, would have done the same. According to the "organ theory" outlined above, any wrongful act committed by a director acting within his authority will be attributed to the company. However, the reverse – that a director is personally liable to third parties for wrongful acts

¹⁰ Matthias Vandenbogaerde, Aansprakelijkheid van vennootschapsbestuurders, Antwerpen, Intersentia, 2009 p.24, n° 29-30.

¹¹ Article 1382 Belgian Civil Code: "...any human act causing a loss to someone else obliges the person who is to blame for the loss to provide compensation".

committed by the company – is not necessarily true. For a director's personal liability to be engaged, an *individual* fault is required. For example, breaches of statutory obligations by the company will not automatically lead to the personal liability of the director, if that statutory obligation is addressed to the company, as opposed to the director. To that effect, the Supreme Court has held that a director will only be liable for a late declaration of bankruptcy, which is a statutory obligation of the company, if it is proven that he is to blame for failing to make such a declaration; such proof is not adduced by the mere fact that there was a failure to declare cessation of payment within the legally allowed period after the bankrupt company ceased to pay. The claimant will have to prove that the individual director knew or ought to have known that a declaration had to be filed. However, since a director is responsible for supervising the company's financial situation, such knowledge will be easily imputed. It could be that a fault in the exercise of a director's management simultaneously breaches the general duty of care (Art. 1382 Civil Code), in which case there is a co-existence of liability.

- (iv) By the government - the managing director of a company in distress may be summoned to appear in Court when the company is put under the monitoring supervision of a commercial judge in the "Chambre de dépistage – depistage kamer". This may be triggered by liability for unpaid social security debts or a contested letter of exchange, seizures; or Court orders etc. The commercial Courts in every judicial district systematically gather data concerning traders facing financial difficulties. On the basis of the gathered information, special divisions within the commercial Court may start inquiries. In case of a company, the managing director will be heard by the Court on the company's financial difficulties and will be able to defend himself, assisted by his consultant (lawyer or accountant). The benefit is that companies are encouraged to take precautionary measures in time.

To avoid the risk that a company in distress would take steps to the detriment of its creditors and if there are serious, precise and concordant indications that the bankruptcy conditions might be fulfilled, the president of the commercial Court may deprive the managing director of its management powers and appoint a provisional administrator.¹²

- (v) By the company itself through an administrator, trustee or equivalent on the basis of infringement of the articles 527 to 529 Companies Code. See 5 (i) above.

In general, an unwritten code exists between office holders to close liquidation proceedings as quickly as possible and therefore avoid proceedings regarding directors' liability. Often the rule of thumb is not to throw good money after bad money. Insolvency office holders also do not want to expose their own liability in case their action in Court does not succeed and they may be found liable by the creditors for using the assets of the company to pursue such proceedings.¹³

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Any party who has suffered losses because of the above can file a claim in damages against the directors and officers of a company as well as the *de facto* directors on the basis provided above under Questions 2, 3 and 4 above.

The Company Code also contains a number of provisions that attach criminal penalties to breaches of the Companies Code, in addition to the civil liability rule in article 528 of the Companies Code.

¹² Article 8 of the Bankruptcy Act.

¹³ Matthias Vandenbogaerde, Aansprakelijkheid van vennootschapsbestuurders, Antwerpen, Intersentia, 2009 p.2, n° 3.

Furthermore, the Bankruptcy Act 1997 inserted article 492*bis* into the Criminal Code, which sets out criminal penalties for “abuse of company assets” by *de jure* and *de facto* directors. As an additional punishment, the Court may strip a person committing this offence of his right to become a director (Art.1 of the Royal Decree n° 22 of 24 October 1934).

Directors may also be disqualified pursuant to Art.3 *bis* § 2 of the Royal Decree n° 22 of 24 October 1934. The judge declaring the bankruptcy may disqualify a *de jure* or *de facto* director as a safety measure in the event that the director contributed to the bankruptcy as a result of his obvious serious fault (Art.530 Companies Code), which would prevent him from performing any future trading activity. Additionally, the Court may deprive such a person of the right to take up a position as director or officer of a company (Art. 3 *bis* § 3 of the Royal Decree n° 2 of 24 October 1934). Such a ban will not last for more than ten years (Art. 3*bis* § 4 of the Royal Decree n° 2 of 24 October 1934).

Article 489 and following of the Criminal Code provides for offences that consist of the conclusion of engagements without sufficient counterparts or which are too important compared with the financial situation of the company; and breach by the bankrupt company of its obligation to cooperate with the insolvency office holder. Article 489 *bis* of the Criminal Code provides that such offences consist of (i) the specific intent to postpone the bankruptcy, buying of goods and selling these under the market price, or borrowing under ruinously expensive conditions, in order to generate cash; (ii) the fact of having expenses or losses or not having justified the existence or the utilization of the assets as they appear from the accounts of the company; (iii) with the specific intent to delay the bankruptcy, the favouring of one creditor to the prejudice of the others; (iv) not filing for bankruptcy when the conditions are met. Article 498 *bis* of the Criminal Code provides that offences consist of (i) misappropriation or concealment of assets; (ii) concealment of all or parts of accountancy documents. Article 490 *bis* of the Criminal Code relates to fraudulent organization of insolvency. Any debtor, trader or not, who fraudulently organized his insolvency may be convicted of this offence. The offence consists of fraudulently organizing one’s insolvency and refusing to execute one’s obligations.

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?
- (b) Is this obligation modified by any rules in relation to the defense against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Extent to which directors and other persons are obliged to co-operate with the investigating officer holders

There exists a legal obligation to co-operate with the insolvency office-holder, failure of which is criminally sanctioned.

Pursuant to article 10 of the Bankruptcy Act, when filing for bankruptcy, the debtor or the directors of the company or delegated supervisory board member must provide preliminary information regarding the state of the company’s affairs including: (i) the annual accounts, (ii) the accounting books, (iii) the employee register and social security numbers, (iv) a list of customers and suppliers, and (v) a list of guarantors. The payroll office has an obligation to provide certain information, for example, the social security numbers, to the insolvency office-holder without cost if the debtor fails to do so.

The insolvency office holder shall, after accepting his position, with all necessary and appropriate means, accept responsibility for safeguarding the insolvency estate (Art. 40 *et seq.*, of the Bankruptcy Act). The insolvency office-holder is, pursuant to article 43 of the Bankruptcy Act, allowed to appoint whomever he believes suitable to assist him with listing and valuing the assets

of the debtor. Very often in reality, an insolvency office-holder appoints a person of trust within the company of the debtor to assist him with obtaining such information.

7.2 Applicable human rights laws

In addition to article 6 ECHR regarding the right to a fair trial, article 3 ECHR on the prohibition of torture and article 8 ECHR on the right of privacy apply. In this context the question also arises as to whether the insolvency-office holder has access to the digital records about the insolvent entity on the private laptop of a director. Regarding illegal acts during a search, reference must be made to the jurisprudence of the Belgian *Cour de Cassation*, which commenced with the Antigone decision of October 14, 2003, which was the subject of a decision by the ECHR. The so-called Antigone jurisprudence has to do with the admissibility of illegally obtained evidence. The *Cour de Cassation* has, since 2003, held that it is up to the judge to decide the admissibility of illegally obtained evidence that is not expressly excluded by statute, in the light of article 6 ECHR taking into account all facts of the case, including the means used to obtain the evidence and the circumstances surrounding the illegal act. The criteria i.e. whether the authority in charge of the investigation intentionally committed the illicit act, the extent to which the gravity of the illicit act eclipses that of the underlying offence, and whether the evidence illicitly obtained concerns only one of the material elements of the offence – must all be taken into consideration.¹⁴

In its decision of July 28, 2009, the European Court repeated that it does not, in principle, decide on the admissibility of certain categories of evidence, such as evidence obtained illegally according to national law. The Court held that, in order to determine if the procedure in its entirety was fair, the Court must ask itself if the rights of defence were respected and it must specifically look into whether the accused was given the possibility to challenge the authenticity of the evidence and to oppose its use. The European Court held that, in the case in question, the evidence gathered in violation of domestic law was not in violation of any article of the convention. It was clear that the national law violated in the case in question, did not coincide with article 8 ECHR or any other article dealing with certain rights considered to be among the most fundamental of the Convention. The Court noted that before the Belgian Court of appeals, the judges engaged in a thorough examination of the configuration of the premises in order to rule on the question of whether there was or was not a trespass. The ECHR concluded: *“In this case, the circumstances in which the impugned evidence was obtained shed no doubt whatsoever on its reliability or accuracy. Furthermore, the applicant had an opportunity to challenge the evidence at three levels of jurisdiction and to object to its use and to the resulted findings, in conformity with the jurisprudence cited by the Court. Thus, the Court finds the merits of the criminal charges against the applicant were examined fairly, in keeping the requirements of Article 6 (1) and there has been no violation of that provision of the convention.”*¹⁵

QUESTION 8

8. Appeals and limitation periods

- (a) What limitation period, if any, applies to the actions referred to above?
- (b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation periods

The directors of a company are free to resign at any moment, for example in the event they do not agree with a decision of the board of directors. As against the company, resignation, termination by the company or expiration of the mandate will have immediate effect, irrespective of the date of publication of the resignation. The director will remain accountable to the company for acts or omissions that occurred during his mandate, even if the loss occurs after the end of this mandate.

¹⁴ Marie-Aude Beernaert and Philip Traest, 'From Categorical Nullities to a Judicially Created Balancing Test', in Stephen C. Thaman, *Exclusionary Rules in Comparative Law*, Springer Science Business Media, Dordrecht, 2013, p.169 – 171.

¹⁵ Marie-Aude Beernaert and Philip Traest, 'From Categorical Nullities to a Judicially Created Balancing Test', *idem*, p.170.

A director's resignation or termination by the company is only effective against third parties as of the publication in the annex of the Belgian Official Gazette (Article 76 of the Companies Code).

The Court of Appeal of Brussels has held that until the replacement of a director, a director has the duty to declare bankruptcy if the conditions therefore are satisfied.¹⁶ The requirement of publication will not be necessary in the event of the expiration of the mandate, provided the duration of the director's mandate is expressed in the founding documents of the company or in the published instrument of appointment. In this case, opposability to third parties has effect without additional formalities.

As regards internal liability, the general meeting decides each year, by ordinary resolution, whether to acquit the directors. Such acquittal constitutes a waiver of the general meeting's right to bring proceedings for the liability on behalf of the company. This acquittal is only valid when the annual accounts contain no omissions or errors. This acquittal does not affect the directors' liability to third parties and individual shareholders on the basis of tort.

Any claim against a director will be statute-barred if it is made after the limitation period of five years after the act took place or, if it has been intentionally hidden, five years after it was discovered (Art. 198, § 1, 4th indent Companies Code).¹⁷ Criminal claims are normally statute-barred after three years. Special rules exist for continuing criminal infringements.

8.2 Appeals

The Court of first instance has jurisdiction in all disputes that are not assigned by law to other courts. Thus the Court of first instance has residual jurisdiction. A commercial Court deals with disputes between traders concerning sums of more than 1860 euro but also with very specific issues such as bankruptcies or proceedings between shareholders of a company. Pursuant to article 574, 1^o of the Judicial Code in so far as the dispute relates to an issue falling within the scope of the Companies Code, the Commercial Court remains competent to handle issues regarding directors' liability, even outside the scope of an insolvency procedure. An opposition procedure is possible against a judgement by default. An appeal procedure is open to most decisions of the first instance Court. There are five Courts of appeal in Belgium (Brussels, Liege, Mons, Ghent and Antwerp). In general, the appeal needs to be filed within a period of one month following notification of the judgment (by Court bailiff) to the opposing party, failing which the appeal becomes statute-barred. An appeal to the Court the Cassation maybe lodged in last instance on the points of law only. The case is pleaded by special lawyers admitted to the Court de Cassation.

QUESTION 9

9. Foreign corporations

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

In principle, the liability of directors in respect of breaches of Company Code or the articles of association is governed by the law applicable to the company or the *lex societatis* (Art. 111, 9^o Belgian Private International Law Code of 2004 ("PILC")). The *lex societatis* is the law of the state where the company's principle establishment is situated, unless the foreign law refers to the law of the state pursuant to which the company was formed (Art. 110 PILC). The Belgian legislator has retained this real seat doctrine after the ECJ's case law involving freedom of establishment in order to ward off potential abuses. Belgium is thus formally still a "real seat" state. In practice, however, Courts will have to take the European case law into account imbedded in the recast of the European Insolvency Regulation.¹⁸ This means that they cannot oblige foreign (European)

¹⁶ Court of Appeal of Brussels, 24 February 2000, [200] Recueil annuel de jurisprudence en droit des sociétés commerciales, 191.

¹⁷ Belgian report, Joris Latui and Eddy Wymeersch (Jan Ronse Instituut), p. 59 - 60, in Study on Directors' Duties and Liability, prepared for the European Commission DG Markt by: Carsten Gerner –Beuerle, Philipp Paech and Edmund Philipp Schuster, (Department of Law, London School of Economics), London, April 2013.

¹⁸ Regulation (EU) 2015/848 of the European Parliament and of the Council of May 20, 2015 on insolvency proceedings.

companies to adhere to Belgian company law once they are validly formed in another Member State. In this respect, no case law has been reported yet.¹⁹

Given that both the Rome I and Rome II regulations²⁰ exclude liabilities arising in companies from their respective scope of application, the *lex societatis* governs managerial errors and breaches of the Companies Code and articles of association, including liability towards third parties (Art. 527 to Art 528 Companies Code).²¹

The principle of the *lex societatis* does not apply to breaches of the general duty of care (Art.1382 Civil Code), which are governed by the *lex loci delicti*. In addition, according to the Insolvency regulation,²² insolvencies are regulated by the law of the Member State where the bankrupt entity has its centre of main interest (*lex concursus*). Hence, it has been argued that liability for obviously serious errors contributing to the state of the bankruptcy pursuant to article 530 Companies Code is governed by the *lex concursus*.²³

The answer to the question which law is applicable for the late declaration of the bankruptcy or for unreasonable continuation of an obviously insolvent company (wrongful trading) is problematic. It seems that the majority of the scholars is inclined towards the *lex concursus*. In practise, this means that the liability of a director for wrongful trading in respect of an English limited company with its centre of main interest in Belgium will be assessed according to the Belgian rules, instead of the English Insolvency Act.²⁴

QUESTION 10

10. Insurance

Is directors' and officers' (D&O) 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?

Pursuant to article 8 of the Law on Non-marine Insurance Agreements, a director can be insured against third party and contractual liability, even for serious errors or criminal acts. Only serious errors expressly listed in the agreement are not insured.

The cover is often written on a "claims made" basis. That is to say it is triggered by a claim made against a D&O (past or present) during the policy period. As D&O liability insurance is only statute-barred after five years (Art.198 Companies Code) it is advisable to provide for tail insurance coverage in the contract up to five years after the term as director.

The policy in general covers the D&O against a claim for a "Wrongful Act" meaning any actual or alleged breach of duty, breach of trust, neglect, error, misstatement, misleading statement, omission, breach of warranty of authority or other act by the director, officer or employee of the company or any other matter claimed against them solely because of their status as a D&O, employee of the company.

¹⁹ Belgian report, Joris Latui and Eddy Wymeersch (Jan Ronse Instituut), p. 66, in Study on Directors' Duties and Liability, prepared for the European Commission DG Markt by: Carsten Gerner –Beuerle, Philipp Paech and Edmund Philipp Schuster, (Department of Law, London School of Economics), London, April 2013.

²⁰ Art.1.2.d) of the Regulation (EC) n° 864/2007 of the European Parliament and of the council of 11 July 2007 on the law applicable to non-contractual obligations and Art.1.2.f) of the regulation (EC) n° 593/2008 of the European Parliament and of the council of 17 June 2008 on the law applicable to contractual obligations.

²¹ Idem Belgian report, Joris Latui and Eddy Wymeersch (Jan Ronse Instituut), p.66.

²² Council Regulation (EC) n° 1346/2000 of 29 May 2000 on insolvency proceedings.

²³ Idem Belgian report, Joris Latui and Eddy Wymeersch (Jan Ronse instituut), p.66.

²⁴ Idem Belgian report, Joris Latui and Eddy Wymeersch, (Jan Ronse Instituut), p.66.

The cover does not apply if the claim is based upon or attributable to:

- the gaining in fact of any personal profit or advantage to which the insured was not legally entitled; or
- the commitment in fact of any dishonest or fraudulent act.

These exclusions only apply if it is established through a judgment or any admission by an insured that the relevant conduct did in fact occur.

A claim on the policy can be made either by the D&O(s) personally or by the company, only if the company has indemnified the relevant director for the loss.

Subject to the terms and conditions of the policy, the insurer has to advance to the insured (or the company) defence costs before the final dispositions of the claim. These have to be repaid in the event and to the extent that the insured (or the company) shall not be entitled to them under the terms and conditions of the policies.

The insured has the right and duty to defend and contest the claim although the insurers have the right to “associate” with the defence. Insurers’ consent to any judgment or settlement is required, not to be unreasonably withheld.

As D&O liability is often incurred cross-border and therefore subject to a variety of duties under different national legislative frameworks, a cross-border insurance contract will be needed. Not all national insurance companies provide for such cross-border insurance coverage but international insurers provide such coverage.

The information provided in this country chapter is correct as at 24/02/2017

BERMUDA

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Directors

A director includes any person duly elected or appointed as a director of a company, an alternative director and any person occupying the position of director by whatever name called.¹

1.2 The twilight period

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

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

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

The “twilight period” generally ends when a formal insolvency procedure commences.²

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

- (i) preferences (e.g. security, charges) - six months;³
- (ii) voidable floating charges - 12 months;⁴
- (iii) transactions at an undervalue (e.g. guarantees) - up to eight years;⁵ and
- (iv) dispositions after winding up petition - from date of petition.⁶

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

¹ Section 2 Companies Act 1981.

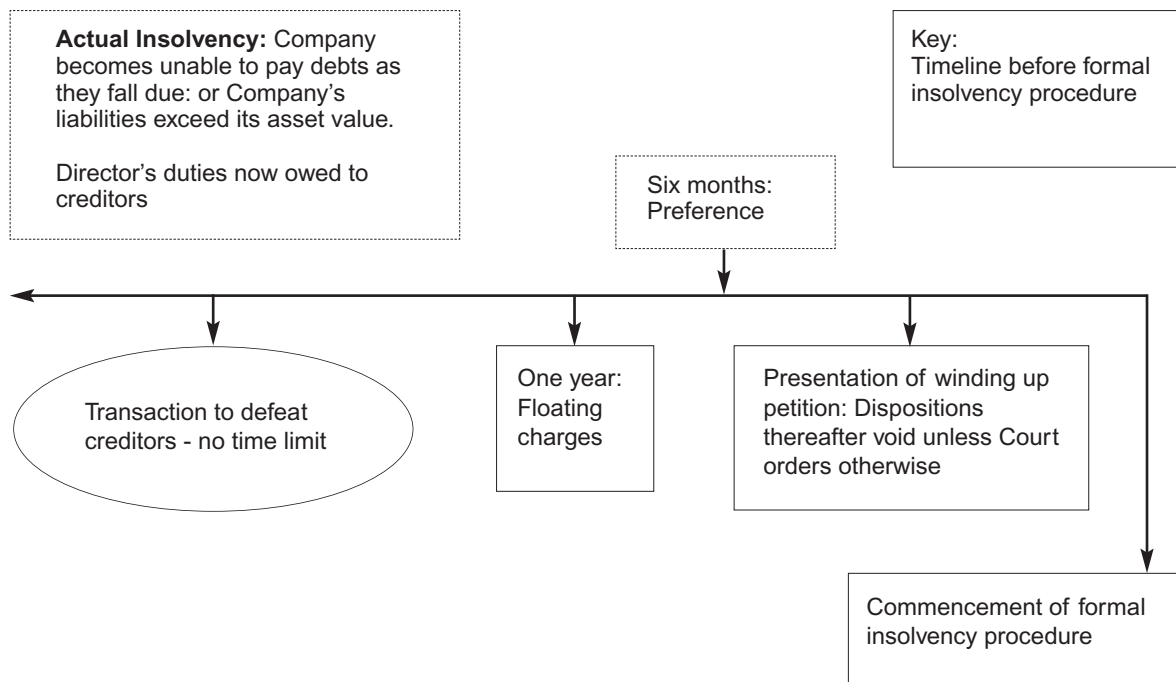
² This will generally be the date on which the winding up petition was issued upon which the Court ultimately made an order that the company enter the insolvency procedure involved or, in the case of a voluntary procedure, the date on which a resolution was passed by the company to pursue that voluntary procedure.

³ Section 237 Companies Act 1981.

⁴ Section 239 Companies Act 1981.

⁵ Sections 36A and 36C Conveyancing Act 1983.

⁶ Section 166 Companies Act 1981.



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

QUESTION 2

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 the director?
- (b) In relation to each act identified in (a) above:-
 - (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement?
 - (iv) Is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director? and
 - (v) What defences, if any, will be available in relation to each offence?

2.1 Fraudulent trading⁷

- (a) This applies where a company is being wound up and it is shown that the business of the company has “been carried on with intent to defraud creditors of the company or the creditors of any other person or for any fraudulent purpose”. The elements of the concept are therefore, as follows:
- (i) there has to be an insolvent liquidation in progress;
 - (ii) there has to have been dishonesty in the running of the business as that is the meaning of defrauding creditors or carrying on a business for a fraudulent purpose;
 - (iii) as dishonesty is involved, a high standard of proof is required to establish civil liability; and
 - (iv) it applies to persons who are “knowingly parties” to the fraudulent trading.
- (b) In respect of fraudulent trading:
- (i) Liability may be criminal or civil.
 - (ii) The Court enjoys a wide discretion to compensate for the loss caused to the company by the director’s conduct. The section provides that a person found liable shall be personally responsible, without any limitation of liability, for all or any of the debts or other liability of the company as the Court may direct.
 - (iii) There is no specified period.
 - (vi) The main defence is that the party concerned was not dishonest. In practice, the party may be able to admit to incompetence, imprudence or even folly as long as he honestly believed that, for example, any new credit incurred would ultimately be repaid in full. It is worth noting that it is rare for persons to be found liable for fraudulent trading.

2.2 Fraud by officers of companies which have gone into liquidation⁸

- (a) This will apply to any officer of the company, past or present, who:
- (i) has by false pretence or by means of any other fraud induced any person to give credit to the company;
 - (ii) with intent to defraud creditors of the company, has made or caused to be made any transfer of or charge on, or has caused or connived at the levying of any execution against, the property of the company; or
 - (iii) with intent to defraud creditors of the company, has concealed or removed any part of the property of the company since, or within two months before, the date of any unsatisfied judgment or order for payment of money obtained against the company,
- where the company is subsequently ordered to be wound up by the Court or subsequently passes a resolution for voluntary winding up.
- (b) If any of (a)(i) - (a)(iii) above are satisfied:
- (i) Liability is criminal.
 - (ii) A person guilty of this offence is liable to imprisonment.
 - (iii) The gravity of the wrongdoing will be reflected in the length of imprisonment. In exercising its punitive jurisdiction under this section, the Court is not seeking to compensate the company.

⁷ Section 246 Companies Act 1981.

⁸ Section 245 Companies Act 1981.

2.3 Offences by officers of companies in liquidation⁹

- (a) If an officer, past or present, of a company that is being wound up (whether by the Court or voluntarily) or is subsequently ordered to be wound up by the Court or subsequently passes a resolution for the winding up:
- (i) does not to the best of his knowledge and belief fully and truly disclose to the liquidator all the property, real and personal, of the company, and how and to whom and for what consideration and when the company disposed of any part thereof, except such part as has been disposed of in the ordinary way of the business of the company; or
 - (ii) does not deliver up to the liquidator, or as he directs, all such part of the real and personal property of the company as is in his custody or under his control, and which he is required by law to deliver up; or
 - (iii) does not deliver up to the liquidator, or as he directs, all books and papers in his custody or under his control belonging to the company and which he is required by law to deliver up;
 - (iv) within twelve months next before the commencement of the winding up or at any time thereafter conceals any part of the property of the company to the value of BMS\$300 or upwards, or conceals any debt due to or from the company; or
 - (v) within twelve months next before the commencement of the winding up or at any time thereafter fraudulently removes any part of the property of the company to the value of BMS\$50 or upwards; or
 - (vi) makes any material omission in any statement relating to the affairs of the company; or
 - (vii) knowing or believing that a false debt has been proved by any person under winding up, fails for the period of a month to inform the liquidator thereof; or
 - (viii) after the commencement of the winding up prevents the production of any book or paper affecting or relating to the property or affairs of the company; or
 - (ix) within twelve months next before the commencement of the winding up or at any time thereafter, conceals, destroys, mutilates or falsifies, or is privy to the concealment, destruction, mutilation or falsification of, any book or paper affecting or relating to the property or affairs of the company; or
 - (x) within twelve months next before the commencement of the winding up or at any time thereafter makes or is privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company; or
 - (xi) within 12 months next before the commencement of the winding up or at any time thereafter fraudulently parts with, alters or makes any omission in, or is privy to the fraudulent parting with, altering or making any omission in, any document affecting or relating to the property or affairs of the company; or
 - (xii) after the commencement of the winding up or at any meeting of the creditors of the company within 12 months next before the commencement of the winding up attempts to account for any part of the property of the company by fictitious losses or expenses; or
 - (xiii) has within 12 months next before the commencement of the winding up or at any time thereafter, by any false representation or other fraud, obtained any property for or on behalf of the company on credit for which the company does not subsequently pay for; or

⁹ Section 243(1) Companies Act 1981.

- (xiv) within 12 months next before the winding up or any time thereafter, under false pretence that the company is carrying on its business, obtains on credit, for or on behalf of the company, any property which the company does not subsequently pay for; or
 - (xv) within 12 months next before the commencement of the winding up or at any time thereafter pawns, pledges or disposes of any property of the company which has been obtained on credit and has not been paid for, unless such pawning, pledging, or disposing is in the ordinary way of the business of the company; or
 - (xvi) is guilty of any false representation or other fraud for the purpose of obtaining the consent of the creditors of the company or any of them to an agreement with reference to the affairs of the company or to the winding up, he shall, in the case of the offences mentioned respectively in paragraphs (m), (n) and (o), of this subsection, be liable on indictment to imprisonment for a term of five years, or on summary conviction to imprisonment for a term of 12 months, and in the case of any other offence.
- (b) In respect of offences by officers of companies in liquidation:
- (i) Liability is criminal.
 - (ii) Where any person pawns, pledges or disposes of any property in circumstances which amount to an offence under subsection (o) above, every person who takes in pawn or pledge or otherwise receives the property knowing it to be pawned, pledged or disposed of in such circumstances as aforesaid shall be liable to be punished in the same way as if he had committed the offence under subsection (o).
 - (iii) For the purpose of this section “officer” shall include any person in accordance with whose directions or instructions the directors of a company have been accustomed to act.
 - (iv) The following defences exist:
 - (A) in relation to subsections (a) – (d), (f), (m) – (o): the accused proves that he had no intent to defraud;
 - (B) in relation to subsections (h) – (j): the accused proves that he had no intent to conceal the state of affairs of the company or to defeat the law.

2.4 Falsification of company books¹⁰

- (a) This involves an officer or contributory of any company being wound up, who destroys, mutilates, alters or falsifies any books, papers or securities, or maker 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) In such circumstances, such officer or contributory is liable on conviction on indictment to imprisonment for a period of five years.

2.5 General Fiduciary duties

- (a) The common law as to general fiduciary duties has been codified in broad general terms under section 97(1)(a) of the Companies Act 1981 (Companies Act), which provides that “every officer of the company in exercising his powers and discharging his duties shall act honestly and in good faith with a view to the best interest of the company.” However, this provision does not replace the common law as to directors’ fiduciary duties.

Bermudian and English common law authorities are considered by the Bermuda Court when dealing with cases involving directors’ fiduciary duties.

¹⁰ Section 244 Companies Act 1981.

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

- (i) the duty to act *bona fide* in the interests of the company;
- (ii) the duty to act for proper purposes;
- (iii) the duties as trustee of company property which is in the hands or control of the directors;
- (iv) the duty to avoid conflict of interest and duty;
- (v) the duty to disclose interest in contacts at general law; and
- (vi) the duty to not make secret profits.

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

(b) In such circumstances:

- (i) Liability for breach of these duties is civil and 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.
- (ii) An officer may be jointly and severally liable only if it is established that "he knowingly engaged in fraud or dishonesty."¹¹ In cases where fraud or dishonesty is not proved against the officer, but he is found liable, the Court will determine the proportionate liability of each defendant and each of the other persons alleged to have caused or contributed to the plaintiff's loss.¹²
- (iii) The officer shall only be liable for his proportionate share of liability. He shall not be liable to the plaintiff for any judgment entered against other parties or to other parties for judgments entered against them.¹³
- (iv) Subject to the statutory limitation considerations there is no time limit within which action may be taken against a director.
- (v) Section 97(5A) of the Companies Act provides that an officer shall not be liable for a breach of his fiduciary duty under section 91(1)(b) of the Companies Act if he relied in good faith upon:
 - (a) financial statements of the company presented to him by another officer of the company; or
 - (b) a report of an attorney, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him.

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

¹¹ Section 98B(2) Companies Act 1981.

¹² Section 98B(3) Companies Act 1981.

¹³ Sections 98B(4) and (5) Companies Act 1981.

Additionally, 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.¹⁴

2.6 Duties of skill and care

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

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

- (b) In such circumstance:
 - (i) Liability for breach of these duties is civil. Subject to paragraph (iii) below, the Court will award damages to compensate the company for loss that has been suffered as a result of the director’s breach of duty.¹⁵
 - (ii) Paragraph 2.5(b)(ii)-(v) above are applicable.

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

- (a) 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 2.6(a) to “a reasonably prudent person in comparable circumstances” does allow the Court to take into account such matters as, for example, the fact that a non-executive director’s functions are discharged on a part-time basis.¹⁶

In the absence of an employment contract the non-executive director will clearly not owe any contractual duties of care to the company. It is accepted that the non-executive director may rely on his co-directors to carry out various tasks and functions. This does not, however, abrogate his responsibility to inform himself about the company’s affairs and to join with his co-directors in supervising and controlling them. The non-executive director 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.

- (b) Section 97(5A) of the Companies Act provides that an officer shall not be liable for a breach of duty of skill and care under section 97(1)(a) of the Companies Act if he relies in good faith upon:
 - (i) financial statements of the company represented to him by another officer of the company; or
 - (ii) a report of an attorney, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him.

¹⁴ Section 281 Companies Act 1981.

¹⁵ In *West Mercia Safetyest v Dodd* [1988] BCLC 250 the Court of Appeal upheld a judgment ordering a misfeasant director to repay the value of a transfer by way of fraudulent preference. In this case, the Court effectively provided a “clawback” to recover the value of the amount wrongfully transferred.

¹⁶ *Focus Insurance Company Limited v Hardy et al Focus Insurance Company Limited v Hardy and Others* 1992 Civil Appeal No.15 where the Bermuda Court of Appeal applied the test of directors’ duties of skill and care established in the English case *Re City Equitable Fire Insurance Company Limited* [1925] 1 Ch 407 in considering the standard of care imposed by Section 97(1)(a) of the Companies Act 1981.

2.8 Incurring further credit

- 2.8.1 The incurring of further credit may be the factual matrix for one of the grounds of liability discussed above, for example (and most probably) fraudulent trading. For further discussion, please see answer to question 4 below.

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 *De facto* directors

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

A *de facto* director is one who acts as a director and is treated as such by the rest of the board even though he may never have been formally appointed a director or there is a defect in the technicalities of his appointment (for example he was appointed at a meeting at which a quorum was not present).

As provided above, "director" is defined 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.

- (b) *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.

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

3.2 Liability of auditor or officer¹⁷

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

¹⁷ Section 98B Companies Act 1981.

- (b) An auditor or officer may be liable jointly and severally only if it is proved that he knowingly engaged in fraud or dishonesty.
- (c) In any case other than that contemplated by subsection (b) hereof, the liability of the auditor or officer, as the case may be, shall be determined as follows:
 - (i) the Court shall determine the percentage of responsibility of the plaintiff, of each of the defendants, and of each of the other persons alleged by the parties to have caused or contributed to the loss of the plaintiff. In considering the percentages of responsibility, the Court shall consider both the nature of the conduct of each person and the nature and extent of the causal relationship between the conduct and the loss claimed by the plaintiff;
 - (ii) the liability of the auditor or officer, as the case may be, shall be equal to the total loss suffered by the plaintiff multiplied by the auditor's or officer's, as the case may be, percentage of responsibility as determined under paragraph (i) hereof.

3.3 Other third parties who may be held liable

- 3.3.1 Liquidators may be found liable for misfeasance or breach of duty owed to the company.¹⁸
- 3.3.2 Third parties who receive property as a result of a preference or transaction at an undervalue will be liable to either return such property or provide such compensation as the Court may order. In addition, where a company is being wound up by the Court, any disposal of the company's property made without the Court's approval after the winding up order has been made will be void.
- 3.3.3 It is also possible for any third party who has dishonestly assisted in a breach of duty by a director or other officer of a company or knowingly received property arising from such breach to be liable in respect of any loss arising.¹⁹ The legal rules relating to knowing assistance and/or receipt of property are applicable in any circumstance and not only in respect of actions taken during the twilight period. The power of the Bermuda Court to apply these rules arises under its general equitable jurisdiction.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Transactions with the company that may be set aside in the twilight period

4.1.1 Transactions at an undervalue²⁰

A transaction at an undervalue is, within certain limits, a disposition of property (i) made with the dominant intention of putting property beyond the reach of a person (or class of persons) who has a claim or may at some time have a claim against the transferor; and (ii) without adequate consideration is voidable at the instance of certain eligible creditors.

¹⁸ Section 247 Companies Act 1981.

¹⁹ For example, a party to "fraudulent trading" (for explanation of this concept see paragraph 2.1 above).

²⁰ Section 36A Conveyancing Act 1993.

This rule is not limited to liquidation (and in fact a liquidator appears not to have standing in relation to this particular jurisdiction). Insolvency is not a prerequisite. A creditor will be an eligible creditor if it falls into one of the following categories: (a) person to whom on, or within two years after, the date of the transfer the transferor owed an obligation which obligation remains unsatisfied on the date of the action or proceeding; and (b) a person to whom, on the date the contingency has fallen in, with the liability remaining unsatisfied; or (c) a person to whom the transferor owed an obligation in consequence of a claim that he made against the transferor, where the cause of action giving rise to the claim occurred prior to, or within two years of, the transfer.²¹

4.1.2 Preferences²²

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

Section 237(1) of the Companies Act provides that “any conveyance, mortgage, delivery of goods, payment, execution or other act relating to property made or done by or against a company within six months before the commencement of its winding-up which, had it been made or done by or against an individual within the six months before the presentation of a bankruptcy petition on which he is adjudged bankrupt, would be deemed in his bankruptcy a fraudulent preference, shall in the event of the company being wound up be deemed a fraudulent preference of its creditors and be invalid accordingly.”

The four conditions under this section are as follows:

- (i) The company must have been unable to pay its debts as they became due at the time that the transfer is made.
- (ii) The transaction must have been in favour of a creditor or some person on trust for a creditor.
- (iii) There must have been an intention to prefer a creditor, or a surety or guarantor for the debt due to creditor, a preference over its other creditors.
- (iv) The disposition complained of must be made within six months of the commencement of the winding up.

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

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

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

4.1.3 Avoidance of floating charges for past value²³

- (a) This provision, which is in addition to the rules regarding 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.

²¹ See part IV A of the Conveyancing Act 1983.

²² Section 238 Companies Act 1981.

²³ Section 239 Companies Act 1981.

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

- (i) the company is in liquidation;
 - (ii) the floating charge was created within 12 months preceding the commencement of the liquidation;
 - (iii) the charge was given otherwise than for cash²⁴; and
 - (iv) the company was then unable to pay its debts or became unable to do so in consequence of the charge.
- (b) There are no specific statutory defences available but, as discussed above, the charge will not be invalid to the extent that cash value is provided.

4.1.4 Disclaimer of onerous property²⁵

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

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

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

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.

4.1.5 Dispositions of the company's property made after the commencement of winding-up²⁶

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.

Commencement of the winding up backdates to the date of presentation of the petition for compulsory winding-up if an order is ultimately made. Such a disposition is void 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.²⁷

4.1.6 Registration of charges

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

²⁴ The cash must be for the charge and it must go to the company itself or in the reduction of the company's indebtedness.

²⁵ Section 240 Companies Act 1981.

²⁶ Section 166 Companies Act 1981

²⁷ See also Rules 46 and 47 of the Companies (Winding-Up) Rules 1982.

4.2 Basis on which directors and other persons involved with the company’s affairs may properly incur further credit during the twilight period

4.2.1 Overview – Incurring further credit

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

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

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

4.2.2 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?

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

(a) Preferences

The law here is concerned with the clawback of payments and the overturning of security.

From the perspective of a creditor doing business with a company the position is likely to be that they should enter into a transaction to accept payment or the grant of security and wait and see what happens. There have been no successful claims of fraudulent preference in Bermuda since its introduction. A liquidator will show the intention of the company and except in exceptional circumstances the transactions are in the usual course of business and necessary to allow the company to continue its business.

(b) Transactions at an undervalue

It is only eligible creditors who can attack such a transaction. Insolvency of the company entering into the transaction is not a prerequisite to an offence being committed. A creditor could attempt to make inquiries into the circumstances of the transferor however there are strict protections for a transferee. The protections include, if a transaction is reversed, that the costs of the transferee may be reserved in full and the transferee has a security interest in the asset to the extent of the claim. The burden is on the eligible creditor to show that the transferee did not act in good faith.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Introduction

In the event of a company going into liquidation, the authority and powers of the directors are generally superseded following such an appointment and taken over by the liquidator. The liquidator is required to review the action taken by the directors and others during the twilight period and where relevant bring proceedings to obtain compensation for the benefit of creditors in respect of any loss caused to the company. Consequently, in most cases it is the liquidator only who is empowered to bring actions against directors and others where there has been a breach of either the legal or fiduciary duties owed to the company. There are a few exceptions to this rule in respect of certain transactions/offences for which action may be brought by creditors or others directly. These are detailed in the table at 5.3.

However, where criminal proceedings are brought against directors or others in respect of some form of criminal action, such proceedings must be brought by the Director of Public Prosecutions (DPP) on behalf of the relevant government department or authority.

5.2 Criminal proceedings

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

Offences

- (a) Fraud in anticipation of winding-up²⁸
- (b) Misconduct in course of winding-up²⁹
- (c) Falsification of company's books³⁰
- (d) Fraudulent trading.³¹

5.3 Civil proceedings

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

²⁸ Section 245 Companies Act 1981.

²⁹ Section 243 Companies Act 1981.

³⁰ Section 244 Companies Act 1981.

³¹ Section 246 Companies Act 1981.

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

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

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Offence	Remedy available
Fraudulent trading	The penalty is up to two years' imprisonment and/or a fine of BMS\$2,500 or both.
Fraudulent trading	The director may be ordered to make such contribution to the company's assets as the Court thinks fit. In exercising its discretion under this section the Court may include a punitive element as well as a compensatory element.
Fraud in anticipation of a winding up	If prosecuted on indictment the penalty is up to two years' imprisonment and, on summary conviction, a term of imprisonment of up to 12 months.
Falsification of company books	If tried by a jury the penalty is up to five years' imprisonment.
Misfeasance	This section provides a mechanism for summary trial and does not create any new category of liability. The Court may order the director to repay, restore or account for the money or the property or any part of it, with interest at such rate as the Court sees fit or to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the Court sees fit.
Fiduciary duties	The director may be ordered to compensate for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit obtained in breach of fiduciary duty.

Offence	Remedy available
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.
Transactions at an undervalue and preferences	<p>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:</p> <ul style="list-style-type: none"> (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 S 237 of the Companies Act 1981 and S 36A of the Conveyancing Act 1993; (e) provide for any surety or guarantor whose obligations to any person were released or discharged (in whole or in part) under the transaction, or by giving of the preference, to be under such new or revived obligations to that person as the Court thinks appropriate;
Transactions defrauding creditors	<p>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.</p> <p>The Court may:</p> <ul style="list-style-type: none"> (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;

Offence	Remedy available
<p>Transactions defrauding creditors</p>	<p>(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;</p> <p>(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.</p> <p>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.</p>
<p>Avoidance of a floating charge</p>	<p>The Court can declare that the floating charge is invalid in whole or in part.</p>

QUESTION 7

7. Duty to co-operate

- (a) **To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

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

7.1.1 Statement of affairs

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

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

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

7.1.2 Delivery of the company's property

Section 186 of the Companies Act applies whenever a winding-up order has been made in respect of a company. In such a case, where a person has any property, money, or books and papers to which the company is prima facie entitled, the Court may require that person forthwith (or within such period as the Court may direct) to pay, deliver, convey, surrender or transfer the property, books, papers or records to the liquidator. This section applies only to any contributory (generally a shareholder), trustee, receiver, banker, agent, or officer of the company.

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

7.1.3 Power to summon persons

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

- (a) any officer of the company;
- (b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; or
- (c) any person whom the Court deems capable of giving information concerning the promotion, formation, trade, dealings, affairs or property of the company.

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

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

7.1.4 Public examination of officers

By virtue of section 196 of the Companies Act,³² where a winding-up order has been made, the Official Receiver may make a report stating his opinion that a stipulated person -

- (a) has been guilty of fraud or dishonesty;
- (b) is in default of any provision of law pertaining to companies; or
- (c) has shown himself to have acted in an improper, reckless or incompetent manner in relation to the company's affairs;

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

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

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

³² See also Section 244 of the Companies Act 1981 which creates the offence of, among other things, falsifying documents for the purpose of misleading any person.

7.1.5 Creditors' voluntary cases

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

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

Section 243 of the Companies Act³³ stipulates that any person, being a past or present officer of the company which is being wound up (by order or voluntarily), commits an offence if he:

- (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) within 12 months 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 BM\$300 or upwards, or conceals any debt due to or from the company; or
- (d) within 12 months 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 BM\$50 or upwards; or
- (e) makes any material omission in any statement relating to the affairs of the company; or
- (f) fails to inform the liquidator of any false debt which he believes has been proved by any person in the winding up; or
- (g) after the commencement of the winding-up prevents production of books and papers relating to the company's property or affairs; or
- (h) within 12 months before the commencement of the winding up or at any time thereafter, conceals, destroys, mutilates or falsifies, or is privy to the concealment, destruction, mutilation or falsification of, any book or paper affecting or relating to the property or affairs of the company; or
- (i) within 12 months before the commencement of the winding up or at any time thereafter makes or is privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company; or
- (j) within 12 months before the commencement of the winding up or at any time thereafter fraudulently parts with, alters or makes any omission in, or is privy to the fraudulent parting with, altering or making any omission in, any document affecting or relating to the property or affairs of the company; or
- (k) after the commencement of the winding up or at any meeting of the creditors of the company within 12 months next before the commencement of the winding up attempts to account for any part of the property of the company by fictitious losses or expenses; or
- (l) has within 12 months before the commencement of the winding up or at any time thereafter, by any false representation or other fraud, obtained any property for or on behalf of the company on credit for which the company does not subsequently pay for; or
- (m) within 12 months before the winding up or at any time thereafter, under false pretence that the company is carrying on business, obtains on credit, for or on behalf of the company, any property which the company does not subsequently pay for; or

³³ See also Section 244 of the Companies Act 1981 which creates the offence of, among other things, falsifying documents for the purpose of misleading any person.

- (n) within 12 months before the commencement of the winding up or at any time thereafter pawns, pledges or disposes of any property of the company which has been obtained on credit and has not been paid for, unless such pawning, pledging or disposing is in the ordinary way of the business of the company; or
- (o) 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.

7.2 Human rights

No human rights laws are applicable in relation to any of the obligations referred to above. The constitution of Bermuda³⁴ does protect certain civil rights but none appears to have any bearing on the discussion in this part.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation periods

8.1.1 Limitation period for criminal proceedings

No limitation period applies to the criminal offences created by virtue of those provisions of the Companies Act referred to in question 2 which are indictable offences. In the case of those identified in the Companies Act as summary offences, the limitation period is three years from the time when the offence is committed.³⁵

8.1.2 Limitation period for cause of action for sum recoverable by statute

The Companies Act does not stipulate limitations periods in connection with the statutory doctrines referred to in question 2. Therefore, the applicable limitation period in respect of any provision enabling the recovery of a sum of money is applicable. That limitation period is 20 years from the date the cause of action accrued.³⁶

8.1.3 Limitation period for civil actions in misfeasance, tort or contract

In relation to breaches of the director's fiduciary duties or for any common law duties in tort, or breach of contract, the limitation period is generally six years from the date on which the cause of action accrued³⁷. Where the cause of action is based on fraud or for the relief of any mistake, or any relevant act has been deliberately concealed by the defendant, the limitations period does not begin to run until the plaintiff discovers the fraud, mistake or concealment³⁸.

8.2 Appeals

Except in relation to interlocutory matters or orders for costs, an appeal may be made from any decision of the Supreme Court of Bermuda, being the lower Court in relation to proceedings of the type described in question 2.³⁹

³⁴ United Kingdom Statutory Instrument SI 1968 No. 182 and Bermuda Constitution Order 1968.

³⁵ Section 278 Companies Act 1981.

³⁶ Section 11 Limitation Act 1984.

³⁷ Section 4 and Section 7 Limitation Act 1984.

³⁸ Section 33 Limitation Act 1984.

³⁹ Section 12 Court of Appeal Act 1964.

Appeals from decisions of the Court of Appeal to the UK Privy Council, being the highest Court of appeal for Bermuda, are permitted as a matter of right from final decisions of the Court of Appeal where the sum at stake is in excess of BM\$12,000 or in any case (final or interlocutory) where the Court of Appeal considers that the appeal should be heard by reason of its “great general of public importance or otherwise.”⁴⁰

QUESTION 9

9. Foreign corporations

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

9.1 Introduction

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

9.2 Jurisdiction of Bermuda Courts

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

- (a) companies incorporated in Bermuda under the Companies Act 1981 and its predecessor legislation;
- (b) overseas companies which are authorised to carry on business in Bermuda.⁴¹

QUESTION 10

10. Insurance

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

- 10.1** It is permissible for a director to take out insurance pursuant to Section 98A of the Companies Act and the company may lawfully pay the premiums.

Section 98A – Insurance of officers

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

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

The information provided in this country chapter is correct as at 30/11/2016

⁴⁰ Section 2 Appeals Act 1911.

⁴¹ Sections 4(1) and 4(1A) Companies Act 1981.

CANADA

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Directors identification / definition

1.1.1 Under Canadian insolvency statutes, namely the Bankruptcy & Insolvency Act¹ (BIA) and the Companies' Creditors Arrangement Act² (CCAA), a "director" in respect of a corporation, other than an income trust, is defined as "a person occupying the position of director by whatever name called and, in the case of an income trust, a person occupying the position of trustee by whatever name called."³ This definition could expand the ranks of persons who may be considered liable as directors to, for example, shareholders exercising powers under a unanimous shareholders' agreement. The CCAA language mirrors the language under the Canada Business Corporations Act⁴ (CBCA), Canada's federal corporate law statute, where "director" includes a person occupying the position of director by whatever name called.

1.1.2 The BIA also 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.⁵ (Those offences are detailed in the response to Question 2).

1.1.3 Further, under the CCAA, where all of the directors of a debtor company have resigned or have been removed by the shareholders without replacement, any person who manages or supervises the management of the business and affairs of the debtor company is deemed to be a director for the purposes of potentially making a compromise of claims against them.⁶

1.2 The twilight period

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 formal insolvency proceedings are instituted. In other words, 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 (e.g., creditors, employees, shareholders). 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.

1.2.2 As a general rule, the twilight period commences at the time the directors and/or others become aware of the insolvency or the impending insolvency of the company and ends when formal insolvency procedures are commenced.

1.2.3 The length of the twilight period can depend on:

(a) whether the transaction is -

- a preference (i.e., it involves a payment by the insolvent debtor to one or more creditors at the expense of other creditors); or
- a transfer at undervalue (i.e., it involves a transaction in which the consideration received by the debtor is conspicuously less than the fair market value of the property or services sold or disposed of); and

¹ R.S.C. 1985, c. C-44. The BIA is Canada's bankruptcy and receivership statute. The BIA also provides a mechanism under which small and medium enterprises can advance and implement restructuring proposals.

² R.S.C. 1985, c. C-36. The CCAA is Canada's restructuring statute for larger enterprises having outstanding debt of at least \$5 million.

³ BIA, section 2 and CCAA, section 2.

⁴ R.S.C. 1985, c. C-44.

⁵ BIA, s. 204. Cases considering the meaning of *de facto* control include *Silicon Graphics Limited v. Canada*, 2002 FCA 260 and *McGillivray Restaurant Ltd. v. The Queen*, 2016 FCA 99.

⁶ CCAA, s. 5.1.

- (b) whether the party to the transaction is dealing with the debtor
- at arm’s length; or
 - at non-arm’s length.

A detailed discussion of when parties are considered to be dealing at “arm’s length” or “non-arm’s length” is included in the response to Question 4.

1.2.4 In the case of a preference,

- (a) if the transaction was with an arm’s length party, the twilight period is three months before the “date of the initial bankruptcy event” until the date of the bankruptcy.
- (b) if the transaction was with a non-arm’s length party, the twilight period is one year before the “date of the initial bankruptcy event” until the date of the bankruptcy.⁷

1.2.5 In the case of a transfer at undervalue,

- (a) if the insolvent debtor was dealing with an arm’s length party and intended to defraud, defeat or delay a creditor, the twilight period is one year before the “date of the initial bankruptcy event” until the date of the bankruptcy.
- (b) if the debtor was dealing with a non-arm’s length party, there are two twilight periods that could apply:
- (i) one year before the “date of the initial bankruptcy event” until the date of bankruptcy;⁸ or
 - (ii) five years before the “date of the initial bankruptcy event” until the day before the day on which the period in (b)(i) begins where
 - (A) the debtor was insolvent at the time of the transfer or rendered insolvent by it, or
 - (B) the debtor intended to defraud, defeat or delay a creditor.

1.2.6 Unlike in the case of preferences or transfers at undervalue between arm’s length parties, where the debtor is dealing with a non-arm’s length party, the insolvency of the debtor is not a necessary prerequisite for finding a transfer at undervalue occurred. However, the insolvency of the debtor is an alternative to proving the debtor intended to defraud, defeat or delay a creditor in the case of the five-year look-back period in (b)(ii) above. A discussion of when a debtor is considered to be an “insolvent person” is included in the response to Question 4.

1.2.7 The twilight periods revolve around the phrase “date of the initial bankruptcy event” which is used to establish the effective date of insolvency for the impugned transactions. Specifically,

- in the case of a voluntary assignment in bankruptcy, the “date of the initial bankruptcy event” is the date the assignment is filed or made;
- in the case of a proposal, which is a form of restructuring under the BIA, the “date of initial bankruptcy event” is the date a notice of intention to make a proposal or a proposal is filed;
- where there has been an application for a bankruptcy order, the “date of the initial bankruptcy event” is the date the application is filed; and
- where proceedings have been commenced under the CCAA, the filing date of those proceedings is the relevant date.

1.2.8 In terms of the end of the twilight periods referenced above, the phrase “date of the bankruptcy” refers to the date on which the insolvent person becomes bankrupt or the date on which proceedings have been commenced under the CCAA.

⁷ BIA, s. 95. The BIA review periods apply under the CCAA, s. 36.1.

⁸ BIA, s. 96. The BIA review periods apply under the CCAA, s.36.1.

- 1.2.9 Notably, liability of directors and officers is not limited to twilight period transactions. Directors and officers have ongoing liabilities under companion remedial statutes for unemployment contributions and pension contributions, as well as environmental liabilities where the corporation cannot satisfy claims.

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 the director?

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

- (i) Is the director's liability considered to be civil, criminal or both?
- (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
- (iii) Will liability attach to all the directors or 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 Breach of fiduciary duties

2.1.1 Directors are subject to certain general fiduciary duties under common law and as imposed by corporate law statutes which, if breached, could result in personal liability for directors. In performing their functions, directors are required to:

- (a) act honestly and in good faith with a view to the best interests of the corporation; and
- (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

2.1.2 The traditional view is that a director owes these fiduciary duties to the corporation and its shareholders but not to creditors. However, there is case law in Canada that follows the approach taken in other common law jurisdictions (i.e., England, Australia, New Zealand), which suggests that when a corporation is insolvent the directors cannot disregard the interests of the creditors. Whether a director owes a duty to creditors when a corporation is insolvent was considered by the Supreme Court of Canada in *Peoples Department Stores Inc. v. Wise (Peoples Department Stores)*.⁹

2.1.3 In *Peoples Department Stores*, the Supreme Court of Canada held that directors owe a fiduciary duty to the corporation and not the corporation's creditors, regardless of whether the corporation is in the "vicinity of insolvency." However, the Supreme Court recognized that, in certain circumstances, it may be legitimate for a director to consider the interests of shareholders, employees, creditors and others when assessing the best interests of the corporation. Although such other interests may be considered, the Supreme Court held that a director's fiduciary duty does not change simply because a corporation is in the "vicinity of insolvency" (e.g., an honest good faith attempt by a director of a corporation to address a corporation's financial problems does not, if unsuccessful, qualify as a breach of a director's fiduciary duty to the corporation). The Supreme Court further held that it is unnecessary to read the interests of creditors into the fiduciary duty since creditors have the oppression remedy (discussed in S 2.7 herein) available to them.

⁹ (2004), 244 D.L.R. (4th) 564 (S.C.C.).

- 2.1.4 After the *Peoples Department Stores* decision, the duty of care provisions of the Ontario Business Corporations Act (OBCA) were amended to clarify that directors only owe their duty of care to the corporation.¹⁰ Therefore, in Ontario, directors will only be liable for a breach of fiduciary duty where an action is commenced by the corporation or where a complainant is granted leave by a Court to bring a derivative action in the name of the corporation. No other Canadian legislation has been amended to relieve directors of this liability.
- 2.1.5 Where a director breaches his or her duties to the corporation, attempts by a shareholder or creditor to assert a derivative or oppression action against a director may raise issues of standing. Where a company is nearing insolvency, a director's breach of his or her duties to the corporation may result in a traceable injury to both shareholders and creditors alike. Courts have struggled with balancing the interests of shareholders and creditors when companies are operating in this twilight period. In these circumstances, it appears that both shareholders and creditors might have standing to assert derivative or oppression claims against directors for breach of their duties to the corporation. (See discussion of oppression and derivative actions in S 2.7 below.)
- 2.1.6 Directors should be aware that claims for professional misconduct by a regulatory authority can still be brought against them notwithstanding a settlement and release regarding the same situation. For example, the Ontario Superior Court of Justice recently held that releases in favour of directors in a class action settlement were not effective as against the regulator of accountants where those claims were not specifically released.¹¹
- 2.1.7 Directors and officers should also be aware that they will be held personally liable for their tortious conduct, even if such conduct was carried out in the best interests of the corporation.¹²

2.2 General bankruptcy offences under the BIA

- 2.2.1 Where a corporation commits an offence under the BIA, any officer or director of the corporation who directed, authorized, assented to, acquiesced in or participated in the commission of the offence is guilty of the offence and is liable upon conviction for the punishment provided for the offence.¹³
- 2.2.2 A bankrupt commits a bankruptcy offence where it:
- (a) makes any fraudulent disposition of the bankrupt's property before or after the date of the initial bankruptcy event;
 - (b) refuses or neglects to answer fully and truthfully all proper questions put to the bankrupt at any examination held pursuant to the BIA;
 - (c) makes a false entry or knowingly makes a material omission in a statement or accounting;
 - (d) after or within one year immediately preceding the date of the initial bankruptcy event, conceals, destroys, mutilates, falsifies, makes an omission in or disposes of, or is privy to the concealment, destruction, mutilation, falsification, omission from or disposition of, a book or document affecting or relating to the bankrupt's property or affairs, unless the bankrupt had no intention to conceal the state of the bankrupt's affairs;
 - (e) after or within one year immediately preceding the date of the initial bankruptcy event, obtains any credit or any property by false representations made by the bankrupt or made by any other person to the bankrupt's knowledge;
 - (f) after or within one year immediately preceding the date of the initial bankruptcy event, fraudulently conceals or removes any property of a value of \$50 or more or any debt due to or from the bankrupt; or

¹⁰ R.S.O. 1990, c. B16, s. 134(1), as amended by the Ministry of Government Services Consumer Protection and Service Modernization Act 2006 (c. 34, Schedule. B, s. 24.).

¹¹ *The Trustees of the Labourers' Pension Fund of Central and Eastern Canada v. Sino-Forest Corporation (Re)*, 2016 ONSC 1156.

¹² *Meridian Credit Union Limited v. Baig*, 2016 ONCA 150.

¹³ BIA, s. 204.

- (g) after or within one year immediately preceding the date of the initial bankruptcy event, hypothecates, pawns, pledges or disposes of any property that the bankrupt has obtained on credit and has not paid for, unless in the case of a trader the hypothecation, pawning, pledging or disposing is in the ordinary way of trade and unless the bankrupt had no intent to defraud.¹⁴

2.2.3 If any of (a) - (g) above are satisfied,

- (a) liability is criminal;
- (b) a person guilty of the offence is liable:
 - (i) on summary conviction, to a fine not exceeding \$5000 or to imprisonment for a term not exceeding 1 year, or to both; or
 - (ii) on indictment, to a fine not exceeding \$10,000 or to imprisonment for a term not exceeding 3 years, or to both;
- (c) the gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered (subject to the maximum restriction);
- (d) the specified period within which the relevant act must have been undertaken in order for liability to attach to a director is described in 2.2.2(a) - (g); and
- (e) absence of an intention to defraud or conceal amounts to a defence.

2.2.4 The acts set out in S 2.2.2 herein are criminal offences in which the government prosecutor may bring an action against the directors and others involved. The trustee in bankruptcy of a company is under a duty to bring any such offences to the attention of the Superintendent of Bankruptcy who will, in turn, deal with the appropriate authority. Rarely have directors been prosecuted in Canada.

2.3 Failure to keep proper books of account

2.3.1 The offence is made out if any officer or director is involved in a corporation which has become bankrupt or has made a proposal and the corporation has, on a previous occasion, been bankrupt or made a proposal -

- (a) while engaged in any trade or business and has not kept and preserved proper books of account; or
- (b) has concealed, destroyed, mutilated, falsified or disposed of, or is privy to the concealment, destruction, mutilation, falsification or disposition of, any book or document affecting or relating to the corporation's property or affairs.¹⁵

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

2.4 Unlawful transactions

2.4.1 The offence is made out where the director or officer participates in a transaction entered into by the bankrupt corporation with any person for the purpose of obtaining a benefit or advantage to which either of them would not be entitled.¹⁶

2.4.2 Where 2.4.1 above is satisfied,

- (a) liability is criminal (although unlawful transactions are also actionable civilly);
- (b) the person guilty of the offence is liable on summary conviction, to a fine not exceeding \$5,000 or to imprisonment for a term not exceeding one year, or to both;

¹⁴ BIA, s. 198(1).

¹⁵ BIA, s. 200(1).

¹⁶ BIA, s. 201(3).

- (c) the gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered (subject to the maximum restriction);
- (d) the offence applies after the corporation becomes bankrupt; and
- (e) absence of intent to obtain a benefit or advantage amounts to a defence.

2.5 Declaration of dividends and redemption of shares

2.5.1 Where the Court finds that either the bankrupt corporation or CCAA debtor paid a dividend, other than a stock dividend, or redeemed or purchased for cancellation any of the shares of its capital stock at a time when the corporation was insolvent or the transaction rendered the corporation insolvent, the directors of the corporation are personally liable.¹⁷

2.5.2 Where 2.5.1 above has occurred,

- (a) liability is civil;
- (b) a director found guilty of this offence is liable to pay to the trustee the amount of the dividend, redemption or purchase price with interest;
- (c) the liability will attach to the directors jointly and severally;
- (d) the declaration of dividends must have occurred within the one-year period immediately preceding the date of the initial bankruptcy event and ending on the date of the bankruptcy; and
- (e) the following defences exist:
 - (i) the director actively dissented from the resolution authorizing the payment of the dividend; or
 - (ii) the director had reasonable grounds to believe that the impugned transaction occurred at a time when the corporation was solvent or that the transaction would not render the corporation insolvent.¹⁸

2.5.3 Directors are well-advised to obtain the report of a professional regarding the solvency determination as they are protected from liability where they have relied in good faith on a professional's report.¹⁹

2.6 Liability for debts due to employees

2.6.1 The Wage Earner Protection Program Act (WEPPA)²⁰ and related Regulations provide for the timely payment of wages and vacation pay (but not severance or termination pay) owed to eligible workers up to an amount equalling the greater of four weeks' maximum insurable earnings under the Employment Insurance Act and \$3,000 per employee.²¹ An eligible worker is one (a) whose employment was terminated as a result of the former employer filing for bankruptcy or becoming subject to a receivership, including as a result of a failed attempt at restructuring, and (b) who is owed wages and vacation pay earned during the six months immediately before the date of bankruptcy / receivership. The payments will be made by the government which is then subrogated to the employees' rights and may maintain an action against the bankrupt, insolvent employer or directors in the name of the employee or in the government's name.

¹⁷ BIA, s. 101(1), (2); CCAA, s. 36.1. See also CBCA, s. 42 and OBCA, s. 38(3). (Note: Provinces other than Ontario have their own Business Corporations Act).

¹⁸ BIA, s. 101(2); CCAA, s. 36.1.

¹⁹ CBCA, s. 123(4).

²⁰ S.C. 2005, c. 47.

²¹ Although the ceiling of \$3,000 is the amount referenced in the WEPPA, that amount is adjusted annually.

2.6.2 According to corporate statutes such as the CBCA, and provincial employment standards legislation, the directors of a corporation are personally liable to the employees for all debts, not exceeding 6 months' wages, for services performed for the corporation.²² This liability generally does not include personal liability for severance pay.²³ The directors are also liable for any vacation pay that accrued over a period of up to 12 months while they were directors.

2.6.3 With respect to the personal liability of directors for the wages and vacation pay set out above,²⁴

- (a) liability is civil;
- (b) the Court may order the directors to pay the debts owed to the employees, with interest at such rate as the Court sees fit;
- (c) the directors are jointly and severally liable for the debt;
- (d) there is no specified period within which the relevant act must have been undertaken in order for liability to attach; and
- (e) a director is not liable unless -
 - (i) the corporation has been sued within 6 months after the debt was due and execution has been returned unsatisfied either in whole or in part; or
 - (ii) the corporation has made an assignment or a bankruptcy order has been made against it under the BIA and a claim for the debt has been proved within 6 months after the date of the assignment or bankruptcy order.

Notably, a director is not liable unless he is sued while he is a director or within two years after ceasing to be a director.

2.7 Oppression and derivative actions

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

2.7.2 A complainant may apply to the Court for an order under the oppression provisions of the CBCA (and comparable provincial corporate statutes) to rectify the matters complained of if the Court is satisfied that in respect of a corporation or any of its affiliates

- (a) any act or omission of the corporation or any of its affiliates effects a result;
- (b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner; or
- (c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer and the Court may make an order to rectify the matters complained of.²⁵

A complainant is defined in some jurisdictions so as to include shareholders and creditors.

2.7.3 The Courts have held that the oppression remedy is primarily aimed at redressing objectively reasonable expectations. The cases refer to the oppression remedy as an equitable remedy. The remedy seeks to ensure fairness – what is “just and equitable” – which is to be judged by the reasonable expectations of the stakeholders in the context and in regard to the relationships at play. Consequently, what is oppressive in one case, may not be so in another.²⁶

²² CBCA, s. 119. Each provincial jurisdiction has its own corporate statute that addresses personal liability for debts owing to employees. In many provinces, there is also statutory liability under employment standards legislation for debts owing to employees.

²³ In some provincial jurisdictions, there is liability for severance pay.

²⁴ Note that the language in each provincial corporate statute varies in this regard.

²⁵ CBCA, s. 241(2).

²⁶ *BCE Inc. v. 1976 Debentureholders*, [2008] S.C.J. No. 37 at para. 59 (*BCE*).

2.7.4 In *BCE Inc. v. 1976 Debenture Holders*,²⁷ the Supreme Court of Canada established a two-part test for determining whether an oppression claim will be successful.²⁸

1. Does the evidence support the “reasonable expectation” the complainant asserts?
2. If so, does the evidence establish that the reasonable expectation was violated by conduct falling within the terms “oppression,” “unfair prejudice” or “unfair disregard” of a relevant interest?²⁹

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

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

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

- (a) liability is civil;
- (b) the Court may make an order to compensate the aggrieved person;
- (c) the Court can apportion liability to each individual director according to their specific involvement when the Court makes an order to compensate the aggrieved person; and
- (d) there is no specified period within which the relevant act must have been undertaken in order for liability to attach.

2.7.8 The Courts have a wide discretion to fashion a remedy appropriate to the circumstances. The remedy to correct an oppressive act “should be done with a scalpel, and not a battle axe”, and the task of the Court is to even the balance, not tip it in favour of the injured party.³⁰ The Court may make an interim or final order which it thinks fit, including an order:

- (a) restraining the conduct complained of;
- (b) appointing a receiver or receiver/manager;
- (c) to regulate a corporation’s affairs by amending the articles or bylaws or creating or amending a unanimous shareholder agreement;
- (d) directing an issue or exchange of securities;
- (e) appointing directors in place of or in addition to all or any of the directors then in office;
- (f) directing a corporation or any other person, to purchase securities of a security holder;
- (g) directing a corporation or any other person, to pay a security holder any part of the money paid by the security holder for securities;

²⁷ *Ibid.*

²⁸ While the decision in *BCE*, *supra* considered section 241 of the CBCA, the analysis equally applies to a consideration of the oppression remedy contained in section 248 of the OBCA, the language of which section is substantially similar to section 241 of the CBCA.

²⁹ *BCE supra*, at paras. 56, 68 and 95.

³⁰ *820099 Ontario Inc. v. Harold E. Ballard Ltd.* (1991), 3 B.L.R. (2d) 123 (Ont. Gen. Div.), affirmed (1991), 3 B.L.R. (2d) 113 (Ont. Div. Ct.).

- (h) 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) 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) compensating an aggrieved person;
- (k) directing rectification of the registers or other records of the corporation;
- (l) winding-up the corporation;
- (m) directing an investigation; and
- (n) requiring the trial of any issue.³¹

2.8 General liability under the BIA

2.8.1 Community service

Where a person has been convicted of an offence under the BIA, the Court may, having regard to the nature of the offence and the circumstances surrounding its commission, and in addition to any other punishment that may be imposed under the BIA, make an order directing the person to perform community service (i.e., unpaid work of social utility), subject to such reasonable conditions as may be specified in the order.³²

2.8.2 Compensation for loss

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.³³

2.9 Removal of directors

- 2.9.1 In addition to the actions that may attract liability for directors, the Court has the authority to remove any director of a company undergoing a BIA or CCAA restructuring if satisfied that the director “is unreasonably impairing or is likely to unreasonably impair” the possibility of a viable proposal, arrangement or compromise, or “is likely to act inappropriately as a director in the circumstances.”³⁴

³¹ CBCA, s. 241(3); OBCA, s. 248(3).

³² BIA, s. 204.1.

³³ BIA, s. 204.3(1).

³⁴ BIA, s. 64(1); CCAA, s. 11.5(1).

QUESTION 3

3. **Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period**
- (a) **In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?**
- (b) **In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?**
- (c) **Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?**

3.1 Non-director liability

- 3.1.1 There are a number of activities during the twilight period in respect of which other persons who do not control the corporation may be held liable.

3.2 Preferences³⁵

A creditor of a corporation may be held liable when an insolvent corporation enters into a transaction with the creditor. If the creditor is an arm's length party and the Court holds that the transaction was made at a time when the corporation was insolvent with an intention to prefer that creditor over others, then the transaction will be void as against the trustee in bankruptcy (or CCAA debtor in the case of a CCAA). If the transfer had the effect of preferring an arm's length creditor, a preference will be presumed and, barring evidence to the contrary, the transaction will be void as against the trustee in bankruptcy.³⁶ If the creditor is a non-arm's length party and the transfer had the effect of preferring the non-arm's length creditor, the transaction will be void as against the trustee in bankruptcy (or CCAA debtor, in the case of a CCAA). A detailed discussion of preferences is included in the response to Question 4.

3.3 Transfers at undervalue³⁷

If the debtor enters into a transaction for which no consideration is received by the debtor or for which the consideration received is conspicuously less than fair market value, then the Court may give judgment to the trustee in bankruptcy (or in favour of the CCAA debtor, in the case of a CCAA) against any other party to the transaction or against any other party privy to the transaction. The party subject to such judgment is required to pay the difference between the actual consideration given or received by the debtor and the fair market value of the property or services. The values on which the Court makes any finding under this section are, in the absence of evidence to the contrary, the values stated by the trustee in bankruptcy or CCAA monitor.³⁸

From a practical standpoint, this means that the creditor of the corporation will be obligated to return to the trustee or CCAA debtor any consideration paid by the bankrupt or CCAA debtor in the transaction. A detailed discussion of transfers at undervalue is included in the response to Question 4.

³⁵ BIA, s. 95.

³⁶ BIA, s. 95(2); CCAA, s. 36.1.

³⁷ BIA, s. 96(1); CCAA, s. 36.1.

³⁸ Trustees in bankruptcy and CCAA monitors are officers of the Court. A trustee in bankruptcy serves as the legal representative of the bankrupt in whom the bankrupt's assets are vested. The trustee is required to impartially represent the interests of creditors in the BIA bankruptcy proceedings. The CCAA requires the Court on an initial application in a CCAA proceeding to appoint a monitor whose principal role is to act as the Court's eyes and ears in ensuring that the restructuring is proceeding appropriately, and whose role includes the dissemination of information to stakeholders. The monitor is not normally an adversary of any party, although the monitor's input (through reports to the Court and recommendations from time to time made therein) can significantly influence the Court's decisions in the CCAA proceedings.

3.4 Liability of persons convicted of BIA offences

As set out in the response to Question 2, where a person has been convicted of an offence under the BIA and any other person has suffered loss or damage because of the commission of the offence, the Court may, at the time sentence is imposed, order the person who has been convicted to pay to the person who has suffered loss or damage or to the trustee of the bankrupt, an amount by way of satisfaction or compensation for loss of or damage to property suffered by that person as a result of the commission of the offence.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Transactions with the company that may be set aside during the twilight period

4.1.1 The objective of an insolvency regime is to ensure fair treatment to all stakeholders who have similar legal rights. There is a framework under the BIA for challenging transactions that may diminish the value of an insolvent debtor's estate, thereby reducing the amount of money available for distribution to the creditors. The BIA framework applies with necessary modifications under the CCAA.³⁹ 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, as set out in the response to Question 1.

Transfers at undervalue

- 4.1.2 A transfer at undervalue is a transaction in which the consideration received by a person is conspicuously less than the fair market value of the property or services sold or disposed of by the person in the transaction. A transfer at undervalue under the BIA may be void as against the trustee in bankruptcy or as against the debtor company under the CCAA (on application by the CCAA monitor).
- 4.1.3 The twilight period and criteria for transfers at undervalue vary depending on whether the transaction was an arm's length or non-arm's length transaction. The applicable twilight periods are set out in the response to Question 1. A discussion of when parties are arm's length or non-arm's length is included below.
- 4.1.4 The trustee in bankruptcy or CCAA monitor is entitled to inquire into transfers at undervalue for the purpose of determining whether a bankrupt or CCAA debtor has paid or received, as the case may be, fair market value for the property involved in the transaction. The trustee in bankruptcy or CCAA monitor is authorized to apply to the Court so that the Court may determine as a question of fact whether the transaction was a transfer at undervalue and whether the other party was at arm's length with the debtor in relation to the transfer.
- 4.1.5 If the consideration given or received is conspicuously greater than or less than fair market value, the Court may grant judgment in favour of the trustee or debtor company (on application by the CCAA monitor) for the difference between the actual consideration given or received and the fair market value of the property involved in the transaction. Pursuant to such a judgment, the trustee or debtor company may recover from other parties to the transaction and / or any other person being privy to the transaction.⁴⁰

³⁹ CCAA, s. 36.1.

⁴⁰ BIA, s. 96. Section 36.1 of the CCAA adopts the BIA framework for challenging transfers at under value and preferences with necessary modifications (e.g., references to "trustee" in the BIA are to be read as references to "monitor"). There appears to be a drafting oversight in the adoption of the BIA framework in that references to be made to monitor are more appropriately references to the debtor company.

Preferences

- 4.1.6 A preference occurs when an insolvent debtor pays one or more creditors at the expense of other creditors. The provisions of the BIA and CCAA with respect to preferences are a means of carrying into effect the principle that all ordinary creditors should rank equally.
- 4.1.7 There is no requirement to prove that the debtor intended to prefer the non-arm's length creditor where the transfer had the effect of preferring one creditor over another.⁴¹ In the case of an arm's length transaction, a preference will be presumed where, in the absence of evidence to the contrary, the transfer had the effect of preferring one creditor over another.⁴² The presumption is rebuttable.⁴³
- 4.1.8 If a payment or other disposition of property is made in circumstances that amount to a preference, the transaction remains valid unless or until it is set aside as a preference. The attack is made by a trustee in bankruptcy or CCAA monitor and the Courts have the ability to declare the transaction to be fraudulent and void as against the trustee or CCAA debtor, as applicable. To attack a transaction as a preference, the trustee or CCAA monitor must prove that the conveyance was made to a creditor.
- 4.1.9 Preferences under the BIA and the CCAA in favour of a creditor may also be void as against the trustee in bankruptcy or debtor company.
- 4.1.10 The twilight period and criteria vary depending on whether the preference is between arm's length parties or non-arm's length parties. Refer to the response in Question 1 for details on the review periods and the discussion below on when parties are arm's length or non-arm's length parties.

Insolvency of debtor

- 4.1.11 Preference remedies can only be invoked if the transaction was effected by an "insolvent person." It is not necessary for the trustee, for example, to prove an act of bankruptcy by the debtor. It is only necessary to prove that the debtor was insolvent at the time of the transaction.
- 4.1.12 "Insolvent person" is defined in the BIA as a person who is not bankrupt, who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under the BIA amount to one thousand dollars, and
- (a) who is, for any reason, unable to meet his obligations as they generally become due;
 - (b) who has ceased paying his current obligations in the ordinary course of business as they generally become due; or
 - (c) the aggregate of whose property is not, at a fair valuation, sufficient, or if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable the payment of all his obligations due and accruing due.⁴⁴
- 4.1.13 In a restructuring context under the CCAA, the BIA test for an insolvent person set out above is given a purposive interpretation. This means that it is appropriate to consider at the time a company files for creditor protection whether it is reasonably foreseeable that there is a looming liquidity condition or crisis that will result in the debtor running out of cash to pay its debts as they generally become due without the benefit of a Court-ordered stay of proceedings, ancillary protection and procedures.⁴⁵

⁴¹ BIA, s.95(1)(b), CCAA, s. 36.1.

⁴² BIA, s. 95(1)(a); CCAA, s. 36.1.

⁴³ BIA, s. 95(1)(a); CCAA, s. 36.1.

⁴⁴ BIA, s. 2(1).

⁴⁵ *Re Stelco Inc.* (2004), 48 C.B.R. (4th) 299, leave to appeal dismissed [2004] O.J. No. 1903 (Ont. C.A.), leave to appeal dismissed [2004] S.C.C.A. No. 336 (S.C.C.).

Intention

- 4.1.14 Where the trustee or CCAA monitor is required to show that the transaction was entered into “with a view to giving that creditor a preference”, only an intention on the part of the insolvent person is required. In determining the intention of the debtor, the test is an objective one, not a subjective one (i.e., the intention will be that which the insolvent person’s conduct bears when reasonably construed and not that which, long after the event, he claims was his intention).

The presumption

- 4.1.15 In the case of an arm’s length preference, the trustee or CCAA monitor is required to prove
- (a) that the transaction took place within three months of the initial bankruptcy event;
 - (b) that the debtor was an insolvent person at the date of the alleged preference; and
 - (c) that at the date when the transaction was effected, it gave the creditor a preference in fact over other creditors.
- 4.1.16 If the trustee or CCAA monitor has proved these three essentials, the transaction is presumed to have been effected with the view to giving a creditor a preference over other creditors.⁴⁶

Defences

- 4.1.17 The presumption can be rebutted by the defendant. If, after considering all the evidence, the Court is satisfied that on the balance of probabilities the debtor was pursuing a purpose other than that of favouring the particular creditor over other creditors, the presumption will be displaced and the trustee or monitor’s application will be dismissed. For example, if the Court concludes that a payment was made in the ordinary course of business and not with the intention to prefer, the presumption will have been rebutted and the payment will stand. Payments in the ordinary course of business will ordinarily be made for one of two reasons:
- (a) so that the bankrupt might take advantage of favourable payment terms; or
 - (b) to secure a continued supply of goods or services from the trade creditor so that the bankrupt could continue in business.
- 4.1.18 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 before the review period, or where there is no reason to prefer the creditor.

Arm’s length / non-arm’s length parties

- 4.1.19 For the purposes of transactions at undervalue and preferences, related persons are, in the absence of evidence to the contrary, deemed not to deal with each other at arm’s length.⁴⁷
- 4.1.20 For the purposes of the BIA and CCAA, persons are “related persons” if they are:
- (a) individuals connected by blood relationship, marriage or adoption;
 - (b) a corporation and
 - (i) a person who controls the corporation, if it is controlled by one person,
 - (ii) a person who is a member of a related group that controls the corporation, or
 - (iii) any person connected in the manner set out in paragraph (a) to a person described in subparagraph (i) or (ii); or

⁴⁶ BIA, s. 95(2); CCAA, s. 36.1.

⁴⁷ BIA, s. 4(5).

- (c) two corporations
 - (i) controlled by the same person or group of persons,
 - (ii) each of which is controlled by one person and the person who controls one of the corporations is related to the person who controls the other corporation,
 - (iii) one of which is controlled by one person and that person is related to any member of a related group that controls the other corporation,
 - (iv) one of which is controlled by one person and that person is related to each member of an unrelated group that controls the other corporation,
 - (v) one of which is controlled by a related group a member of which is related to each member of an unrelated group that controls the other corporation, or
 - (vi) one of which is controlled by an unrelated group each member of which is related to at least one member of an unrelated group that controls the other corporation.⁴⁸

4.1.21 For the purposes of the BIA and CCAA, “relationship” is

- (a) where two corporations are related to the same corporation within the meaning of subsection 4(2) (being the definition of “related persons”), 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.⁴⁹

⁴⁸ BIA, s. 4(2); CCAA, s. 2(2).

⁴⁹ BIA, s. 4(3); CCAA, s. 2(2).

4.2 Payment of dividends or redemption of shares while insolvent

- 4.2.1 Where a corporation has paid a dividend, other than a stock dividend, or redeemed or purchased for cancellation any of the shares of the stock of the corporation within the period commencing on the day that is one year before the initial bankruptcy event and ending on the date of bankruptcy or the date of the CCAA filing, as applicable, the Court may, on application by the trustee under the BIA or CCAA monitor, inquire into the transaction to ascertain whether it occurred at a time when the corporation was insolvent or whether it rendered the corporation insolvent.⁵⁰ If the transaction occurred at such a time, the Court may give judgment to the trustee or in favour of the CCAA debtor, as applicable, against the directors of the corporation, jointly and severally, in the amount of the dividend or redemption or purchase price, with interest, that has not been paid to the corporation, provided that the Court finds that (i) the transaction occurred at a time when the corporation was insolvent or the transaction rendered the corporation insolvent; and (ii) the directors did not have reasonable grounds to believe that the transaction was occurring at a time when the corporation was not insolvent or that the transaction would not render the corporation insolvent.⁵¹
- 4.2.2 Directors have the onus of proving that the corporation was not insolvent at the time of the transaction and/or that the directors had reasonable grounds to believe that the transaction was occurring at a time when the corporation was not insolvent.⁵²
- 4.2.3 A director is protected from the provisions of this section if the director protested against the payment of the dividend or the redemption or purchase for the cancellation of shares of the stock of the corporation. Where certain statutory requirements are satisfied, the Court may give judgment to the trustee or in favour of a CCAA debtor, as applicable, against a shareholder who is related to one or more of the directors, in the amount of the dividend or redemption or purchase price referred to.⁵³

4.3 Provincial legislation addressing certain transactions

- 4.3.1 A trustee in bankruptcy can also resort to statutes other than the BIA. The Ontario Fraudulent Conveyances Act⁵⁴ is one such example. This legislation, which is enacted at a provincial level, enables the trustee or other creditors to attack any transaction that was entered into with the intention of defeating, delaying or hindering creditors. In Ontario, the limitation period to challenge transactions is generally two years from the time when the plaintiff first became aware of the fraudulent conveyance.⁵⁵ All Canadian provinces have similar legislation.
- 4.3.2 A sale in bulk is voidable in Ontario unless the buyer has complied with the provisions of the Bulk Sales Act.⁵⁶ 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. Except for in Ontario, legislation on bulk sales has been repealed in the rest of Canada. The first reading of a Bill to repeal the Bulk Sales Act (Ontario) was completed on June 8, 2016.⁵⁷

Assignment and Preferences Act

- 4.3.3 The Ontario Assignments and Preferences Act⁵⁸ (APA) is ordinarily used by a trustee when the time limits under S 95 of the BIA have expired. Under the APA, it is necessary to prove (a) a gift, conveyance, assignment or transfer or delivery over; (b) an intent to give a creditor an unjust preference over creditors or over any one of them; and (c) at the time of the gift, conveyance, assignment or transfer or delivery over, the debtor was in insolvent circumstances.⁵⁹ There are some important differences between the requirements under the BIA and those under the APA which, generally speaking, make it more difficult to prove a preference under the APA. There are also important differences between Ontario legislation and that of other provinces.

⁵⁰ BIA, s. 101(1). Section 36.1 of the CCAA incorporates and adopts the provisions of section 101 of the BIA with necessary modifications.

⁵¹ BIA, s. 101(2); CCAA, s. 36.1.

⁵² BIA, s. 101(2); CCAA, s. 36.1.

⁵³ BIA, s. 101(2.2).

⁵⁴ R.S.O. 1990, c. F. 29.

⁵⁵ The Court of Appeal for Ontario in *Re Edwards* (2011), 336 D.L.R. (4th) 719, held that general limitation periods in provincial statutes apply to bankruptcy proceedings. See also *msi Spergel Inc. v. I.F. Propco Holdings (Ontario) 36 Ltd.*, 2013 ONCA 550.

⁵⁶ R.S.O. 1990, c. B-14.

⁵⁷ Bill 218, Burden Reduction Act, 1st Sess, 41st Parl, Ontario, 2016.

⁵⁸ R.S.O. 1990, c. A.33.

⁵⁹ APA, s. 4.

Fraudulent conveyances

- 4.3.4 The Ontario Fraudulent Conveyances Act⁶⁰ (FCA) does not conflict with the BIA and a trustee is entitled to make use of such legislation to supplement the rights and remedies provided by the BIA. Similarly, other assignment, preference and conveyance legislation has been found not to conflict.
- 4.3.5 The effect of the FCA is that a conveyance that is fraudulent and void against creditors is not absolutely void but only voidable, the conveyance is good as between the parties to it.
- 4.3.6 The FCA renders void a conveyance of property made with the intent to defeat, hinder, delay or defraud creditors or others. The act makes an important distinction between voluntary conveyances and conveyances made for good consideration. If a conveyance is voluntary, it is only necessary to show the fraudulent intent of the maker. If it is made for good consideration, it is necessary to show the fraudulent intent of both parties to the transaction.
- 4.3.7 Under the FCA, the plaintiff does not have to show that the creditors were in fact delayed, defeated or defrauded, only that the grantor had an intention to defeat, hinder, delay or defraud creditors.
- 4.3.8 If there is no consideration for a conveyance, it is irrelevant whether or not the grantee had notice or knowledge of the fraudulent intent of the grantor. In the case of a voluntary conveyance, the trustee needs only prove that the grantor had the intent to defeat, hinder, delay or defraud creditors.
- 4.3.9 If the Court finds a transaction to be a fraudulent conveyance, the trustee or monitor will be entitled to a declaration that the conveyance is void as against him and that he is the owner of the debtor's interest in the property.

Defences

- 4.3.10 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.
- 4.3.11 Even if the Court finds that the transaction was a fraudulent conveyance, it is not void if it was made for good consideration and *bona fide* to a person not having, at the time of the conveyance, notice or knowledge of the intent to defraud.

4.4 Protection of transaction made in good faith with bankrupt

- 4.4.1 The purpose of S 97(1) of the BIA⁶¹ (as incorporated into the CCAA) is to deal with the effect of the relation back of the trustee's title in various sections of the BIA, such as the provisions dealing with preferences. S 97(1) applies to payments, conveyances, etc. that take place between the date of the initial bankruptcy event and the date of bankruptcy. Four types of transactions as set out in paragraphs (a) - (d) below are protected if made in good faith and if they do not constitute a transfer at undervalue, a preference or a fraudulent conveyance. The four headings are:
- (a) a payment by the bankrupt to any of the bankrupt's creditors;
 - (b) a payment or delivery to the bankrupt;
 - (c) a conveyance or transfer by the bankrupt for adequate valuable consideration; and
 - (d) a contract, dealing or transaction including any giving of security, by or with the bankrupt for adequate valuable consideration.
- 4.4.2 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 preferences.

⁶⁰ R.S.O. 1990, c. F29.

⁶¹ Section 97(1) of the BIA; CCAA, s. 36.1.

4.5 Directors' decision-making

- 4.5.1 The details of directors' duties are considered in the response to Question 2. There is a fiduciary relationship between the directors and the company. Two primary fiduciary duties of directors are recognized, namely, a duty of care and a duty of loyalty.⁶²
- 4.5.2 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.⁶³
- 4.5.3 In the event of insolvency, even outside of a formal bankruptcy, directors of an insolvent corporation continue to owe their duties to the corporation. See the discussion of this issue in S 2.1.
- 4.5.4 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. See the discussion of the oppression remedy in S 2.7.
- 4.5.5 However, the potential for action to have an adverse impact on creditors and other stakeholders may be enhanced when the company is insolvent. Directors must carefully consider the impact of any action during the twilight period, including the incurrence of further credit, on creditors and other stakeholders. Notably, the Ontario Court of Appeal held an officer personally liable for "inducing" a bank to extend credit to a company when it was in financial difficulty.⁶⁴ 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.

4.6 Business judgement rule

- 4.6.1 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 judgement, even if the judgement ultimately turns out to be wrong in hindsight. In the United States, the business judgement 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.
- Directors should act in accordance with the business judgement rule.
- 4.6.2 Directors should avoid actual conflicts of interest, avoid preferential treatment of certain constituencies, disclose all potential director contacts or relationships that could create even an appearance of a conflict of interest, and they should act only with the requisite information and due deliberation.
- 4.6.3 A director acting honestly and in good faith is generally not accountable to the corporation or its shareholders for self-profiting from a non-arm's-length transaction if (a) appropriate disclosure of the interest was made, (b) the directors approved the contract or the transaction, and (c) the contract or transaction was "reasonable and fair" to the corporation at the time when it was approved.⁶⁵
- 4.6.4 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.
- 4.6.5 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.

⁶² *People's Department Stores Ltd. (1992) Inc., Re*, 2004 SCC 68; *BCE Inc., Re*, 2008 SCC 69.

⁶³ *People's Department Stores Ltd. (1992) Inc., Re*, 2004 SCC 68; *BCE Inc., Re*, 2008 SCC 69.

⁶⁴ *NBD Bank, Canada v. Dofasco Inc.* (2000), 46 O.R. (3d) 514 (C.A.).

⁶⁵ *BCA*, s.120(7).

4.7 Releases

4.7.1 A statutory compromise of the corporation's liability does not in itself relieve a director or officer of their personal liability incurred in their capacity as such. However, a proposal under the BIA or a proposed plan of arrangement under the CCAA may provide for the compromise of claims against directors if

- (a) the claims do not relate to the creditor's contractual rights against such directors;
- (b) the claims are not based on allegations of either misrepresentation, wrongful or oppressive conduct by directors toward creditors; and
- (c) the Court determines the compromise to be fair and reasonable in the circumstances.⁶⁶

4.7.2 The legislation does not address the compromise of claims against officers. However, cases have held that if the plan of arrangement contains releases for the corporation's officers and is approved by the various constituencies, it should be viewed as a contract between the debtor and its creditors and the Court should not interfere with it.⁶⁷

4.7.3 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.

4.7.4 The Court of Appeal for Ontario has held that the CCAA provides jurisdiction to release third parties in a plan of compromise or arrangement, including (although distasteful) from fraud, as long as there is a reasonable connection between the third party claim being compromised and the restructuring plan and the plan itself is fair and reasonable. In *Re Metcalfe & Mansfield Alternative Investments II Corp.*,⁶⁸ the application judge and the Court of Appeal for Ontario focused on the following factors in concluding that the required connection existed and the releases were justified:

- The parties to be released are necessary and essential to the restructuring of the debtor;
- The claims to be released are rationally related to the purpose of the plan and necessary for it;
- The plan cannot succeed without the releases;
- The parties who are to have claims against them released are contributing in a tangible and realistic way to the plan;
- The plan will benefit not only the debtor companies but creditors (in that case note-holders) generally;
- The voting creditors who have approved the plan did so with knowledge of the nature and effect of the releases; and
- The releases are fair and reasonable and not overly broad or offensive to public policy.

Leave to appeal this decision to the Supreme Court of Canada was denied.

In a more recent Ontario case, the Court held that the treatment of third party releases applies equally in the context of BIA proposal proceedings as in CCAA proceedings.⁶⁹

⁶⁶ BIA, s. 50(13) and (14); CCAA, s. 5.1. See *NBD Bank, Canada v. Dofasco Inc.*, 1999 CarswellOnt 4077 (Ont. CA.); *Kitchener Frame Ltd. (Re)*, 2012 ONSC 234; *Re Metcalfe & Mansfield Alternative Investments II Corp.*, 2008 ONCA 587; *Timminco Ltd., Re.*, 2014 ONSC 3393; *Labourer's Pension Fund of Central and Eastern Canada (Trustees of) v. Sino-Forest Corp.*, 2016 ONSC 1156.

⁶⁷ *Re Canadian Airlines Corp.* (2000), 20 C.B.R. (4th) 1 (Alta. Q.B.) at 23. See also, *Re Metcalfe & Mansfield Alternative Investments II Corp.*, 2008 ONCA 587; *Timminco Ltd., Re.*, 2014 ONSC 3393; *Labourer's Pension Fund of Central and Eastern Canada (Trustees of) v. Sino-Forest Corp.*, 2016 ONSC 1156; *NBD Bank, Canada v. Dofasco Inc.*, 1999 CarswellOnt 4077 (Ont. CA.).

⁶⁸ 2008 ONCA 587, leave to appeal to the Supreme Court of Canada dismissed 2008 CanLII 46997 (SCC). See also *Bul River Mineral Corp., Re*, 2015 BCSC 113; *Holley v. Northern Trust Co. Canada*, 2014 ONSC 889; *Angiotech Pharmaceuticals Inc., Re*, 2011 BCSC 450.

⁶⁹ *Re Kitchener Frame Ltd.* (2012), 86 C.B.R. (5th) 274 (Ont. S.C.).

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 4 above?

- 5.1.1 In a 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 the response to Question 2. All criminal proceedings are handled by the government prosecutor.

5.2 Criminal proceedings

- 5.2.1 The acts set out in Ss 2.2 and 2.4 herein are criminal offences in which the government prosecutor may bring an action against the directors and others involved. The trustee in bankruptcy of a company is under a duty to bring any such offences to the attention of the Superintendent of Bankruptcy who will, in turn, deal with the appropriate authority.

5.3 Civil proceedings

- 5.3.1 The trustee in bankruptcy or CCAA monitor is the party who will bring proceedings in respect of transfers at undervalue, preferences, and fraudulent conveyances.
- 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.⁷⁰ In some cases, the definition of complainant under the oppression remedy provisions explicitly includes creditors.⁷¹
- 5.3.3 The Courts have held that a creditor may be a “proper person” for the purposes of the oppression remedy.
- 5.3.4 There was initially some uncertainty, but the case law has now clarified that a trustee in bankruptcy can assert an oppression claim on behalf of creditors. The argument in favour of allowing the trustee to be a proper person is that the trustee is the representative of the creditors of the bankrupt estate and has all the causes of action of the bankrupt.
- 5.3.5 The Court of Appeal for Ontario has held that given the purpose and clear language of the oppression provisions in the OBCA, where a bankrupt is a party to an allegedly oppressive transaction, the trustee is neither automatically barred from being a complainant nor automatically entitled to that status, rather it is for the judge at first instance to determine in the exercise of his discretion whether in the circumstances of the particular case, the trustee is a proper person to be a complainant.⁷²

⁷⁰ CBCA, s. 241 and 248; and OBCA, s. 245 and 248.

⁷¹ For example, see the Alberta Business Corporations Act (although this remains subject to the exercise of the Court’s discretion) and the New Brunswick Business Corporations Act.

⁷² *Olympia & York Developments Ltd. (Trustee of) v Olympia & York Realty Corp.* (2004), 46 C.B.R. (4th) 313 (Ont. C.A.).

5.4 Other

- 5.4.1 Directors are also jointly and severally 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 in respect of these obligations.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Offence	Remedy available
BIA general	Where a person has suffered a loss or damage as a result of an offence committed under the BIA, the Court may order the person convicted to pay to the party harmed or to the trustee of the bankrupt estate an amount by way of satisfaction or compensation for the loss of or damage to property.
Transfers at Undervalue	Where the Court finds that the debtor entered into a transaction and the consideration was conspicuously greater or less than the fair market value of the goods or services contracted for, then the Court may order that the other party to the transaction pay to the trustee or CCAA debtor, as applicable, the difference between the consideration actually paid and the fair market value.
Preferences	Where the Court holds that a transaction is a preference, then the transaction is void as against the trustee or CCAA debtor, as applicable. The trustee or CCAA debtor has the right to recover the property of the debtor given to the creditor as consideration for the transaction.
Declared dividends and redeemed shares	Where a corporation that is bankrupt or in CCAA proceedings has paid a dividend other than a stock dividend, or redeemed or purchased for cancellation, any shares of the corporation, at a time when the corporation was insolvent or the transaction rendered the corporation insolvent, the Court may grant judgment to the trustee or CCAA debtor, as applicable, against the directors of the corporation, jointly and severally, in the amount of the dividend or redemption or purchase price, with interest thereon that has not been paid to the corporation.
Bulk sales legislation	A sale in bulk in Ontario is voidable unless the buyer has complied with the provisions of the BSA. If a sale in bulk has been set aside or declared void and the buyer has taken possession of the stock in bulk, the buyer is personally liable to account to the creditors of the seller for the value thereof. ⁷³
Oppressive conduct	Where a corporation acts in a manner that is oppressive to a creditor, a Court can make any one of a number of orders as set out in S 2.7.8.

⁷³ The first reading of a Bill to repeal the Bulk Sales Act (Ontario) was completed on June 8, 2016; Bill 218, Burden Reduction Act, 1st Sess, 41st Parl, Ontario, 2016.

QUESTION 7

7. Duty to co-operate

- (a) **To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder's investigation into the company's affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

7.1 Obligation to co-operate with investigation into company's affairs

- 7.1.1 Where a bankrupt is a corporation, the officer executing the assignment, or such (a) officer of the corporation; or (b) person who has, or has had, directly or indirectly, control of the corporation as the official receiver may specify, shall attend before the official receiver for examination and shall perform all of the duties imposed on a bankrupt by s. 158, and, in case of failure to do so, the officer or person is punishable as though that officer or person were the bankrupt.
- 7.1.2 Subsections 16(3) to 17(2) of the BIA set out the duties and powers of the trustee in obtaining possession of the property of the bankrupt. S 158 of the BIA imposes the following duties on a bankrupt:
- (a) informing the trustee of all property that is under his/her possession or control and delivering it to the trustee;
 - (b) delivering to the trustee of all books, records, documents, writings and papers relating to the property or affairs of the bankrupt;
 - (c) attending before the official receiver for examination under oath with respect to the conduct of the corporation, the causes of the bankruptcy and the disposition of property;
 - (d) preparing and submitting to the trustee a statement of the bankrupt's affairs;
 - (e) making or giving all the assistance within his power to the trustee and making an inventory of assets;
 - (f) making disclosure to the trustee of all property disposed of within the period beginning on the day that is one year before the date of the initial bankruptcy event or such other date as the Court may direct;
 - (g) making disclosure to the trustee of all property disposed of by gift or settlement without adequate valuable consideration in the five year period prior to the bankruptcy;
 - (h) attending the first meeting of creditors;
 - (i) when required, attending other meetings of creditors or of the inspectors or attend on the trustee;
 - (j) submitting to such other examinations under oath with respect to property as may be required;
 - (k) aiding to the utmost of his power, in the realization of the property and the distribution of proceeds among creditors;
 - (l) executing such powers of attorneys, conveyances, deeds and instruments as may be required;
 - (m) examining the correctness of all proofs of claim filed, if required by the trustee;

- (n) in the case of any person that to his knowledge has filed a false claim, disclosing that fact to the trustee;
- (o) informing the trustee of any material change in the bankrupt's financial situation;
- (p) doing such acts or things in relation to the bankrupt's property in the distribution of the proceeds among his creditor as may be reasonably required for the trustee; and
- (q) keeping the trustee advised at all times of the bankrupt's place of residence or address.⁷⁴

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

7.1.4 Under an examination, a witness may claim the protection of S 5(2) of the Canada Evidence Act.⁷⁵ 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 criminal proceedings thereafter. Similar language protecting against self-incrimination is found in S 13 of the Charter of Rights and Freedoms.⁷⁶

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation periods

8.1.1 The limitation period for bringing an action against the director for any offence punishable by way of indictment is five years from the commission of the offence. If the offence is punishable by way of summary conviction, then the limitation period is three years from the commission of the offence.⁷⁷

Limitation period for civil actions

8.1.2 In relation to any liabilities created by the BIA or in relation to breaches of directors' fiduciary duties, the limitation period, in several provinces is generally six years from the date on which the cause of action accrued.⁷⁸ In Ontario, Alberta, Saskatchewan and New Brunswick, the limitation period is generally two years from the date on which the claim was discovered, with } an outside overall limitation period of 15 years in the case of Ontario.

8.2 Appeals

8.2.1 The Courts of appeal are given the power and jurisdiction to hear and determine appeals from the superior Court sitting in bankruptcy. An appeal will only be available, however, in the following cases:

- (a) if the point and issue involves future legal rights;
- (b) if the order or decision is likely to affect other causes of a similar nature in the bankruptcy proceedings;
- (c) if the property involved in the appeal exceeds \$10,000 in value;

⁷⁴ BIA, s. 158.

⁷⁵ R.S.C., 1985, c. C-5.

⁷⁶ See Part I of the Constitution Act, 1982, 1982, c. 11 (U.K.), Schedule B.

⁷⁷ *Can. (A.G.) v. Hamelin* (1986), 62 C.B.R. (N.S.) 96 (Ont. S.C.).

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

(e) in any other case, by leave of a judge of the Court of Appeal.⁷⁹

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

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

(a) against a conviction;

(i) on a question of law alone;

(ii) on a question of fact or a question of mixed fact and law with leave of the Court of Appeal; or

(iii) on any other ground with leave of the Court of Appeal; or

(iv) against a sentence with leave of the Court of Appeal, unless the sentence is one fixed by law.⁸⁰

An appeal is available in summary conviction matters as of right with no leave requirements.⁸¹

QUESTION 9

9. Foreign corporations

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

9.1 Introduction

9.1.1 The legal provisions and procedures outlined in the BIA and CCAA generally apply to corporations that are authorized to carry on business in Canada or that have an office or assets in Canada wherever incorporated and any income trust. Banks, authorized foreign banks within the meaning of S 2 of the Bank Act, insurance companies, trust companies, loan companies and railway companies are excluded from the BIA and the CCAA, and are subject to provisions of the Winding-Up and Restructuring Act⁸² (WURA).

9.1.2 In general, all the provisions of the BIA and CCAA relating to the administration of a Canadian company apply equally to the administration of a foreign company.⁸³

9.2 Jurisdiction of Canadian Courts

9.2.1 Canadian Courts have a broad statutory and equitable authority.

⁷⁸ See Limitation Act (British Columbia), The Limitations of Actions Act (Manitoba), Limitation of Actions Act (Nova Scotia), Statute of Limitations (PEI), Limitations Act (Newfoundland).

⁷⁹ BIA, s. 193.

⁸⁰ Criminal Code R.S.C. 1985 c. C-46, as amended, s. 675(1).

⁸¹ Criminal Code, s. 813(a).

⁸² RSC 1985, c. W-11.

⁸³ Refer to Part XII of the BIA and Part IV of the CCAA.

- 9.2.2 With few minor differences, Canada has adopted the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvencies (1997), one of the objectives of which is to advance the fair and efficient administration of cross-border insolvencies.⁸⁴
- 9.2.3 If no foreign proceeding has been taken against the debtor, all the property of the bankrupt, both moveable and immovable, vests in the trustee in bankruptcy when bankruptcy occurs. To obtain possession, the trustee may have to comply with the formal requirements of the law of the jurisdiction where the property is located, but legal title is conferred on the trustee by the BIA.
- 9.2.4 The BIA and the CCAA have a specific scheme for administering debtor companies where proceedings outside of Canada have been commenced in respect of the debtor companies. Foreign proceedings are defined in the BIA and the CCAA as judicial or administrative proceedings in a jurisdiction outside of Canada dealing with creditors' collective interests generally under any law relating to bankruptcy or insolvency in which the property and affairs of a debtor are subject to control or supervision by a foreign Court for the purposes of reorganization or liquidation.⁸⁵
- 9.2.5 A foreign representative may apply to the Canadian Court for recognition of a foreign proceeding in respect of which he or she is a foreign representative.⁸⁶ A foreign representative is defined in the BIA and the CCAA as a person or body, including one appointed on an interim basis, who is authorized, in a foreign proceeding in respect of a debtor, to administer or monitor the debtor's property or affairs for the purpose of reorganization or liquidation, as the case may be, or to act as a representative in respect of the foreign proceeding.⁸⁷
- 9.2.6 If the Court is satisfied that an application for the recognition of a foreign proceeding relates to a foreign proceeding, as defined in the BIA or CCAA, and that the applicant is a foreign representative in respect of that foreign proceeding, the Court will make an order recognizing the foreign proceeding. The Court will be required to specify in the order whether the foreign proceeding is a foreign main proceeding or a foreign non-main proceeding.⁸⁸
- 9.2.7 A foreign main proceeding is a foreign proceeding in a jurisdiction where the debtor has the centre of the debtor's main interests. In the absence of proof to the contrary, a debtor's registered office and, in the case of a debtor who is an individual, the debtor's ordinary place of residence are deemed to be the centre of the debtor's main interests.⁸⁹ A foreign non-main proceeding is a foreign proceeding, other than a foreign main proceeding.⁹⁰ In this regard, the CCAA departs from the UNCITRAL Model Law, which requires that the debtor have an establishment in the foreign jurisdiction in question before a foreign proceeding, that is not a foreign main proceeding, can be recognized as a foreign non-main proceeding.
- 9.2.8 Recent case law has established three principal factors to be considered by Courts where a foreign representative seeks to rebut the presumption that a debtor's centre of main interest is its registered office. The following factors, considered as a whole, tend to indicate whether the location in which the proceeding has been filed is the debtor's centre of main interest: (i) the location is readily ascertainable by creditors; (ii) the location is one in which the debtor's principal assets or operations are found; and (iii) the location is where the management of the debtor takes place.⁹¹
- 9.2.9 Where the Court determines that a foreign proceeding is a foreign main proceeding, the Court is required, on the making of an order recognizing the foreign proceeding, to grant certain enumerated relief subject to any terms and conditions it considers appropriate.⁹² For other orders or where the Court determines that a foreign proceeding is a foreign non-main proceeding, the Court has the discretion to make any order it considers appropriate in the circumstances.⁹³

⁸⁴ The UNCITRAL Model Law on Cross-Border Insolvencies is incorporated into the provisions of the BIA and the CCAA but does not appear in Model Law form or language.

⁸⁵ BIA, s. 268(1); CCAA, s. 45(1).

⁸⁶ BIA, s. 269(1); CCAA, s. 46(1).

⁸⁷ BIA, s. 268(1); CCAA, s. 45(1).

⁸⁸ BIA, s. 270; CCAA, s. 47.

⁸⁹ BIA, s. 268(2); CCAA, s. 45(2).

⁹⁰ BIA, s. 268(1); CCAA, s. 45(1).

⁹¹ *Re Lightsquared LP*, 2012 ONSC 2994. See also *Elephant & Castle Group Inc.* (2011), 81 C.B.R. (5th) 102 (Ont. S.C.).

⁹² BIA, s. 271; CCAA, s. 48.

⁹³ BIA, s. 272; CCAA, s. 49 and 50.

- 9.2.10 Under the BIA and the CCAA, if an order is made recognizing a foreign proceeding, the foreign representative may commence and continue a proceeding for a bankruptcy order, interim receiver, proposal or restructuring in respect of a debtor as if the foreign representative were a creditor, trustee, liquidator or receiver of property of the debtor, or the debtor, as the case may be.⁹⁴
- 9.2.11 The making of an order recognizing foreign proceedings and other orders in respect of a debtor for whom foreign proceedings have been recognized, does not preclude the debtor company from commencing or continuing proceedings under the BIA, CCAA or the WURA.⁹⁵ In cases of foreign main proceedings, the foreign representative may have the right to be a party to any such proceedings.

QUESTION 10

10. Insurance

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

10.1 Directors' liability insurance is available in Canada

- 10.1.1 Generally, the coverage that is available to the directors will cover amounts that the directors are legally required to pay as a result of any claim brought against them as a result of wrongful acts, and includes damages, judgments, settlements and defence costs, but generally excludes fines, penalties 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.
- 10.1.2 Most D&O policies offer two types of coverage: "Side A" and "Side B" coverage. The former provides coverage to individual directors and officers for loss resulting from claims made against them for their wrongful acts. This type of coverage applies where the directors and officers are not indemnified by the corporation. Corporate indemnity may be unavailable (i) by reason of insolvency or where the corporation is experiencing financial difficulty, or (ii) where prohibited by corporate statute or the corporation's by-laws. "Side B" coverage, reimburses the corporation for its loss where it has indemnified its directors and officers. "Side B" coverage does not protect the corporation for its own wrongdoing.⁹⁶
- 10.1.3 In addition, many policies offer "Side C" coverage (also known as "entity" coverage), which covers claims made against the corporation itself. Payments made for the benefit of the corporation put pressure on the overall policy limit. Accordingly, the amount of coverage available to directors and officers may be reduced or even exhausted by claims made against the corporation.
- 10.1.4 To protect against the risks that coverage may be exhausted, a corporation might consider:
- (a) purchasing "Side A-only" excess coverage (meaning additional insurance for the benefit of the directors and officers only); and
 - (b) including a "priority of payments" clause in favour of the directors and officers (which will ensure that amounts owed to the directors and officers are paid ahead of amounts owed to the corporation).

⁹⁴ BIA, s. 274; CCAA, s. 51.

⁹⁵ BIA, s. 271(4); CCAA, s. 48(4) and s. 49(3).

⁹⁶ Carol Hansell, *Directors and Officers in Canada: Law and Practice*, (Toronto: Carswell 2016) at chapter 15.

- 10.1.5 Notably, there are two main types of “Side A-only” excess coverage: standard follow-form excess “Side A” coverage and excess umbrella “Side A” coverage (also known as “Side A Difference in Conditions” excess coverage (“DIC Coverage”). Where “Side A-only” excess coverage is follow-form, coverage is extended in accordance with the same terms and conditions as the primary policy. By contrast, DIC Coverage is broader than follow-form excess “Side A” coverage and acts as primary insurance where the primary policy has failed to respond (for example, where the primary policy is cancelled or where the primary policy is more restrictive than the DIC Coverage).
- 10.1.6 Director and officer liability policies are typically sold for one-year terms on a “claims-made” basis, which means that coverage will only apply to claims made during the policy period, regardless of when the wrongful act giving rise to the claim occurred. More specifically, a policy is most commonly provided on a “claims-made and reported” basis, where claims must not only be made, but reported to the insurer, during the policy period.
- 10.1.7 Consideration ought to be given to how the terms “director” and “officer” are defined in the insurance policy. For example, the policy may only cover present directors and officers and not past or future directors. In this regard, directors and officers that have resigned may not have coverage.

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

- (a) Those relating to exposures deemed uninsurable, such as:
- illegal personal profits or gains;
 - reimbursement of illegally paid remuneration; and
 - profits or gains realized due to insider information; and dishonest acts – except defence costs.
- (b) Those relating to risks which are to be covered under other policies or for which no insurance is available, such as:
- claims covered by other director’s and officer’s policies, except for amounts exceeding the amounts covered by those policies;
 - bodily injury or property damage;
 - claims related to employee pension or welfare benefit plans; and
 - nuclear incidents.
- (c) Those which are specific to the nature and purpose of directors’ and officers’ policies, such as:
- pending or prior litigation;
 - circumstances known at the time the policy came into effect;
 - claims made by an organization or on its behalf;
 - acts giving rise to claims committed before the company became a subsidiary of the insured organization; and
 - service on the board of directors of companies other than the insured company or its subsidiaries, unless the insured or its subsidiaries makes a special request for such service in which case insurance might be provided.⁹⁷

⁹⁷ Carol Hansell, *Directors and Officers in Canada: Law and Practice*, (Toronto: Carswell 2016) at chapter 15.

10.3 Indemnification provisions under the CCAA

- 10.3.1 As additional protection under the BIA or CCAA, the Court has authority to grant a priority charge over all or part of the property of the debtor in favour of any director or officer of the company for an amount necessary to indemnify them against obligations and liabilities they may incur following the commencement of the proposal or CCAA proceedings.⁹⁸ The charge does not apply in respect of a specific obligation or liability incurred by a director or officer if, in the Court's opinion, the liability was incurred as a result of the director's or officer's gross negligence or wilful misconduct or, in Québec, the director's or officer's gross or intentional fault.⁹⁹
- 10.3.2 The Court may not grant the charge if, in its opinion, the company could obtain adequate indemnification insurance for the director or officer at a reasonable cost.¹⁰⁰

The information provided in this country chapter is correct as at 30/09/2016

⁹⁸ BIA, s. 64.1; CCAA, s. 11.51(1); *Re Northstar Aerospace Inc.* (2013), 2 C.B.R. (6th) 83 (Ont. S.C.).

⁹⁹ CCAA, s. 11.51(4).

¹⁰⁰ CCAA, s. 11.51(3).

CAYMAN ISLANDS

QUESTION 1

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

(a) How are directors identified / defined?

(b) 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 Directors identification / definition

In Cayman, there is no statutory definition¹ of who is a director. However, a director can be defined as someone who is responsible for the management and conduct of the company's affairs and its business operations. A director may be formally appointed by resolution of the shareholders or may be someone upon whose instructions the company is accustomed to act. These latter persons are known as "shadow directors". Whether *de facto* directors or *shadow directors*, under Cayman law, all are subject to the same duties and responsibilities.

The duties and liabilities of directors of Cayman companies arise primarily under common law, such duties include skill, care and diligence and fiduciary duties to the company. There is also the Cayman Islands Monetary Authority (CIMA) statement of guidance and registration for directors of regulated entities.

1.2 The twilight period

There is no definitive twilight zone in that once the liquidation ensues there may be various claims against a director that a liquidator can pursue. Most, but not all of these, can only be pursued by the liquidator following his appointment. From a statutory and practical perspective, once appointed, a liquidator's investigations will focus on those transactions which took place in the six months leading up to the date of the presentation of the petition (s. 146 - unfair preferences) and those which took place between the date of the presentation of the petition and the date of the winding-up order (s. 99 - dispositions after the date of the presentation of the petition). The liquidator will then consider whether there were any transactions which represent dispositions at an undervalue pursuant to s. 146.

Section 99 refers to dispositions of property after the commencement of the liquidation and relates back to the date of the presentation of the petition.

Section 145 deals with unfair preferences. It allows an official liquidator to go back up to six months prior to the commencement of the liquidation which, according to s.100, is the date of the presentation of the petition. If the company was insolvent at the time, (s. 93 sets out the circumstances in which a company is unable to pay its debts as and when they become due), and the payment was made to a related party, the rebuttable presumption is that the payment was made with a view to preferring the creditor concerned. A related party is someone who has "...the ability to control the company or exercise significant influence over the company in making financial and operation decisions".

Section 146 refers to dispositions at an undervalue. If the official liquidator is able to establish intent to defraud, a claim can be pursued for up to six years after the date of the relevant disposition. In other words, if the transaction complained of took place three years prior to the start of the liquidation, the liquidator has a further three years to challenge the transaction.

Section 147 addresses the issue of fraudulent trading. It allows the Court to impose personal liability on anyone who has knowingly been a party to the business of the company being carried on with the intent to defraud creditors. There is no time frame set out in the legislation although, in practical terms, the further into the past the fraud occurred, the more difficult it will be to establish the *mens rea* to support a fraudulent trading claim.

¹ All references to sections are, unless stated otherwise, to the Companies Law (2016 Revision) ("Companies Law").

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 the director?

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

- (i) Is the director’s liability considered to be civil, criminal or both?**
- (ii) Can a director be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?**
- (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement?**
- (iv) What defences, if any, will be available in relation to each offence?**

2.1 Acts during the twilight period that a director be held personally liable or which may otherwise have adverse consequences

If a director has been responsible for causing the company to enter into an unfair preference transaction, a disposition at an undervalue or a disposition in the period between the date of the presentation on the petition and the date of the winding-up order, the liquidator would be able to commence recovery actions against the recipients to recompense the company for its loss.

However, if the liquidator is not successful in those recovery actions he may have a misfeasance claim against the director responsible for causing the company to enter into the transaction which resulted in loss.

2.1.1 Fraudulent trading (S 147)

The requirements to establish a fraudulent trading claim are set out in S 147 (1) and are:-

- that the company is in liquidation; and
- the business of the company has been carried on with the intent to defraud creditors.

In these circumstances, pursuant to S 147 (2):-

“The Court can may declare that any persons who were knowingly parties to the carrying on of the business in the manner mentioned in sub-section (1) are liable to make such contribution, if any, to the company’s asset as the Court thinks proper.”

2.1.2 Misfeasance

This is a claim for breach of fiduciary duty, most often against a director or shadow director. A misfeasance claim in the context of a company in liquidation is most likely to arise from an allegation of the misappropriation of funds or assets, or becoming accountable for any assets or property of the company. It could also arise in the context of a director causing a company to operate its business in such a way as to cause loss, eg a controlling shareholder / corporate shadow director manipulating the operations of a subsidiary in such a way as to cause loss to the subsidiary and its creditors, but for the benefit of the controlling shareholder.

The Court can impose such order as it thinks fit that the defendant contributes to the assets of the company.

2.1.3 Fraud in anticipation of winding - up (S 134)

Where a company is ordered to be wound up by the Court, or passes a resolution for voluntary winding - up, any person, who is or was an officer, professional service provider, voluntary liquidator or controller of the company and who, within the twelve months immediately preceding the commencement of the winding - up, has-

- (a) concealed any part of the company's property to the value of ten thousand dollars or more or concealed any debt due to or from the company;
- (b) removed any part of the company's property to the value of ten thousand dollars or more;
- (c) concealed, destroyed, mutilated or falsified any documents affecting or relating to the company's property or affairs;
- (d) made any false entry in any documents affecting or relating to the company's property or affairs;
- (e) parted with, altered or made any omission in any document affecting or relating to the company's property or affairs; or
- (f) pawned, pledged or disposed of any property of the company which has been obtained on credit and has not been paid for (unless the pawning, pledging or disposal was in the ordinary way of the company's business), with intent to defraud the company's creditors or contributories, commits an offence and is liable on conviction to a fine and to imprisonment for five years.

2.1.4 Transactions in fraud of creditors (S 135)

Where a company is ordered to be wound up by the Court or passes a resolution for voluntary winding - up, any officer or professional service provider of the company who –

- (d) 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
- (d) has concealed or removed any part of the company's property, with intent to defraud the company's creditors or contributories, commits an offence and is liable on conviction to a fine and to imprisonment for five years.

2.1.5 Misconduct in the course of winding-up (S 136)

Where a company is being wound up, whether by the Court or voluntarily, a person who is or was a director, officer or professional service provider of the company and who -

- (a) does not to the best of his knowledge and belief fully and truly discover to the liquidator-
 - (i) all the company's property (except such part as has been disposed of in the ordinary way of the company's business);
 - (ii) the date on which and manner in which the company's property or any part thereof property was disposed of, if it was disposed of;
 - (iii) the persons to whom any property was transferred, if it was disposed of; or
 - (iv) the consideration paid for any property which was disposed of;
- (b) does not deliver up to the liquidator or does not deliver up in accordance with the directions of the liquidator any of company's property which 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 does not deliver up, in accordance with the directions of the liquidator, all documents in his custody or under his control which belong to the company and which he is required by law to deliver up;

- (d) knows or believes that a false debt has been proved by any person in the winding-up and fails to inform the liquidator of such knowledge or belief as soon as practicable;
- (e) prevents the production of any document affecting or relating to the company's property or affairs; or
- (f) 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 the company's creditors or contributories, commits an offence and is liable on conviction to a fine of US\$25,000 or to imprisonment for a term of five years, or to both.

2.1.6 Material omissions from statement relating to company's affairs (S 137)

- (1) Where a company is being wound up, whether by the Court or voluntarily, a person who is or was a director, an officer a manager or a professional service provider of the company, commits an offence if he makes any material omission in any statement relating to the company's affairs, with intent to defraud the company's creditors or contributories.
- (2) A person who commits an offence under subsection (1) is liable on conviction to a fine of twenty-five thousand dollars or to imprisonment for a term of five years, or to both.

In this section, "officer" includes a shadow director.

2.2 Liability of the directors – civil or criminal

In relation to each act identified in (a) above (2.1.1 - 2.1.6) the liability is as follows:-

- (a) Fraudulent trading - Liability can be both civil and criminal.
- (b) Misfeasance - Liability is civil.
- (c) Offences in anticipation of winding-up - Liability in respect of these offences is criminal and on conviction can lead to a fine and / or imprisonment for up to five years.
- (d) Transactions in fraud of creditors - Liability in respect of these offences is criminal and on conviction can lead to a fine and / or imprisonment for up to five years.
- (e) Misconduct in the course of winding-up - Liability is criminal and conviction can lead to a fine of up to US\$25,000 and / or imprisonment for up to five years.
- (f) Material omissions from statement relating to company's affairs - Liability is criminal and conviction can lead to a fine of up to US\$25,000 and / or imprisonment for up to five years.

2.3 Personal liability of directors

- (a) Fraudulent Trading - To the extent that the Court orders a director to make a contribution to the assets of the company, it is in effect imposing personal liability on a director for a portion of the liabilities of the company.
- (b) Misfeasance - If the Court orders a compensatory payment to the company as a result of a finding that the director breached his fiduciary duty, as with fraudulent trading, it is in effect imposing personal liability on a director for a portion of the liabilities of the company.
- (c) Other offences - In respect of those offences pursuant to Ss. 134 – 137 there is no personal liability, although all offences involve criminal liability.

2.4 Extent of liability

- (a) Liability will attach to the individual director against whom action is taken. In practice, the Director of Public Prosecutions (DPP) will receive a report from the liquidator (and it will be that department's decision as to whether to institute proceedings and, if so, against whom.

2.5 Time period that the transactions were entered in order for liability to attach

- (a) Section 134 – fraud in anticipation of winding-up - specifically refers to offences which have taken place in the 12 months immediately preceding the commencement of the liquidation.

QUESTION 3

3. Other persons involved with the company’s affairs who may be liable in relation to their actions during the relevant period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable for their action or inaction during the relevant period?
- (b) In respect of which acts or failure to act may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (a) Can those other persons be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?

As noted in paragraph 1(a) above, there is no statutory definition of “director” in the Cayman Islands legislation and formally appointed directors, de facto directors and shadow directors are all subject to the same duties and liabilities.

In addition to directors, a number of other categories of person may have civil and criminal liabilities imposed by Cayman Islands law in respect of the company’s activities during the “twilight period” and over the course of the company’s winding - up. These categories of person include:

- “officer”, which includes managers and secretaries (S 2);
- “controller”, which is person appointed by the Cayman Islands Monetary Authority to take control of the company;
- professional service provider; and
- voluntary liquidator.

The offences and actions giving rise to civil liability which apply to these persons are set out below.

Offences / activity	Persons liable (other than directors)
Fraud in anticipation of winding-up (S 134)	Officers, professional service providers, voluntary liquidators and controllers.
Transactions in fraud of creditors (S 135)	Officers and professional service providers.
Misconduct in course of winding-up (S 136)	Officers and professional service providers.
Material omissions from statement relating to company's affairs (S 137)	Officers and professional service providers.
Fraudulent trading (S 147)	Any persons knowingly party to the fraudulent trading.

There is no difference between the liability that may be imposed on directors and any other persons in respect of these offences / activities (see paragraph 2 above).

In addition, third parties who receive property as a result of a voidable preference (S 145) or a disposition of property made at an undervalue with an intent to defraud creditors (S 146) may be liable to return the property.

Third parties who knowingly assist in a breach of duty by a director or knowingly receive property arising from the breach of duty may have a liability to the company for its loss.

QUESTION 4

4. Transactions during the relevant period

- (a) On what basis may transactions with the company in the relevant period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons properly incur further credit during the relevant period?

4.1 Basis that transactions with the company in the relevant period may be set aside

Transactions entered into with the company during the twilight period can be set aside on the basis that they constitute either a preference or a disposition made at an undervalue.

4.1.1 Voidable preferences

Pursuant to S 145 of the Companies Law (2013 Revision), every conveyance or transfer of property, or charge thereon, and every payment obligation and judicial proceeding, made, incurred, taken or suffered by any company in favour of any creditor or class of creditor at a time when the company is unable to pay its debts within the meaning of S 93, with a view to giving such creditor a preference over the other creditors, shall be invalid if made, incurred, taken or suffered within six months immediately preceding the commencement of a liquidation. There is no requirement for the transaction to have been made with an intention to defraud creditors.

Where the payment is made to a related party of the company, which is defined as a party which has the ability to control the company or exercise significant influence over the company in making financial and operating decisions, it is deemed to have been made with a view to giving that creditor a preference.

The test for determining whether the company entered into the transaction with a view to giving a creditor a preference over the other creditors is the “dominant intention to prefer” test ascribed by the common law.² The Court can infer an intention to prefer from the circumstances of the case; there is no requirement that the intention can only be established by direct evidence.

A company shall be deemed to be unable to pay its debts within the meaning of S 93 if:

- (a) a creditor by assignment or otherwise to whom the company is indebted at law or in equity in a sum exceeding US\$100 has served a demand for payment on the company at its registered office which the company has neglected to pay, secure or compound to the satisfaction of the creditor for a continuous period of three weeks;
- (b) execution of other process issued on a judgment, decree or order obtained in the Court in favour of a creditor at law or in equity in any proceedings instituted by such creditor against the company, is returned unsatisfied in whole or in part; or

² *RMF Market Neutral Strategies (Master) Limited v DD Growth Premium 2X Fund* [2013] 2 CILR 361.

- (c) it is proved to the satisfaction of the Court that the company is unable to pay its debts. The test of inability to pay debts under this section is one of commercial insolvency, the so-called cash flow test, rather than a balance sheet test. It is based on a company's present inability to pay debts as they fall due.³

The “commencement of liquidation” is defined, depending on the circumstances, as:

- (i) in the case of a voluntary winding-up, the date when the resolution for the appointment of a voluntary liquidator is passed by the company or when the period, if any, fixed for the duration of the company by the articles of association has expired; or
- (ii) in the case of compulsory winding-up proceedings, the presentation of a petition for winding-up the company.

4.1.1.1 Defences

There are no statutory or common law defences available to a statutory claim under S 145. The effect of a payment falling within S 145 is that it is invalid and the recipient is obliged to pay back an equivalent sum of money to that received. There is no discretion in the Court to make any other order.⁴

4.1.2 Disposition made at an undervalue

A disposition at an undervalue occurs where a company has disposed of its property for either no consideration or for significantly less than the value, in money or money's worth, of the property with an intention to wilfully defeat an obligation or liability (including a contingent liability) owed to a creditor which existed at the time of disposition and has subsequently entered into liquidation.

Pursuant to S 146, every disposition of property made at an undervalue is voidable at the instance of its official liquidator who maintains the burden of establishing an intention on the part of the company to defraud its creditors. Where the burden is established, the Court can make an order for restoration of the *status quo* by unwinding the transaction.

There are no statutory or common law defences available to a statutory claim under S 146. The effect of a disposition falling within S 146 is that it is invalid and the recipient is obliged to return the property to the company. Where a disposition is set aside under S 146 and the Court is satisfied that the transferee has not acted in bad faith, the transferee shall have a first and paramount charge over the property which is the subject of the disposition of an amount equal to the entire costs properly incurred by the transferee in the defence of the action or proceedings.

4.1.3 Disposition of the company's property made after the commencement of winding-up

Pursuant to S 99, when a winding-up order has been made, any dispositions of the company's property and any transfer of shares or alteration in the *status quo* of the company's members made after the commencement of the winding-up is, unless the Court otherwise orders, void.

4.2 **Basis that directors and other persons involved with the company's affairs may incur credit during the twilight period**

An unsecured loan to the company does not constitute a disposition of the company's property and is therefore outside the scope of Ss. 145 and 146.

However, a director of a Cayman Islands company is under a fiduciary duty, when exercising his judgment, to act in good faith in what he considers to be the best interests of the company. Where the company is insolvent or of doubtful solvency, the interests of the company are aligned with those of its creditors and directors are expected to proceed in a manner which minimises the potential loss to creditors. A director should not cause the company to incur further liabilities where he knows that there is no reasonable prospect of the company avoiding insolvency and, in certain circumstances, a director may be held personally liable to contribute to the company's assets, e.g. where he is knowingly a party to the company's fraudulent trading under S 147.

³ *In the matter of FIA Leveraged Fund* (FSD 13 of 2012), at paragraph 105; *Culross Global SPC Limited v Strategic Turnaround Master Partnership Limited* [2008] CILR 447.

⁴ *In re Weaving Macro Fund Fixed Income Ltd* [2015] 2 CILR 278.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Introduction

Following the appointment of a liquidator to a company,⁵ the authority and powers of the directors are generally superseded and taken over by the liquidator. The liquidator appointed is required to review the actions taken by the directors 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. Several of the offences set out in Part V of the Companies Law arise only in the context of a winding-up and subsequent appointment of a liquidator. Consequently, in most cases only the liquidator is empowered to bring actions against directors and others where there has been a breach of either the legal and / 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 at 5.3.2 below.

However, where criminal proceedings are brought against directors or others in respect of some form of criminal action, such proceedings must be brought by the DPP of the Cayman Islands. The DPP⁶ is entitled to bring prosecutions in the Cayman Islands Summary Court, Grand Court and Court of Appeal.

5.2 Criminal proceedings

5.2.1 Offences

The DPP may bring an action against the directors and others involved in relation to the offences set out below. The liquidator is under a duty as an officer of the Court to bring any such offences to the attention of the DPP.

- (a) Fraudulent trading – S 147
- (b) Fraud in anticipation of winding-up – S 134
- (c) Transactions in fraud of creditors – S 135
- (d) Misconduct in the course of winding-up – S 136
- (e) Material omission in statement of affairs – S 137
- (f) A director can also be criminally liable under the Penal Code (2013 Revision) for offences of theft and fraud, including:
 - (i) making a false statement with an intent to deceive members or creditors – S 257, Penal Code; and
 - (ii) false accounting – S 255, Penal Code.
- (g) Money laundering offences under the Money Laundering Regulations (2015 Revision).⁷
- (h) Creation of false or misleading market and insider dealing – Ss. 24 and 25 of the Securities Investment Business Law (2015).

⁵ Typically, in the Cayman Islands two liquidators are appointed. However, for the purposes of these questions we refer to a liquidator in the singular.

⁶ This office was created by s 57 of the Cayman Islands Constitution, 2009.

⁷ As promulgated under the Proceeds of Crime Law (2014 Revision).

5.3 Civil proceedings

- 5.3.1 In relation to civil proceedings, the ability to bring actions against directors and others is primarily held by the liquidator. However, in respect of certain actions which have caused loss to the company and its creditors, a wider range of persons are allowed to bring actions to recover funds for the benefit of the company's creditors. Where an action for a contribution to the company's assets is successful, even if the person bringing the action is not the officeholder, any recoveries made will be for the benefit of all creditors of the company and will be distributed amongst the creditors in accordance with the normal rules relating to priority and *pari passu*.
- 5.3.2 The table below sets out those 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, creditor, or contributory
Fraudulent trading	Liquidator or DPP
Avoidance of property dispositions	Liquidator
Breach of fiduciary duty	Liquidator, creditor or contributory
Voidable preference	Liquidator
Transactions at an undervalue	Liquidator
Disqualification	While there is no formal statutory disqualification regime in the Cayman Islands, CIMA ⁸ must give its written approval for the appointment of a director or other senior officer by a licensee. ⁹ CIMA is obliged to refuse to grant such approval if it is of the opinion that the director or other senior officer is not a fit and proper person to hold such office.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Offence	Remedy available
Dispositions of property	Any disposition 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, unless otherwise ordered by the Court.
Unfair preference	When disposition of the company's property is made within six months immediately preceding the winding-up (or two years in the case of connected parties) with a view to giving a creditor a preference over the other creditors, a liquidator may seek a Court order restoring the position to what it would have been had the preferential disposition not been made.

⁸ Cayman Islands Monetary Authority.

⁹ As defined in the Banks and Trusts Companies Law (2013 Revision).

Offence	Remedy available
Transactions at an undervalue	Every disposition of property made at an undervalue by or on behalf of a company with intent to defraud shall be voidable at the instance of the liquidator.
Fraudulent trading	The liquidator may apply to Court for an order requiring the wrongdoer (ie a director or officer) to contribute to the company's assets, as the Court thinks appropriate.
Misfeasance	The Court may impose such order as it thinks fit that the director make a contribution to the assets of the company.
Fraud in anticipation of winding-up	The director may be liable on conviction to a fine and imprisonment for up to five years.
Transactions in fraud of creditors	The director may be liable on conviction to a fine and to imprisonment for up to five years.
Misconduct in the course of winding-up	The director may be liable on conviction to a fine of US\$25,000 or to imprisonment for a term of up to five years, or to both.
Material omissions from statement relating to company's affairs	The director may be liable on conviction to a fine of US\$25,000 or to imprisonment for a term of up to five years, or to both.
Breach of fiduciary duty	The director may be ordered to compensate the company for all loss and damage caused by a breach of his fiduciary duty. Alternatively, the director as fiduciary may be required to account for any profit that he or she has received in breach of fiduciary duty (a plaintiff must elect between equitable compensation and an account as the two are alternatives to, and inconsistent with, each other).
Making a false statement with an intent to deceive members or creditors	The director may be liable on conviction to imprisonment for up to seven years.
False accounting	The director may be liable on conviction to imprisonment for up to seven years.
Money laundering offences under the Money Laundering Regulations	Offences under these regulations may lead to either, on summary conviction, a fine of approximately US\$6,000 or on indictment a term of imprisonment for up to two years and a fine upon conviction.
False or misleading market / insider dealing	A party who commits an offence under S 24 or 25 of the Securities Investment Business Law is liable on summary conviction to a fine of US\$4,000 and to imprisonment for one year; or on conviction on indictment to a fine of US\$10,000 and to imprisonment for up to seven years.

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3(a) above obliged to co-operate with the insolvency office - holder's investigation into the company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Duty to co - operate with investigation into the company's affairs

Section 103(1) of the Companies Law establishes a duty on every relevant person to co-operate with the official liquidator. "Relevant person" includes any person who, whether resident in the Islands or elsewhere:

- (a) has made or concurred with the statement of affairs;
- (b) is or has been a director or officer of the company;
- (c) is or was a professional service provider to the company;
- (d) has acted as a controller, advisor or liquidator of the company or receiver or manager of its property; or
- (e) not being a person falling within paragraphs (a) to (c), is or has been concerned or has taken part in the promotion, or management of the company.

This section does not specifically include shadow directors, but S 103(1)(d) and (e) suggest that these provisions also cover a person who is deemed to be a shadow director.

Through S 103(7), the power is extra-territorial in that the Court can make an order against a relevant person resident outside the Cayman Islands and can issue a letter of request to a foreign Court to obtain evidence from a relevant person resident outside the Cayman Islands.

7.2 Private examination of relevant persons

By virtue of S 103(3) of the Companies Law, where a company is being wound up, the official liquidator may at any time before its dissolution apply to the Court for an order (a) for the examination of any relevant person; or (b) that a relevant person transfer or deliver up to the liquidator any property or documents belonging to the company.

The relevant person can be examined either by an affidavit in answer to written interrogatories, by oral examination by the official liquidator, or both.

7.3 Company's statement of affairs

Section 101 of the Companies Law states that where the Court has made a winding-up order or appointed a provisional liquidator, the liquidator may require certain persons to prepare and submit to him a statement as to the company's affairs in a prescribed form. The persons who may be required to provide such a statement are as follows:

- (a) Persons who are or have been directors or officers of the company.
- (b) Persons who are or have been professional service providers to the company.
- (c) Persons who are or have been employees of the company, during the period of one year immediately preceding the relevant date.

The statement must be verified by affidavit and must include such information as particulars of the company's assets, liabilities and details of the company's creditors, amongst other things. The statement must be submitted within 21 days after the prescribed notice of the requirement is given by the liquidator.

A person who without reasonable excuse fails to comply with the requirement to provide a statement of affairs, is liable on conviction to a default fine.

Is this obligation modified by any rules in relation to the defence against self - incrimination? Are any human rights laws applicable to such obligations? For example in Europe, 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.

7.4 Applicable human rights laws

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

Order 7, rule 3(11) of the Cayman Islands Companies Winding Up Rules 2008 provides, in the context of oral examination of a relevant person regarding a corporation, that “the examinee shall answer all the question put to him (subject to any claim of self - incrimination or legal professional privilege) which are within his knowledge or means of knowledge regarding any matter within the scope of the order and is compellable to give the names and addresses of all persons who reasonably might be expected to have knowledge”.

By the United Kingdom’s Act of ratification of 20 May 1976, the International Covenant on Civil and Political Rights (ICCPR) was extended to the Cayman Islands. 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”. Article 7(6) of the Cayman Islands Constitution Order 2009 also states that “[n]o person who is tried for a criminal offence shall be compelled to give evidence at the trial”. This right may be relied upon by a relevant person under question during an investigation of a company.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What appeals are available from the decision of the lower Courts?

8.1 Limitation period for criminal proceedings

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 actions referred to above.

Article 78 of the Criminal Procedure Code (2014 Revision) states that “no offence which is triable summarily shall be triable by a Summary Court unless the charge or complaint relating to it is laid within six months from the date on which evidence sufficient to justify proceedings came to the actual or constructive knowledge of a competent complainant.”

8.2 Limitation period for civil actions

In relation to breaches of the director’s fiduciary duties or for any common-law duties in tort (other than libel or slander) or breach of contract, the limitation period is generally six years from the date on which the cause of action accrued.¹⁰ Where the cause of action is based on fraud of the defendant, or any relevant fact has been deliberately concealed by the defendant, or for the relief from the consequences of a mistake, the limitation period does not begin to run until the plaintiff discovers the fraud, concealment or mistake.¹¹

The Companies Law does not stipulate general limitation periods in connection with the actions referred to above, but a claim for fraudulent trading pursuant to S 147 of the Companies Law must be commenced by an official liquidator within six years after the date of the relevant disposition.¹²

¹⁰ Section 4(1), Limitation Act (1996 Revision).

¹¹ Section 37(1), Limitation Act (1996 Revision).

¹² Section 146(4), Companies Law.

8.3 Appeals

There is a right of appeal from any judgment of the Grand Court in the exercise of its civil jurisdiction to the Court of Appeal. Where leave is not required, the notice of appeal must be filed within 14 days after the date of the judgment.¹³ If leave is required, the summons or motion must be filed within 14 days from the date on which the judgment or order is filed.¹⁴

Appeals from decisions of the Court of Appeal to the Privy Council, being the highest Court of appeal for Cayman Islands, are permitted in one of three circumstances:

- (a) as of right (but subject to the Court of Appeal confirming that right and imposing conditions as appropriate) where the matter in dispute is of the value of £300 or upwards or where the appeal involves directly or indirectly a claim to or question with respect to property or a right of the value above £300;
- (b) with leave of the Court of Appeal where in the opinion of the Court the question involved is one that, by reason of its great general or public importance, ought to be submitted to the Privy Council; or
- (c) with special leave of the Privy Council – the Judicial Committee of the Privy Council will determine the application for leave to appeal on the papers or at an oral hearing.

QUESTION 9

9. Foreign corporations

9.1 Introduction

The availability of Cayman Islands law actions, including against directors, in relation to a winding-up and brought by a liquidator, will generally depend on whether a company may be wound up under Cayman Islands law. That topic is addressed below at 9.2.

9.2 Winding-up of a foreign company

In terms of S 89 of the Companies Law, “company” includes a foreign company in respect of which the Cayman Court has made a winding up order.

In terms of S 90 of the Companies Law, the Cayman Court may make a winding-up order in respect of a foreign company which:

- (a) has property located in the Islands;
- (b) is carrying on business in the Islands;
- (c) is the general partner of a limited partnership; or
- (d) is registered with the Registrar under Part IX of the Companies Law (having a place of business or carrying out business on the Islands).

It should be noted that whilst the Cayman Court can make a winding-up order in respect of a foreign company, any formal dissolution of that Company as a legal entity will need to take place in the jurisdiction of incorporation of such Company.

As with a Cayman Islands winding-up of a Cayman Islands company, whether a judgment against a director or enforcement over assets in a foreign jurisdiction can then be effectively pursued based on the law of that foreign jurisdiction.

¹³ Section 19, Court of Appeal Law (2011 Revision).

¹⁴ Section 11(5), Court of Appeal Rules (2014 Revision).

9.3 Foreign insolvency proceedings of a foreign company

Sections 240-242 of the Companies Law, which supplement and partially codify the common law, provide that on the application of a foreign representative the Cayman Court may make ancillary orders to assist foreign insolvency proceedings against the foreign company or other relevant person for the purposes set out in S 241.¹⁵ It is thus possible that domestic Cayman Islands law actions, relevant to those purposes,¹⁶ could be made available to a foreign representative in respect of a foreign company, even where there is no Cayman Islands winding-up.¹⁷ The Privy Council decision in *Singularis Holdings Ltd v PwC*¹⁸ precludes this possibility of domestic actions applying in a foreign insolvency on a common-law basis (unless by the terms of the actions they apply), but not on the basis of Ss. 240-242.

QUESTION 10

10. Insurance

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

Directors' and officers' insurance cover is available. Also, indemnity clauses in the company's articles of association and / or the director's service contract, are often used. The effect of such clauses is to contract out of claims against the director at the suit of, or derivative actions from, the company. Although such clauses are allowed, they will not protect a director against liability caused by fraud, wilful neglect or default as it is not possible to contract out of the irreducible core of obligations owed by a fiduciary.¹⁹

The information provided in this country chapter is correct as at 28/02/2017

¹⁵ The purposes are: (a) recognising the right of a foreign representative to act in the Islands on behalf of or in the name of a debtor; (b) enjoining the commencement or staying the continuation of legal proceedings against a debtor; (c) staying the enforcement of any judgment against a debtor; (d) requiring a person in possession of information relating to the business or affairs of a debtor to be examined by and produce documents to its foreign representative; and (e) ordering the turnover to a foreign representative of any property belonging to a debtor. S 242 states the Court is to be guided by matters which will best assure an economic and expeditious administration of the debtor's estate, consistent with: (a) the just treatment of all holders of claims against or interests in a debtor's estate wherever they may be domiciled; (b) the protection of claim holders in the Islands against prejudice and inconvenience in the processing of claims in the foreign bankruptcy proceeding; (c) the prevention of preferential or fraudulent dispositions of property comprised in the debtor's estate; (d) the distribution of the debtor's estate amongst creditors substantially in accordance with the order prescribed by Part V; (e) the recognition and enforcement of security interests created by the debtor; (f) the non-enforcement of foreign taxes, fines and penalties; and (g) comity.

¹⁶ Albeit this is more likely to be Cayman claw-back type claims than Cayman claims against directors which might fall less easily into the purposes set out in s 241 (see above).

¹⁷ In *Picard v Primeo Fund* (CA) [2014] (1) CILR 379 the Cayman Court of Appeal allowed domestic Cayman claw-back claims against Cayman incorporated investors in respect of the Madoff bankruptcy in New York on the basis of ss 240-242.

¹⁸ *Singularis Holdings Ltd v PwC* (PC) [2014] UKPC 36, judgment of Lord Sumption at paragraph 102.

¹⁹ *Renova Resources v Gilbertson and others* (GC) [2009] CILR 268.

CHINA

Introduction

The issues concerning the “twilight zone” in China are mainly governed by the Company Law as amended in 2013 (Company Law) and the Enterprise Bankruptcy Law of 2006 (Bankruptcy Law). Both represent the government’s serious commitment to market-oriented reforms and its efforts to close the gap between the domestic regime and international rules in corporate and bankruptcy practice. The implementation of these laws has promoted market discipline and rule of law in China’s transitional period as it moves towards a market economy.

Presently, China does not have a uniform business enterprise law. The current framework has been developed from a dual-track of legislations: on one line, there are enterprise laws that are adopted based on the ownership classification under the old ideology, such as the State-Owned Enterprises Law (1986), Urban Collective Enterprise Law (1991), Sino-Foreign Equity Joint Venture Law (1979 as amended in 2016), Sino-Foreign Contractual Joint Venture Law (1988 as amended in 2016), and Wholly Foreign Owned Enterprise Law (1986 as amended in 2016). On the other line, the Company Law (1993 as amended in 2013), the Partnership Enterprise Law (1997 as amended in 2006) and the Sole Proprietorship Enterprise Law (1999), known as the modern enterprise system, have also been introduced into China. As a result, some rules on directors’ liabilities may not be strictly consistent under different laws and it may be difficult to discuss them one by one within the limited space of this project. Thus, this chapter will have its primary focus on the provisions of the Company Law, the Bankruptcy Law and related regulations.

In addition to the formal legislation, some other legal rules may also need to be taken into account, such as the judicial interpretations and circulars promulgated by the Supreme People’s Court and various state regulatory authorities, such as China Securities Regulatory Commission (CSRC), Ministry of Commerce (MOFCOM) and the State Administration of Industry and Commerce (SAIC). As a country with a strong civil law tradition, judicial decisions are neither systematically reported, nor strictly followed as precedents, although a guiding case practice has been developed by the Supreme People’s Court since 2011 to provide the lower courts with practical reference. As a result, this chapter includes a limited number of cases in order to illustrate application and enforcement of the laws in practice. Under the current Chinese legal system, however, the judicial interpretations issued by the Supreme People’s Court have been playing a very important role in stipulating judicial policies and approaches in practice. Thus far, the Supreme People’s Court has promulgated two sets of provisions on the application of the Bankruptcy Law on 9 September 2011 (Part I) and 5 September 2013 (Part II), respectively.

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

QUESTION 1

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

(a) How are directors identified / defined?

(b) 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 Identification / definition of directors

Neither the Company Law, nor the foreign investment enterprise laws provide a definition of “directors”. Under the current Company Law, directors are just those who are duly elected and appointed by the shareholders’ meeting by a simple majority.¹ As such, the common law concepts, such as “*de facto* director” or “shadow director” are not used in China. In *Ding Liye v China Securities Regulatory Commission*, the plaintiff challenged the Commission’s fine against him as a director of a listed company for its serious failure to comply with the disclosure rules on the ground that he was just a ‘nominal’ appointment by the controlling shareholder without any substantive power. This argument was rejected by the Intermediate People’s Court of Beijing.²

The Company Law also for the first time defines senior officers, the controlling shareholder and the *de facto* controller of a company and subjects them to various legal liabilities. According to art. 216 (1), senior officers include managers, deputy managers, persons in charge of the financial affairs of the company, the secretaries of listed companies and other individuals specified in the articles of association. In general, a senior officer shall owe the same duties and attract the same liability as a director.³

1.2 The twilight period

In terms of liability against directors, the current Enterprise Bankruptcy Law seems to stipulate different twilight periods on different grounds. Articles 31, 32 and 33 set out the transactions vulnerable to the avoidance power due to an unfair preference or fraud with the referring-back period of even longer than one year (see the discussion below). In all these situations, the legal representative and other responsible persons shall be held liable for damages to the creditors’ interest.⁴ Moreover, art. 125 provides that directors, supervisors and senior officers shall be liable for their violation of duty of loyalty and due diligence causing bankruptcy of the enterprise, which seems to allow certain cause of actions based on transactions even beyond the period of avoidance power.

It should be noted that in China, as a socialist country, directors of different types of enterprises may be subject to different forms of liability. Most of the provisions of the Criminal Law mentioned below apply only to directors or managers of state-owned companies and enterprises (SOEs) as measures to protect the state’s assets and public ownership.⁵ As a result, directors of these companies may face more forms of liability during the twilight period compared with directors of other companies. For instance, according to Article 73 of the Law of Enterprise with State Assets of 2008 directors and senior officers of wholly state owned companies or enterprises or state capital holding companies shall be dismissed for the serious loss suffered by these companies and disqualified for at least five years.

Since the twilight period concerns both transactions of a company vulnerable to attack and personal liabilities of directors and other parties involved, different laws need to be considered. Chapter 4 of the Bankruptcy Law sets out four types of avoidance powers with different referring-back periods. Article 31 of the Bankruptcy Law allows the avoidance power to be exercised to rescind any transaction without consideration or at an obviously unreasonable price, upgrading an unsecured claim to a secured one, making payment for premature debts, or giving up claims

¹ Articles 38 (2) and 44 of the Company Law.

² The judgment is available at <http://www.platolaw.com/article/1310621214515-RGQGY5MXEKBQ.pdf> (in Chinese).

³ Articles 147, 148, 149 and 152 of the Company Law and art. 125 of the Bankruptcy Law.

⁴ Article 128 of the Bankruptcy Law.

⁵ Such as arts. 166, 167, 168 and 169 of the Criminal Law of 2015.

that the debtor enterprise may exercise within one year of the bankruptcy petition being accepted by the People's Court.

Secondly, according to art. 32 a payment of unfair preference made within six months before the People's Court's acceptance of the bankruptcy case, may be revoked where the debtor enterprise repays its debts to certain creditors while it is insolvent.⁶ It should be noted that unlike other jurisdictions with a single and uniform insolvency test, the Bankruptcy Law sets out two bankruptcy tests: a cash-flow test and a balance-sheet test. This approach is clearly intended to provide the People's Court with more discretion in making an insolvency declaration.⁷ As a result, the application of art. 32 may be subject to some uncertainties.

The third type of avoidance targets transfers or concealing of the debtor's assets in order to evade or fabricate obligations. Article 33 of the Bankruptcy Law empowers the bankruptcy administrator to recover all these assets on the ground of the transaction being void *ab initio* without specifying a timeframe.

Finally, any assets of the debtor company seized by its directors, supervisors or senior officers by way of abnormal incomes or misappropriation, shall be recovered subject to an unspecified period.⁸

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

In terms of personal liability, directors and senior officers may be subject to both criminal and civil penalties. For the former, the Criminal Law of China sets out criminal penalties against the wrongdoings of company directors, supervisors and senior officers in dealing with assets of their company, including concealing the company's assets or making a false record in the course of liquidation; transfer of the company assets at a price obviously lower than the market price; and corruption or misappropriation for personal benefit causing significant losses, particularly to state-owned companies.⁹ The penalties, depending on the gravity of the case, may range from detention, a fine, imprisonment or even the death penalty.¹⁰ As such, the duration of the twilight period in the criminal law context can be very long as the criminal statutory limitation may run from five years to more than 20 years, depending on the gravity of the case.¹¹

Before the promulgation of the Bankruptcy Law of 2006, the Supreme People's Court issued the Provisions on Certain Issues Concerning Trials of Enterprise Bankruptcy Cases on 30 July 2002 (The Supreme People's Court Provisions of 2002). According to this judicial circular, as a measure to combat fraudulent bankruptcy practice, the People's Court shall not accept a bankruptcy petition if the debtor is found to have evaded its obligations by concealing or transferring its assets.¹² Even if a bankruptcy case has been accepted, the People's Court may still turn down the bankruptcy petition if the conduct of evasion is found, or the whereabouts of large amounts of funds of the debtor are unknown without reasonable explanation.¹³ In these circumstances, the case may be referred directly to the state authority for criminal investigation.¹⁴

For civil liability cases, in addition to the periods for exercising the avoidance power, art. 125 of the Bankruptcy Law explicitly stipulates that directors, supervisor and senior officers shall be liable for violation of their fiduciary and due diligence duties causing the bankruptcy of the debtor and shall be disqualified on such ground for three years from the end of the bankruptcy proceedings. Article

⁶ The insolvency test is stated in art.2 of the Enterprise Bankruptcy Law as the debtor enterprise being unable to repay all the debts due, its assets are insufficient to repay all the debts, or the debtor apparently lacks the capacity to pay the debts.

⁷ The insolvency test has been further elaborated upon in the Provisions on Certain Issues Concerning Application of the Enterprise Bankruptcy Law of the Supreme People's Court (Part 1) dated 9 September 2011.

⁸ *Ibid*, art. 36.

⁹ See arts. 161, 162, 166, 167, 168, 169 and 271 of the Criminal Law of China of 2015.

¹⁰ For example, under art. 271 of the Criminal Law a director may be sentenced to imprisonment for more than five years for unlawful misappropriation of large sum of company's assets. Arts. 271 and 383 even stipulates the death penalty for embezzlement of large sum of state assets.

¹¹ Article 87 of the Criminal Law of China of 2015. Art. 87 (4) provides that for the crimes deserving life imprisonment or death penalty the statutory limitation could be extended for more than 20 years, subject to the approval of the People's Supreme Procuratorates.

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

¹³ *Ibid*, art. 14.

¹⁴ *Ibid*, art. 102.

101 of the Supreme People's Court Provisions of 2002 further provides that the liquidation committee (under the Bankruptcy Law of 2006 this should be the power of the bankruptcy administrator) may take legal action against the legal representative or other responsible persons for damages caused by their concealing, misappropriating, unfair transfer of the debtor's assets, changing of security arrangements, payment of premature debts and giving up the debtors' claims.

The Supreme People's Court adopted its Consolidated Provisions on Certain Issues Concerning Application of the Company Law on 1 March 2014 (Consolidated Provisions 2014 of the Supreme People's Court). According to art. 14 of the Consolidated Provisions (Part 3), directors and other senior officers may be held jointly liable with a shareholder who engaged in capital flight to the extent of the sum withdrawn, if they assisted with such conduct rendering the company unable to repay the debts. As such, the course of action against directors and senior officers in this type of case may reach back to their conduct at the time of aiding and abetting.

According to art. 135 of the General Principles of Civil Law, the statutory limitation to deal with these types of misconduct through civil proceedings shall be two years, unless the law provides otherwise. The two-year period starts to run when the party concerned knows, or should have known, of the infringement, but cannot be longer than 20 years. In practice, the People's Court may also exercise its discretion in applying the laws to a given case. The bankruptcy of Harbin Purchasing Supply Centre¹⁵ in 1995 may serve as a good example in this regard. In this case, the Supreme People's Court found that the Centre had withdrawn most of its capital before it applied for the bankruptcy of a wholesale market it had established. Although the withdrawal took place beyond the reach of the avoidance power period, the Court allowed the recovery from the Centre in terms of art. 58 (1) of the General Principles of Civil Law, which states that a contract shall be void *ab initio* if it is used as a means for unlawful activity.

As with most other nations, under the current legal regime there is no single uniform twilight zone, but different time frames that subject directors and other persons involved to different types of liability, depending on the nature and gravity of the conduct concerned.

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 the director?
- (b) In relation to each act identified in (a) above:
 - (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement?
 - (iv) What defences, if any, will be available in relation to each offence?

Under the current Company Law, directors and senior officers¹⁶ owe their fiduciary duties to their companies, which include the duty of loyalty and due diligence and the duty of compliance with the law, regulations and the articles of association of the company.¹⁷ More specifically, a director is prohibited from misappropriating the company's assets, depositing the company's assets in any personal account, providing a loan or security to others in violation of the articles of association,

¹⁵ 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).

¹⁶ Article 217 of the Company Law defines the scope of senior officers, including managers, chief financial officers, the secretary of listed companies and other individuals stipulated in the articles of association of the company.

¹⁷ *Ibid.*, art. 148.

dealing with company in conflict of interests, seizing the company's business opportunity, receiving bribes or secret commissions, disclosing the company's secrets without approval and other conduct in violation of fiduciary duties.¹⁸

Article 150 of Company Law stipulates that directors shall be liable for damages to the company caused by their violation of the law, regulations and articles of association in discharging their duties. Moreover, under art. 113 all directors are responsible for resolutions adopted by the board of directors as a whole. They shall be liable for the loss suffered by the company due to the violation of the law, regulations and the articles of the company by the board resolutions.

A director may only be exempted if he opposed the adoption of the resolution concerned and such opposition was recorded in the minutes of the board meeting.

Article 125 of the Bankruptcy Law further provides that directors shall be liable for the bankruptcy caused by their violation of fiduciary and due diligence duties and shall be disqualified for three years at the end of the bankruptcy proceedings.

The mechanism of independent directors has been introduced as a means of improving corporate governance in China. Article 123 of the Company Law requires all listed companies to appoint independent directors and the State Council, as the Central Government, was drafting a regulation in this regard at the time of writing. According to art. 50 of the Principles of Corporate Governance of Listed Companies of 2002 promulgated by the CSRC, independent directors owe their fiduciary and due diligence duties to all shareholders to safeguard the interests of the company, particularly the interests of minority shareholders. As such, a new cause of action against independent directors has emerged. In 2001, the CSRC imposed a fine against the directors of Baiwen Company¹⁹ of Zhengzhou City after serious misrepresentations and insolvency were revealed. One of the independent directors lodged his appeal for reconsideration on the ground that his post was merely an honorary one and he did not participate in the company's management or receive an honorarium. The CSRC rejected his arguments and the People's Court later dismissed his claim on the ground of statutory limitation. Although the court did not rule on the substantive matter, it has been widely agreed that the case would have a significant impact on directors' duties and liabilities.

In a more recent case,²⁰ the First Intermediate People's Court of Beijing, in affirming the CSRC's fine against a director of a listed company for its disclosure violation, held that the burden of proof shall be on the director to show due fulfilment of his due diligence duty.

Together with the enhancement of the legal liability of directors to the company and shareholders, the legal rules on creditor protection have also been improved in recent years. As mentioned above, the Bankruptcy Law streamlines directors' liability to creditors in the course of bankruptcy and liquidation proceedings. First, the avoidance power may annul transactions without consideration or below a reasonable price, as an unfair preference or even as a transaction with fraudulent intention. Directors are also subject to the avoidance power obliging them to return the company's assets that were misappropriated.²¹

Article 128 of the Bankruptcy Law holds the legal representative, (who under the Company Law could be served by the Chairman of the board, an executive director or a manager)²² and other responsible persons liable to compensate creditors for damage caused by their violation in this regard. Article 101 of the Supreme People's Court Provisions (2002) also provides that the legal representative of a bankrupt enterprise and other responsible persons are liable for their unfair or fraudulent transfer of assets.

Secondly, in the course of bankruptcy and liquidation proceedings, the Bankruptcy Law mandates the legal representative of the debtor and other senior officers to co-operate in good faith. In particular, they are under a legal duty to take due custody of the assets, seals, accounts, books and documents of the debtor, faithfully to answer questions from the court, the bankruptcy administrator and creditors, and not to leave their residence without the court's permission.²³ Violation of these duties may lead to the court's summoning them for questioning, admonishment

¹⁸ *Ibid*, arts. 148 and 149.

¹⁹ The case is reported and discussed in Feng Guo, Zhang Yan and Tao Guanghui (ed.), *Cases in China Securities Market*, People's University of China Press, 2003, at 93-116 (in Chinese).

²⁰ *Supra*, note 2.

²¹ Articles 31, 32, 33 and 36 of the Bankruptcy Law.

²² Article 13 of the Company Law.

²³ Article 15 of the Bankruptcy Law.

and a fine.²⁴ Moreover, without the court's approval, a director and other senior officers cannot transfer any share of the debtor they hold to any third party.²⁵

Thirdly, under the Consolidated Provisions 2014 of the Supreme People's Court, directors of a company, together with shareholders, shall be liable for losses caused by their failure to commence the voluntary liquidation within the required statutory period.²⁶ According to art. 184 of the Company Law, the liquidation should begin within 15 days of the taking place of events stipulated either by the law or the shareholders' agreement, such as the end of the operational term or shareholders' agreement.

Directors may also be liable to creditors for the disposition of company assets in bad faith,²⁷ or cancellation of the company's business registration using a false liquidation or without liquidation at all.²⁸ For insolvent dissolution, art. 183 of Company Law provides that shareholders with 10% voting powers may petition the People's Court to dissolve the company if the continuation of its operational and managerial difficulties would cause serious losses to the interests of the shareholders and other solutions may not be feasible.

As discussed above, directors' liabilities may not be the same in companies of different ownership. For example, in addition to the general rules applicable to all enterprises, the Enterprise State Assets Law of 2008 sets out a separate provision that subjects directors, supervisors and senior officers of enterprises with state investment to loyalty and due diligence obligations and with the duty not to harm the state investment interest,²⁹ otherwise they shall be disciplined, disqualified or even punished with criminal liability.³⁰ Moreover, a person responsible for serious losses of state assets will face disqualification from appointment in any state or controlled enterprise for a minimum period of five years, up to a maximum of life.³¹

The Criminal Law includes some articles against directors' unlawful conduct in handling company affairs. Most of these provisions are stipulated as offences for the violation of state regulation of companies and other enterprises, such as unlawful profiteering by taking bribes, or engaging in competing business,³² causing significant losses to the company by way of dealing with family members and friends,³³ negligence of duties resulting in significant losses to the company,³⁴ and abuse of powers for their own benefit at the cost of the company.³⁵ However, virtually all these criminal penalties are only applicable to cases involving state-owned companies or enterprises or state-owned assets. The criminal liability against directors' encroachment of company assets are separately provided for as crimes violating property rights, with more severe penalties against the directors of the SOEs state-owned enterprises.³⁶ Consequently, the Criminal Law treats SOEs and private companies with different deterrence and punishment schemes.

In recent years, some new causes of action against directors and senior managers have been introduced. For example, the Criminal Law amendments have criminalized certain misconduct by directors and senior officers of listed companies in violation of their fiduciary duties which cause the company to suffer material losses, such as false bankruptcy with asset concealment or other fraudulent transactions,³⁷ and provision of funds, services or assets to any entity or individual without capacity of repayment, and the giving up of claims without sufficient reason.³⁸ Such criminal liability has been further expanded to failure to make employees' salary payments through transfer or the concealment of assets.³⁹

In considering the actions potentially giving rise to liability, the business and legal environment in China should be taken into account. On the one hand, the culture of market trust and credit is still weak compared to other developed market economies. Certain legal protection to creditors, such

²⁴ *Ibid*, arts 126, 127 and 129.

²⁵ *Ibid*, art. 77.

²⁶ Article 18 of the Consolidated Provisions of 2014 (Part 2).

²⁷ *Ibid*, art. 19.

²⁸ *Ibid*, arts. 19 and 20.

²⁹ Article 26 of the Enterprise State Assets Law of 2008.

³⁰ *Ibid*, art. 71.

³¹ *Ibid*, art. 41.

³² Articles 165 - 169 of the Criminal Law of 2015.

³³ *Ibid*, art. 166.

³⁴ *Ibid*, art. 167.

³⁵ *Ibid*, arts. 168 and 169.

³⁶ *Ibid*, arts. 271 and 272.

³⁷ Article 6 of the Sixth Criminal Law Amendment dated 29 June 2006.

³⁸ *Ibid*, art. 9.

³⁹ Article 41 of the Eighth Criminal Law Amendment dated 25 February 2011.

as insolvent trading, has been stipulated in neither the Company Law nor the Bankruptcy Law. Actions against directors' wrongdoing are still difficult due to the developing infrastructure and lack of institutional support. On the other hand, the imposition of liability against directors thus far seems primarily to focus on the losses or damage to the company or creditors without sufficient attention to the mental state of the director concerned, or the market conditions. Business judgement protection, for instance, is not available as a defence in the current legal regime.

QUESTION 3

- 3. Other persons involved with the company's affairs who may be liable in relation to their actions during the relevant period**
- (a) In addition to those persons referred to in 1(a) above, can others be held liable for their action or inaction during the relevant period?**
- (b) In respect of which acts or failure to act may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?**
- (a) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?**

Given the current corporate structure and business environment, other persons, in addition to directors, may also be liable as a result of their involvement in the affairs of the companies in the twilight zone. First, the Company Law is based on the German model with a supervisory board as an organ to monitor directors' performance for shareholders. In terms of duties and liabilities owed to the company, a supervisor is treated virtually the same as a director. As such, if supervisors fail to carry out their fiduciary and other duties, the same liabilities will be imposed on them. The Company Law has significantly expanded the supervisors' powers in corporate governance, including the examination of a company's financial condition, a motion to dismiss directors and senior officers, the convening of general meetings, carrying out their own investigation into the company's affairs by appointing professional firms and filing legal actions against directors and senior officers in the People's Court.⁴⁰ As a result, supervisors may be liable for any violation of the law, regulations, articles of association, and their fiduciary duties which cause losses or result in the bankruptcy of the company.⁴¹

A controlling shareholder is defined as a shareholder who contributes or owns more than 50% of the company shares, or whose holdings, although less than 50% of the company's share capital, are sufficient to have a significant influence on resolutions of the general meeting.⁴² A non-shareholder may be deemed a *de facto* controller as a result of his actual control over the company through agreements or other arrangements.⁴³ Articles 20 and 21 of the Company Law hold shareholders, particularly the controlling shareholders and the *de facto* controller, liable under the doctrine of "lifting the corporate veil" for their serious infringement of creditors' interests by abusing the corporate entity and causing damage to the company through transactions with their affiliates.

In some cases bankrupt companies were established by government organizations without sufficient capital to meet the minimum capital requirement at that time. In practice the People's Court has repeatedly held the government liable in these circumstances. For example, in *Pin Ding Branch of Shaxi Oil Co v The Oil Development Group of Bai City of Jilin*,⁴⁴ the Supreme People's Court held that the defendant company's veil should be lifted and that the government office should be held liable to the extent of the registered capital on the finding that the company, without any of its own capital, was established by the local government and the company's assets were later transferred to another firm formed by the same government office before a judgment was issued in favour of the creditor plaintiff.

⁴⁰ Articles 53, 54, 118 and 151 of the Company Law as amended in 2013.

⁴¹ *Ibid.*, Art. 149.

⁴² Article 216 (2) of Company Law.

⁴³ *Ibid.*, art. 216.

⁴⁴ The case is reported in the Research Office of the Supreme People's Court, Collection of Judicial Interpretations of the Supreme People's Court, vol.1 (1949-1993), (People's Court Publishing House, 1994), at 1570-72 (in Chinese).

In addition, the promoters and shareholders of a company will be liable for any failure to make their capital contribution or withdrawal of their capital contribution after the formation of the company. Articles 28, 30 and 93 of the Company Law respectively require a shareholder of a limited liability company or joint stock company who fails to make his capital contribution according to the articles of association to make up the balance, whilst other original shareholders are jointly liable for it to outsiders. Article 199 further imposes a fine of 5-15% of the unpaid or falsely paid sum against such a shareholder or promoter. Moreover, the *de facto* controller may also be jointly liable to the company's creditors for aiding and abetting the unlawful withdrawal of registered capital by any shareholder.⁴⁵

The Company Law introduced for the first time the concept of the one-man company into China in 2005. However, this new form of company was adopted with deep concerns for potential abuse. As a result, the sole member of a one-man company has to prove the separation of his personal property from assets of his company, failing which he is held jointly liable with the company.⁴⁶

The Amendment to the Company Law in 2013 abolished the minimum statutory capital requirement; thus a company concerned may be established according to the capital stipulation of its articles of association without going through government verification and examination, as was the case prior to the amendment.⁴⁷ Although the liberalization has been welcomed by the market, the potential legal risks, such as undercapitalization and false capital contribution, do not seem to be well addressed yet.

A shareholder may also be liable for negligence in not carrying out the liquidation of his company in a timely manner. In *Cunliang Trading Ltd. of Shanghai v. Jiang Zhidong and Wang Weiming*,⁴⁸ the shareholders were held jointly liable with the company for the damages to its creditors caused by a loss of assets and books of account due to their negligence after the company's business licence was revoked by the government. According to the Court, shareholders as a whole shall bear the legal duty to liquidate their company in a timely manner, when needed, regardless of the amount of each shareholder's holding.⁴⁹

As a socialist market economy, the top management of SOEs and state-controlled companies are still appointed by the government. As discussed above, the liability for abusing powers, neglecting duties and crimes leading to losses of the state assets are not limited to directors of the companies / enterprises concerned, but apply generally to all the responsible individuals and entities, including the state assets supervision authority, the auditing or accounting firms.⁵⁰

The Bankruptcy Law replaced the government-controlled "liquidation group" with a new system of a bankruptcy administrator. Under arts. 13 and 122 of the Bankruptcy Law, a bankruptcy administrator shall be appointed by the People's Court when a bankruptcy petition is accepted and his duty ends when the debtor's business registration is cancelled after the termination of the bankruptcy proceedings, unless there are unfinished legal actions or arbitral proceedings. During this period, the bankruptcy administrator reports to the People's Court and is subject to the supervision of the creditors' meeting.⁵¹ He shall carry out his due diligence and faithfully discharge his duties.⁵² In case of a violation of his legal duties, a bankruptcy administrator may be fined and held liable to compensate losses caused to creditors or a third party.⁵³

In the course of marketization, professionals have been playing an increasingly important role and their practicing ethics and standards are also rapidly developing. For example, the Company Law includes a provision against firms that commit false asset appraisal, verification and certification, and material omission. They will be subject to a fine of up to five times their income from the relevant case, revocation of the firm's license, disqualification of the professionals involved, and civil liability to compensate the victims concerned, unless they can prove their innocence.⁵⁴ The Supreme People's Court has held the Housing Administration of Nanchang City liable for RMB 2.48 million in damages to the bank that granted a loan of RMB 7 million to the debtor on reliance of the Housing Administration's appraisal of a flat as collateral of the borrower. The

⁴⁵ Article 14 of the Consolidated Provisions 2014 of the Supreme People's Court (Part 3).

⁴⁶ Article 63 of the Company Law.

⁴⁷ *Ibid.*, arts. 28 and 29.

⁴⁸ This case has been selected by the Supreme People's Court as its Guiding Case #9 dated 18 September 2012; an English translation is available at <https://cgc.law.stanford.edu/guiding-cases/guiding-case-9/>

⁴⁹ The decision is available at the People's Court Website at <http://www.chinacourt.org/article/detail/2014/01/id/1209471.shtml> (in Chinese).

⁵⁰ Chapter 8 of the Law on State Enterprise Assets of 2008.

⁵¹ Article 23 of the Bankruptcy Law. The duties of a bankruptcy administrator are stipulated in art. 25 of the Bankruptcy Law.

⁵² *Ibid.*, art. 27.

⁵³ *Ibid.*, art. 10.

⁵⁴ Article 207 of the Company Law.

Housing Administration was found negligent in verifying the property documents in violation of the professional standards, which rendered the fraudulent borrowing possible.⁵⁵

The Commercial Bank Law of 2003 prohibits a commercial bank from granting loans on a credit basis to its affiliate, or granting other types of loans with preferential conditions.⁵⁶ Furthermore, Chapter 5 of the Law on Administration of Banking Regulation of 2003 in particular specifies administrative and criminal liability against violations of the banking law and loaning procedures.

The current law does not have clear rules on the liability of a third party in the twilight zone. However, the very general and broad provision of the General Principles of Civil Law of 1986 may always be relied on by the court to deal with a third party who enters into transactions with a company with knowledge of its insolvency or in conspiracy with the company or its directors. For instance, art. 106 provides that a natural or legal person shall bear civil liability for his violation of another's property rights. Articles 17 and 38 of the Bankruptcy Law subject a third party possessor of the debtor's assets to a legal obligation to return them to the bankruptcy administrator. Moreover, upon completion of the bankruptcy proceedings, the guarantor and any third party who is jointly liable for the unpaid debts shall be responsible for the settlement of the unpaid debts of the bankrupt enterprise.⁵⁷

Finally, it should be noted that in China criminal liability is widely imposed. For all the parties and conduct identified above, criminal penalties may be applied once the violation is considered to have reached a grave level.⁵⁸

QUESTION 4

4. Transactions during the relevant period

- (a) On what basis may transactions with the company in the relevant period be set aside?**
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?**
- (c) On what basis may directors and other persons properly incur further credit during the relevant period?**

Generally, as discussed above, transactions with the debtor company less than six months prior to the commencement of the bankruptcy proceeding may be vulnerable to the attack pursuant to the avoidance power if the debtor was insolvent at the time.⁵⁹ Certain actions within one year of the commencement of the bankruptcy proceeding may be avoided against counterparties who have received assets from the debtor company without consideration (or at an apparently unreasonable price) or who have become better off due to their security status being upgraded to the detriment of other creditors, who have received premature payment, or whose obligation to the debtor has been waived.⁶⁰ By the same token, all unlawful income made by insiders of the debtor company (including directors, supervisors, and senior officers) in abuse of their powers, is recoverable by the bankruptcy administrator.⁶¹

The Supreme People's Court adopted its Interpretation on Certain Issues Concerning Application of Contract Law (Part 2) on 24 April 2009. The Interpretation sets out, amongst other things, some guidelines for the practical application of art. 74 of the Contract Law, which allows a creditor to set aside a transaction of the debtor through judicial proceedings if the transaction damages his lawful interest due to the debtor giving up its claims, transferring assets without consideration or at an unreasonably low price. In terms of art. 19 of this Interpretation, a price which is 30% or more

⁵⁵ *Jiangxi Branch of the Bank of China v. Housing Administration of Nanchang City*, (The Supreme People's Court, decided on 30 September 2003; Printed at the Bulletin of the Supreme Court of PRC, issue 2 (2004), at 22-27 (in Chinese).

⁵⁶ Article 40 of the Commercial Bank Law as amended in 2015.

⁵⁷ Article 124 of the Bankruptcy Law.

⁵⁸ Article 131 of the Bankruptcy Law and art. 215 of the Company Law.

⁵⁹ Article 32 of the Bankruptcy Law.

⁶⁰ *Ibid*, art. 31.

⁶¹ *Ibid*, art. 36.

below the market price shall be considered unreasonable, although other factors may also be taken into account in determining whether the price is unreasonable.

Under the Law on State Enterprise Assets, as a special measure to protect assets that the state invested in enterprises, art. 72 provides that any transactions shall be void where bad faith conspiracy harmful to the state assets and their property rights, is found.

As a general rule, during liquidation the company shall not continue to carry out business activities irrelevant to the liquidation.⁶² As a result, to what extent a pre-bankruptcy contract can be recognized, performed and enforced shall be decided by the bankruptcy administrator.⁶³ Under the Bankruptcy Law, any payment to a creditor by the debtor after the commencement of bankruptcy proceedings is null and void.⁶⁴ Moreover, according to the “automatic stay rule”, all the civil lawsuits and arbitral proceedings that have been commenced, but not completed, shall not be continued until the bankruptcy administrator takes over the debtor’s assets.⁶⁵ Moreover, all enforcement proceedings shall also be suspended until after the bankruptcy petition is accepted by the People’s Court.⁶⁶

Under arts. 25(5), 26 and 61(5) of the Bankruptcy Law, the bankruptcy administrator, the People’s Court and the creditors’ meeting may decide whether the debtor can continue its business operations after the commencement of bankruptcy proceedings. More importantly, as a result of the bankruptcy law reform in 2006, a reorganization system has been introduced into China based on the “debtor remaining in possession” during the reorganization period.⁶⁷ In order to facilitate a smooth reorganization, secured creditors may not exercise their security rights and further security may be created in favour of new creditors to support the continuing operations of the debtor company in the reorganization period.⁶⁸ Creditors of the debtor may also reach settlement in respect of the unpaid debts.⁶⁹ Thus, counterparties may still be able to deal with the debtor company in the twilight zone. However, the rules of the current regime are still not detailed enough to guarantee clarity and certainty.

The Bankruptcy Law does not prohibit the debtor from incurring further debts after entering the twilight zone, as long as they are fair and *bona fide* and meet the procedural requirements. For example, after commencement of bankruptcy proceedings the bankruptcy administrator has the power to decide how to deal with contracts that have not been performed, and to notify the counterparties accordingly. If the administrator does not notify the counter-party concerned within two months of commencement of the bankruptcy proceedings, or does not reply to the counter-party’s request urging performance within 30 days, the contract shall be deemed to be discharged. On the other hand, the counter-party is entitled to demand security if the bankruptcy administrator decides to continue to perform the contract.⁷⁰

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

Article 41 of the Bankruptcy Law defines the scope of the bankruptcy costs, which include the legal costs of the bankruptcy proceedings, the costs of administration, liquidation and distribution of the debtor’s assets and the remunerations of the bankruptcy administrator and other staff involved. Moreover, certain debts incurred after commencement of the bankruptcy proceedings shall be the common debts of all the creditors, such as debts incurred for performing the relevant contracts, managing the relevant assets, tort liabilities caused by the debtor and the bankruptcy administrator, and settlement of labour costs and social insurance for a debtor’s continuing operation in the course of the bankruptcy proceedings.⁷¹

In order to ensure the smooth implementation of a reorganisation plan, the priority claims of the secured creditors shall be suspended during the reorganisation period. However, the secured

⁶² Articles 205 of the Company Law.

⁶³ Articles 18 and 20 of the Bankruptcy Law.

⁶⁴ *Ibid.*, art. 16.

⁶⁵ *Ibid.*, art. 20.

⁶⁶ *Ibid.*, art. 19.

⁶⁷ *Ibid.*, art. 73.

⁶⁸ *Ibid.*, art. 75.

⁶⁹ *Ibid.*, Ch 9.

⁷⁰ Article 18 of the Bankruptcy Law.

⁷¹ *Ibid.*, arts. 42 and 43.

creditors concerned may demand to exercise their rights if their interest may be prejudiced due to damage to the secured property or significant loss to its value during the reorganisation. The debtor or the bankruptcy administrator may create further security for new borrowings for continuing the business operations of the debtor company for the purposes of reorganisation,⁷² which will be treated as the debts of common benefits with its priority to existing security rights.⁷³

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

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Enforcement actions

According to arts. 31, 32, 34, 35 and 36 of the Bankruptcy Law, the bankruptcy administrator is empowered to petition to the People's Court to avoid unfair or fraudulent transactions against third parties, shareholders of the debtor company with unpaid contributions, its directors, supervisors and senior officers, and creditors concerned to recover the assets of the debtor. The public security department and the People's Procuratorate may carry out criminal investigations and prosecutions, if needed, in cases of serious violation that may trigger criminal liability.⁷⁴

The debtor company may have a cause of action against its directors, supervisors and senior officers for breach of their legal duties and for violation of the law, regulations and the articles of the company resulting in loss to the company. They will be liable to compensate the company for losses caused by their wrongdoing and will further be accountable to the company for any unlawful income they have made by means of corruption, misappropriation, and conflict of interest dealings.⁷⁵ If the company or the supervisors fail to take the legal action requested, shareholders may institute their derivative action on behalf of the company,⁷⁶ or claim in their own names.⁷⁷ Moreover, the creditors and debtor company may also sue the controlling shareholder and the *de facto* controller on the grounds of abusing the corporate entity⁷⁸ and abusing their status through transactions with their affiliates.⁷⁹

The Supreme People's Court in its Provisions on Certain Issues Concerning Application of Bankruptcy Law (Part II) stipulates its further support to the bankruptcy administrator for his enforcement actions, including actions of recovery against the possessor of the debtor company's assets on unlawful concealment or transfer,⁸⁰ against the legal representative or other responsible persons for damages to the company caused by their intentional or negligent conducts,⁸¹ against promoters, directors, senior officers and *de facto* controllers for their flight of capital contribution and aiding and abetting conducts,⁸² and directors, supervisors and senior officers for the recovery

⁷² *Ibid*, art. 75.

⁷³ *Ibid*, art. 42 (4); and An Jian (ed.), Annotation of Enterprise Bankruptcy Law of PRC, Beijing: Law Press, 2006, at 110 (in Chinese).

⁷⁴ *Ibid*, Arts. 131 and 215 of the Company Law.

⁷⁵ *Ibid*, Arts. 113 and 149 of the Company Law.

⁷⁶ *Ibid*, Art. 151.

⁷⁷ *Ibid*, Art. 152.

⁷⁸ *Ibid*, Art. 20.

⁷⁹ *Ibid*, Art. 21.

⁸⁰ Article 17 of the Provisions (Part II).

⁸¹ *Ibid*, Art. 18.

⁸² *Ibid*, Art. 20.

of their abnormal incomes during the twilight period in the form of performance bonuses and salaries while the workers' payments were in arrears.⁸³

Although the doctrine of insolvent trading has not been introduced through formal legislation, the Supreme People's Court has adopted some rules which may lead to a similar practical effect. According to art. 1 of the Consolidated Provisions 2014 of the Supreme People's Court (Part 2), serious operational difficulties may be a sufficient ground to dissolve a company through liquidation. In such a case, creditors may take legal action against shareholders, directors, the controlling shareholder or the *de facto* controller of the debtor company, for their failure to commence the liquidation within the statutory period (thereby causing losses to the company) and the disposition of the company's assets in bad faith or without liquidation.⁸⁴

The creditors' meeting or the creditors' committee has the power to supervise the bankruptcy administrator in the performance of his duties. They may take the matter to the People's Court if the bankruptcy administrator refuses his supervision.⁸⁵ The debtor or a third party may sue the bankruptcy administrator for damages caused by his failure to duly perform his duties.⁸⁶ The People's Court may also of its own volition penalize directors and other relevant persons for their refusal to cooperate, dishonest conduct and other violations.⁸⁷

The Second Company Law Provisions of 2008 further entitle creditors to take legal action against the shareholders of an insolvent company for their unpaid capital subscription,⁸⁸ and against members of the liquidation group for damages caused by their violation of the law, regulations or the articles of the company.⁸⁹

In China, the "liquidation group" represents a complex practice. Before adoption of the Enterprise Bankruptcy Law, liquidation groups were used in all SOE bankruptcy proceedings, which mainly comprised officials from different government departments such as labour, taxation, finance and state assets management. This practice has been replaced with the professional bankruptcy administrator system by the new law. However, the old practice has not yet been completely repealed. Article 24 of the Law stipulates that the bankruptcy administrator can be professionals or professional firms as well as a liquidation group formed by the relevant government departments or institutions. In practice, the liquidation group is still being used, particularly in SOE bankruptcy proceedings.

As stated above, the upper-level state department of the SOEs concerned, and the State Commission of State Assets Administration and Supervision, are empowered to discipline persons responsible for serious losses of state assets due to their wrongdoing or neglect of their duties. These types of case may even lead to criminal prosecution.⁹⁰

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

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

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

⁸³ *Ibid*, art. 24.

⁸⁴ Articles 18, 19 and 20 of the Consolidated Provisions 2014 of the Supreme People's Court (Part 2).

⁸⁵ Article 68 of the Bankruptcy Law.

⁸⁶ *Ibid*, art. 130.

⁸⁷ *Ibid*, arts. 126, 127 and 129.

⁸⁸ Article 22 of the Consolidated Provisions 2014 of the Supreme People's Court (Part 2).

⁸⁹ *Ibid*, art. 23.

⁹⁰ Chapter 8 of the Law on State Enterprise Assets.

- (b) Restoration, which may include the return of the company's assets by company insiders due to misappropriation, by third parties for their possession, reception through unfair preference or fraudulent or unfair trading, or by shareholders for their unpaid capital contributions.
- (c) Procedural measures and enforcement, which may include the “automatic stay”, adjudication of the disputes between / among the parties concerned in the bankruptcy and liquidation proceedings,⁹¹ and measures to compel the return of assets, books of account and documents,⁹² and the presence of management of the debtor.⁹³
- (d) Dismissal of the bankruptcy administrator if he does not perform his duty fairly and competently in accordance with the law.⁹⁴ The Supreme People's Court in its Provisions on Appointment of Administrators in Enterprise Bankruptcy Cases of 2007 further articulated the legal grounds for dismissing a bankruptcy administrator, which may include loss of his practicing licence or civil capacity, conflict of interests, gross negligence or bad intention, incompetence, violation of the law and expiration of his insurance.⁹⁵

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3(a) above obliged to co-operate with the insolvency office - holder's investigation into the company's affairs?**
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

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

First, when submitting the bankruptcy application, the debtor is required to explain the cause of its losses and submit relevant accounting books, a detailed list of liabilities, accounts receivable, the employees' settlement plan, the record of payment of employees' wages and their social security and other relevant documents to the People's Court.⁹⁶ If the bankruptcy petition is filed by a creditor, after accepting the case the People's Court shall ask the debtor to submit all the relevant account books and documents specified above within 15 days.⁹⁷ A fine or other compulsory measures may be imposed against the responsible individuals for their refusal to hand over the books and documents, or for falsifying or destroying the documents.⁹⁸

Second, once the bankruptcy administrator has been appointed, the debtor is required to hand over operation of its business and affairs to the administrator⁹⁹ and stop making payment to any individual creditor.¹⁰⁰ Moreover, art. 15 of the Bankruptcy Law mandates the legal representative, financial officer and other relevant management of the debtor to take due custody of the assets, seals, account books and other documents under their possession, to carry out their necessary work and faithfully answer the questions according to the request of the People's Court and the bankruptcy administrator, to attend the creditors' meetings and faithfully answer the creditors' inquiries, not to leave their residence without the court's permission, and not to appoint any new

⁹¹ Such as disputes regarding the debts owed and its registration between the debtor and the creditor (art. 58 of the Bankruptcy Law), disputes regarding the distribution plan (arts. 65 and 66), disputes between creditors and the bankruptcy administrator on supervision (art. 68), and disputes regarding the reorganization plan (art. 87).

⁹² *Ibid.*, art. 127 of the Bankruptcy Law.

⁹³ *Ibid.*, arts. 126 and 129.

⁹⁴ *Ibid.*, art. 22.

⁹⁵ Articles 26, 33 and 34 of the Provisions on Appointment of Administrators in Bankruptcy Cases.

⁹⁶ *Ibid.*, art. 8; and art. 6 of the Supreme People's Court Provisions of 2002.

⁹⁷ *Ibid.*, art. 11.

⁹⁸ *Ibid.*, art. 127; and art. 6 of the Supreme People's Court Provision on Certain Issues Concerning Application of Bankruptcy Law (Part 1).

⁹⁹ *Ibid.*, art. 25.

¹⁰⁰ *Ibid.*, art. 16.

director, supervisor or senior officer. Any violation of these legal duties may lead to a mandatory summons, reprimand, fine or detention by the People's Court.¹⁰¹

Third, under the Bankruptcy Law both the creditors and the debtor may apply to the People's Court for reorganization. If the reorganization plan is approved by the People's Court, the debtor will take possession of its assets to carry on its business under the supervision of the bankruptcy administrator.¹⁰² In the period of reorganization, the debtor and its management shall implement the reorganization plan in good faith and in a co-operative way with the bankruptcy administrator; otherwise the People's Court may upon the request of any interested party terminate the reorganisation and make a bankruptcy declaration.¹⁰³ The debtor enterprise may also reach a settlement with its creditors. Such settlement must be made *bona fide*; a settlement may be avoided by the People's Court if it is made by fraudulent or other unlawful means.¹⁰⁴

With regard to the imposition of criminal liability in the twilight zone period, the legal regime has been improved recently through the amendments to the Criminal Procedure Law in 2012. For example, under art. 50 of the Law, the state authority shall not force self-incrimination of the defendant. Another concern in this regard is that the defendant's right of access to lawyers may be restricted during some periods. According to the Law, a criminal defendant may have the right to appoint his attorney only after the state authority completes its first interrogation or compulsory measures.¹⁰⁵ Also, a lawyer may not have access to the file of the case or verify the evidence with his client until after the public security office has completed its investigation and transferred the file to the People's Procuratorate for prosecution.¹⁰⁶

As a whole, China has made notable progress in terms of protection of the lawful rights of defendants which are codified in the Criminal Procedure Law and relevant laws and regulations. In addition to the provisions in the Constitution Law,¹⁰⁷ the Criminal Procedure Law contains provisions to safeguard the fundamental rights of suspects. A director may rely on these articles to protect his lawful rights.¹⁰⁸ However, at local level full compliance with the legal rules may still be a challenge to the judiciary and the government. For instance, some cases have been reported in recent years where foreign businessmen were unlawfully detained with maltreatment in debt disputes.¹⁰⁹

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What appeals are available from the decision of the lower Courts?

In the bankruptcy and reorganisation period, some appeal procedures are stipulated. For example, parties may appeal to the People's Court at the next upper level against the ruling of the lower court not to accept the bankruptcy petition within 10 days of the decision.¹¹⁰ Creditors who refuse to accept the court ruling on disposition of the debtor's assets and the distribution may request the same People's Court to reconsider its ruling within 15 days of the pronouncement of the decision. However, reconsideration does not stop implementation of the decision, although it might be changed later.¹¹¹

¹⁰¹ *Ibid*, arts. 126 and 129.

¹⁰² *Ibid*, arts 73,89 and 90.

¹⁰³ *Ibid*, arts 78 and 93.

¹⁰⁴ *Ibid*, art. 103.

¹⁰⁵ Article 33 of the Criminal Procedure Law of 2012.

¹⁰⁶ *Ibid*, arts. 37 and 38.

¹⁰⁷ Article 33 of the Constitution of China states that the State respects and protects human rights. The Constitution of the People's Republic of China was adopted at the fifth session of the fifth National People's Congress on 4 December, 1982, and amended in 1993, 1999 and 2004. Article 37 provides that citizens' freedom of the People's Republic of China is inviolable. No citizen may be arrested except with the approval or by decision of a People's Procuratorate or by decision of a People's Court, and arrests must be made by a public security organ. Unlawful detention or deprivation or restriction of citizens' freedom of the person by other means is prohibited, and unlawful search of the person of citizens is prohibited. Article 38 further prohibits libel, false accusation or false incrimination directed against citizens by any means.

¹⁰⁸ For example, a defendant shall have the right to defence, and the People's Courts shall have the duty to guarantee such right under art. 11. See also arts. 12, 14, 32, 47, 50, and 54 of the Criminal Procedure Law of 2012.

¹⁰⁹ For a recent report, see "Kidnapped Indian Businessman in China Released", Daily News and Analysis (India), 25 May 2012, available at <http://www.dnaindia.com/print710.php?cid=1693696>.

¹¹⁰ Article 12 of the Bankruptcy Law.

¹¹¹ *Ibid*, art. 66.

Generally, according to arts. 135 and 137 of the General Principles of Civil Law, the statutory limitation of civil actions is two years from the time of infringement or the time the injured party knows, or should have known, of the infringement. This period may be a variable period due to suspension¹¹² or interruption.¹¹³ However, under art. 137 of the General Principles of Civil Law, the People's Court will not entertain any civil action if 20 years have elapsed since the infringement. As such, the 20-year period is an invariable period, regardless of any suspension or interruption.

It should be noted that the statutory limitation period may be changed in the near future. According to the Draft General Principles of Civil Law as part of the civil code compilation in China which has been submitted to the national legislature for deliberation in June 2016, the limitation period shall be extended from two to three years.¹¹⁴

Under the Bankruptcy Law, creditors must accept distribution of the bankruptcy proceedings within two years. If a creditor fails to do so, the People's Court will distribute the assets concerned among the other creditors.¹¹⁵ Moreover, creditors may petition to the People's Court if new or further assets are discovered within two years of termination of the bankruptcy proceedings.¹¹⁶

Currently, there is no special limitation period applicable to actions against directors and other officers. As a result, the general limitation of civil and criminal actions is applied to these actions. Moreover, a director who is penalised with administrative sanctions, such as administrative fine or disqualification under the Bankruptcy Law and Company Law, may either ask the relevant state authority to reconsider the penalty imposed against him within 60 days of his knowledge of the penalty,¹¹⁷ or directly petition the People's Court to strike down the administrative decision within six months.¹¹⁸

Where directors' and other officers' conduct constitutes a criminal offence, the limitation period prescribed in the Criminal Law of PRC shall apply. In accordance with art. 87 of the Criminal Law of China as amended in 2015, crimes are not to be prosecuted where:

- (a) in cases where the maximum legally prescribed punishment is fixed-term imprisonment of less than five years, and five years have elapsed;
- (b) in cases where the maximum legally prescribed punishment is fixed-term imprisonment of more than five years but less than 10 years, and 10 years have elapsed;
- (c) in cases where the maximum legally prescribed punishment is fixed-term imprisonment of more than 10 years but less than 15 years, and 15 years have elapsed; and
- (d) in cases where the maximum legally prescribed punishment is either life-imprisonment or the death penalty, and 20 years have elapsed.

With the approval of the Supreme People's Procuratorate, prosecution may be filed beyond the 20-year limitation in special cases.¹¹⁹

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

Under art. 147 of the Civil Procedure Law, if a party refuses to accept a judgment of first instance of a local People's Court, he has the right to lodge an appeal with the People's Court at the next higher level within 15 days of the date on which the written judgment was served. Where a party refuses to accept a written order of first instance of a local People's Court which normally is used

¹¹² According to art. 139 of the General Principles of Civil Law of 1986, a limitation of action shall be suspended during the last six months of the limitation if the plaintiff cannot exercise his right of claim because of *force majeure* or other obstacles. The limitation shall resume on the day when the grounds for the suspension are eliminated.

¹¹³ Article 140 of the General Principles of Civil Law provides that a limitation of action shall be discontinued if a lawsuit is brought or if one party makes a claim for or agrees to fulfilment of his obligations. A new limitation shall be counted from the time of the discontinuance.

¹¹⁴ Report, "With civil code, China aims to realize rule of law", Xinhua News Agency, 30 June 2016; at http://news.xinhuanet.com/english/2016-06/30/c_129105083.htm.

¹¹⁵ Article 119 of the Bankruptcy Law.

¹¹⁶ *Ibid*, art. 123.

¹¹⁷ Article 9 of the Administrative Reconsideration Law of 1999.

¹¹⁸ Article 46 of the Administrative Procedure Law as amended in 2014.

¹¹⁹ 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 - art. 89 of the Criminal Law as amended in 2015.

to deal with procedural matters, he has the right to file an appeal with the People's Court at the next higher level within 10 days of service of the written order.

If a defendant in a criminal proceeding refuses to accept a judgment or order of the first instance court, he has the right to appeal in writing or orally to the People's Court at the next higher level according to art. 216 of the Criminal Procedure Law of 2012. The time limit as set out in art. 219 of the Law for an appeal or a protest against a judgment is 10 days. The time limit for an appeal or a protest against a procedural order is five days. The time limit is counted from the day when the written judgment or order is received.

An administrative proceeding may also be commenced by an enterprise against a government authority for unlawful interference with its business autonomy. The party concerned may first require the relevant state department to reconsider its decision under the Administrative Reconsideration Law of 1999. Article 2 entitles a party to file an administrative action based on the Administrative Procedure Law of 2014. According to art. 44 of the Law, if a citizen, a legal person or any other organisation applies to an administrative organ for reconsideration, the organ must do it; the party may also directly initiate a legal action at the People's Court.

Anyone who refuses to accept the reconsidered decision may bring a lawsuit before the People's Court within 15 days of receipt of the reconsidered decision. If the administrative organ conducting the reconsideration fails to make a decision within the stipulated period, the applicant may bring a lawsuit before the People's Court within 15 days of expiration of the time limit for reconsideration, except as otherwise provided for by the law.¹²⁰ The party may further file his case to the next higher level of the People's Court if the first instance court refuses to register his case.¹²¹

QUESTION 9

9. Foreign corporations

A foreign company is defined in art. 191 of the Company Law as "a corporation that is established according to foreign laws in a foreign jurisdiction". Foreign companies may carry out their business operation in China by way of a branch office, subsidiary, wholly foreign-owned enterprise, limited liability company, joint stock companies or joint venture. Since the Bankruptcy Law applies to all types of enterprises with legal person status, thus bankruptcy or liquidation, of foreign branches, subsidiaries, investment companies and enterprises in China is governed by the Bankruptcy Law.

Article 195 of the Company Law provides that a branch of a foreign company shall not have legal person status in China and the foreign company must be responsible for all the liabilities the branch has incurred in China. Article 197 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 completion of the liquidation.

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

Although there is no specific provision on whether the rules governing transactions in the twilight zone under the Company Law and Bankruptcy Law are applicable to foreign corporations, they should be equally applicable to foreign companies in China including directors' duties and liabilities. For instance, art. 196 of the Company Law stipulates that a branch of a foreign company shall abide by

¹²⁰ Article 45 of the Administrative Procedure Law as amended in 2014.

¹²¹ *Ibid*, art. 52.

the laws and regulations of China and shall not harm the social public interests of the nation. Thus, directors of foreign companies may be held liable if they commit unfair preference or fraudulent trading causing damages to the creditors, their companies or the social public interests of China.

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

QUESTION 10

10. Insurance

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?

Given the short experience of a market economy, liability insurance for directors and officers (D&O insurance) is still underdeveloped in China. Such insurance was not recognised by the government regulation until 2001 when the CSRC in its Guiding Opinions to Establish the Independent Director System in Listed Companies allowed necessary insurance arrangements to reduce the risks of independent directors in performing their duties.¹²² The CSRC further adopted the Principles of Corporate Governance of Listed Companies in 2002 which stipulates that, with the approval of the shareholders' meeting, a listed company may purchase liability insurance for its directors; however, the liabilities of directors for their violation of the law, regulations and the articles of association of the company are excluded.¹²³ On this basis, some insurance companies have marketed their D&O insurance programs.

However, presently less than 5% of directors of more than 2000 listed companies in China have purchased liability insurance. This can probably be attributed to some institutional defects. First, the inadequacy of relevant insurance legislation gives rise to difficulties in the development of D&O liability insurance. The current D&O insurance regime is, to a large extent, merely confined to listed companies in the CSRC's provisions as low rank administrative circulars as compared with the central government regulations and national legislation. The Company Law does not include any permissive or enabling provision in this regard. Secondly, although in recent years the increasing number of liability cases against directors and senior officers has attracted more attention to D&O insurance, the developing legal regime and corporate governance with lax enforcement have on many occasions become obstacles for creditors and stakeholders to seek effective legal remedies. Thus far, only a very limited number of directors and senior officers have been held personally liable in legal proceedings. Finally, the market risks and uncertainties in China's transitional journey to become a full market economy are much greater compared to other developed jurisdictions. As a result, insurance companies may have to take a self-protective approach by including many exclusion and exceptional clauses in their insurance policies, which will inevitably negatively affect the value of the D&O insurance products in the market.¹²⁴

The information provided in this country chapter is correct as at 01/01/2017

¹²² Article 7 (6) of the Guiding Opinions to Establish the Independent Director System in Listed Companies promulgated by the Chinese Securities Regulation Commission on 16 August 2001.

¹²³ Article 39 of the Principles of Corporate Governance of Listed Companies promulgated by the CSRC on 7 January 2002.

¹²⁴ The information is collected from the report on directors' liability insurance of Zhengquan Shibao (Securities Times), 7 January 2012, at http://stock.stcn.com/content/2012-01/07/content_4412070.htm (in Chinese) and Hao Junfu, "Institutional Analysis of Demand Discrepancy for D&O Insurance in China and the U.S.", *Financial Theory and Practice*, Issue 2 (2013), at 97-101 (in Chinese).

COLOMBIA

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 The directors

Under Law 222 of 1995 any of the following individuals / persons may be appointed as officers and directors; they are called “administrators” by this law:¹

- The legal representative of the company may be an individual or a company; it represents the company, acts as its manager and has the powers granted by the law and the by-laws. The legal representative may enter into or perform any act or contract included in the corporate purpose or directly related to the company's existence or operation.²
- The liquidator is in charge of the process of liquidating the company;³ it is the legal representative of the company during liquidation, and must be an individual or a company.
- The board of directors is made up of at least three members each of whom has an alternate;⁴ it has the powers provided for in the law and the by-laws; absent specific provisions in the by-laws to the effect, it is presumed that the board has sufficient powers to enter into any acts or contracts included in the corporate purpose and to make all necessary decisions to pursue the company's objectives.⁵ This includes instructing the statutory representative or other third parties to carry out any necessary actions. The functions of the board of directors are administrative in nature, not representative. It is subordinated to the shareholders' meeting, and it acts as a body, not through individual decisions.
- A so-called factor is the representative of a commercial establishment of a company. It may be an individual or a company.⁶ A factor must disclose to third parties that he is acting on behalf of the company.
- Other individuals may act as directors or officers if they have any of the above powers pursuant to the by-laws.⁷

1.2 The twilight period

There is no specific statute of limitations setting a period prior to an insolvency proceeding within which the relevant act must have been carried out for liability to attach to a director.

1.2.1 The twilight period before insolvency proceedings start

Under Art. 74 of Colombian insolvency law (Law 1116 of 2006), in the course of insolvency, reorganization or liquidation proceedings, any creditor or the insolvency representative may initiate an avoidance action⁸ against the following acts of the company when (a) they affect any creditor adversely or (b) when they affect the priority of payments and the debtor's assets are insufficient to satisfy all the liabilities recognized in the insolvency proceedings.

¹ Article 22 of Law 222 of 1995.

² Article 196 of the Code of Commerce.

³ Article 228 of the Code of Commerce: the designation is mandatory unless the company is a limited liability company where all the members unanimously agree to liquidate the company themselves (article 229 Code of Commerce).

⁴ Article 434 of the Code of Commerce.

⁵ Article 438 of the Code of Commerce. The board of directors is mandatory in corporations “S.A., *sociedad anónima*”, is discretionary in other types of companies.

⁶ Article 1332 of the Code of Commerce.

⁷ Article 22 of Law 222 of 1995 contains a blanket provision that includes this kind of individuals with the powers of administrators in the concept of administrators.

⁸ For more information about avoidance actions please see *Avoidance of Antecedent Transactions and Crossborder Insolvency*. INSOL International. Colombia Chapter. 2014.

Such acts are:

- (a) Payment of obligations, transfers in lieu of payment, and any acts that imply the transfer, disposal, constitution or cancellation of liens or the setting of ownership restrictions on property when they are made to the detriment of the debtor's assets, or leases that block or hinder the insolvency or reorganization proceedings. These acts must have taken place during the 18 months prior to the start of the insolvency proceedings; and there must be no evidence that the transferee or lessee acted in good faith.
- (b) Gratuitous acts executed within the 24 months prior to the start of insolvency proceedings; and
- (c) Amendments to the by-laws within the 6 months prior to the start of the insolvency proceedings when they diminish the assets of the debtor to the detriment of the creditors or when they modify the liability of the debtor's shareholders.

The avoidance action is designed to rescind past transactions to which the insolvent debtor was a party, or transactions involving the assets of the debtor that affected creditors. The latter includes reducing the assets of the debtor or impeding proper application of the principle of equitable allocation between creditors of the same class. Indeed, it is an action designed to preserve the integrity of the assets of the insolvent debtor.

In the context of corporate groups,⁹ there are regulations that relate to avoidance actions. Such regulations provide avoidance criteria to protect intra-group transactions in the interest of the group as a whole in some cases, and in other cases to subject the transactions to particular scrutiny because of the relationship between the parties as group members.

Article 22 of Decree 1749 of 2011 provides the same twilight period for corporate group members when the members initiate insolvency proceedings on different dates¹⁰ or when they file a joint application for initiation of all their insolvency proceedings.¹¹

The key issues in avoidance actions are whether the acts executed by the company have affected any creditor adversely, establishing priority of payments or whether or not the assets of the debtor are sufficient to satisfy all creditors recognized in the insolvency proceedings.

1.3 Loss of capital

The Colombian Code of Commerce requires that a total-asset-to-capital ratio be applied as an insolvency test; and it establishes a period of 18 months for the shareholders to resolve the economic crisis, counted from the date of the financial statements on which the crisis became evident.

If the situation is not remedied, corporate dissolution is to proceed. In this case, the decisions taken by the shareholders are restricted to those directly related to liquidation.

The shareholders must take sufficient measures to preserve the worth of the corporate standing and avoid liquidation during the mentioned 18 months. Initiating a reorganization process or judicial liquidation are among said measures.

The Code of Commerce Code refers also to suspension of payments [by the debtor]. Specifically, it requires the company managers to report this situation to the shareholders in full, providing them with all supporting documents. Failure to do so renders the managers jointly and severally liable for any damage or harm inflicted to the shareholders or third parties.

For subsidiaries of foreign companies, when losses reduce assets under 50% of capital, the parent company must reinstate the capital lost in the operation. Failure to do so makes the foreign subsidiary's representative liable for any obligations derived from the operations carried out from the date on which the parent company became required to reinstate the subsidiary's capital.

⁹ Decree 1749 of 2011, unified today into the so-called "Decreto Único del Sector Comercio, Industria y Turismo" DUR 1074/15 (the so-called Unified Regulation for the Commerce, Industry and Tourism Sectors).

¹⁰ The twilight period for all the members of the corporate group is counted from the moment the first member of the group initiates the insolvency proceeding.

¹¹ Same start date for all the group members.

Failure by the shareholders or managers to comply with their fiduciary duties may result in civil liability actions initiated by or on behalf of creditors under Article 82 of Law 1116 of 2006.¹²

The law tries to identify the time at which a director knew or must have known that it was no longer reasonable to think that the company would be able to avoid insolvency proceedings.

The twilight period terminates when formal insolvency proceedings or voluntary liquidation start.

1.4 Other factors

There are subjective, objective and other additional factors that must occur for a company to initiate insolvency proceedings.

Objective factors refer to economic circumstances that must be proven by the company to access an insolvency proceeding. Mainly, these are suspension of payments or imminent default on payments.

1.4.1 Suspension of payments

First, in accordance with Article 9 of Law 1116 of 2006, the debtor is considered to incur a suspension of payments when “defaulting for over 90 days on two or more obligations acquired during its activity, or by the existence of at least two writs of payment against it for the payment of commercial and / or labour obligations equal to, in both cases, no less than 10% of the debtor’s total debt on the date of the financial statements of the application”.

1.4.2 Imminent default

Second, in accordance with the same article, the debtor is under imminent default on payments when “market or internal circumstances are proven that affect or may reasonably affect to a material extent normal compliance with obligations due in a period of one year or less”.

1.4.3 Other factors

Additionally, under Law 1116 these other factors must exist for the debtor to be able to initiate insolvency or reorganization proceedings:

- (a) The legal term to determine grounds for dissolution is still open, and measures to remedy the situation and avoid dissolution have been taken.
- (b) The accounting books are kept in accordance with the law.
- (c) In case the debtor has social security liabilities, the related actuarial calculation must have been approved and all social security payments must be up to date.

1.5 Persons that may initiate proceedings

Depending on the objective factors and the type of proceeding, legitimate standing is required to apply for or trigger the initiation of insolvency proceedings varies. Therefore, the following may initiate or apply for the initiation of an insolvency proceeding:

1.5.1 Suspension of payment

In the case of suspension of payments,

- (a) the debtor;

¹² Article 82 of Law 1116 of 2006. Civil liability of shareholders or members, managers, auditors and employees. Where the common guarantee of creditors is affected by wrongful or negligent conducts of shareholders or members, managers, auditors and employees, then the same will be civilly liable for the payment of any outstanding company debt. The shareholders or members who were not aware of the actions or omissions or who voted against them will not be subjected to said liability provided they do not carry out the actions. In cases of non-compliance or abuse of powers or functions, breach of the law or the bylaws, it will be presumed that the party or person that committed the fault is liable. Any contract clauses that seek to absolve shareholders or members, managers, auditors and employees from the above liability will be treated as if they had never been written. In case the manager is a legal entity, the entity and its legal representative shall be held liable. The suit must be brought by any creditor; the proceeding will be pursued as the summary proceeding set by the Code of Civil Procedure. It must be brought before the insolvency judge or court, as the case may be, and will be pursued independently from the insolvency proceeding, which shall not be suspended. The liability set here will be enforced without detriment to any other applicable penalties and without regard to the corporate type. Available in Spanish online at: www.secretariasenado.gov.co.

- (b) one or more creditors of defaulted obligations;
- (c) the Office of the Superintendence in charge of surveillance over the debtor or its activity; or
- (d) the foreign representative.

The Colombian Office of the Superintendence of Companies may start an insolvency or reorganization proceeding *ex officio*.

1.5.2 Imminent default

When the debtor is in imminent default -

- (a) the debtor;
- (b) several external creditors unrelated to the debtor or the debtor's shareholders or members; or
- (c) the foreign representative.

1.6 Judicial liquidation proceedings

Judicial liquidation proceedings may be initiated in the following cases:

- (a) If the debtor has suspended payments and initiates the proceedings directly, or when the debtor fails to provide information in a timely manner where the same is required in a reorganization proceeding initiated by a creditor;
- (b) If the debtor abandons its business operations;
- (c) If the debtor has suspended payments and the related surveillance authority initiates the proceedings;
- (d) By the order of a duly justified decision by the Colombian Office of the Superintendent of Companies, issued *ex officio* or as a consequence of the initiation of a reorganization proceeding, or when the debtor fails to update its credit and voting rights qualification and grading project as required by the decision that starts the reorganization proceeding;
- (e) Upon request by the debtor and several creditors whose credits amount to at least 50% of company's liabilities;
- (f) Upon request where judicial liquidation proceedings have been initiated by a foreign authority or representative, pursuant to Law 1116 of 2006; or
- (g) In case the debtor has defaulted on pension payments, or has collected mandatory withholding taxes or social security discounts from employee payments and has failed to pay / deposit these amounts within the term set by the competent Court, which may not exceed 3 months.

The initiation of judicial liquidation proceedings implies that suspension of payments has occurred.

It is essential that every insolvency proceeding has been approved by a shareholders' meeting. The Board of Directors does not have the requisite authority to initiate an insolvency proceeding without the consent of the shareholders' meeting.

1.7 Summary

Transactions such as payments, new liens or guarantees or charges, or transfers or sales of assets may be vulnerable to attack by any creditor, or the insolvency representative such as a liquidator: (i) where the company's acts have affected any creditor adversely or the priority of payments or where the assets of the debtor are insufficient to satisfy all the liabilities recognized in the insolvency proceedings and (ii) where the company initiates formal insolvency proceedings (e.g. reorganization or judicial liquidation) within a certain twilight period (six months or two years depending on the acts).

At the time a director becomes aware (or must have come to know) that an insolvency proceeding or voluntary liquidation is the only reasonable prospect facing the company, from that moment on he is in the wrongful trading “zone” and at risk of personal liability unless, from that time, he does everything he can to minimize losses to the creditors.

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 the director?
- (b) In relation to each act identified in (a) above:
- (i) Is the director’s liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?
 - (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?

Law 222 of 1995 provides that directors and officers must act in good faith,¹³ with loyalty¹⁴ and with the diligence of a good businessman.¹⁵ Therefore, their actions must be carried out serving the interests of the company, taking into account the interest of the shareholders.¹⁶

In the fulfilment of their functions and duties, and specifically of the duty of loyalty, directors are required to:¹⁷

- (a) employ all their efforts pursuing the corporate purpose adequately;¹⁸
- (b) comply strictly with all applicable laws and bylaws;
- (c) allow the company’s statutory auditor to carry out his duties and work adequately;
- (d) guard and protect the commercial and industrial property of the company;
- (e) abstain from insider trading absolutely;
- (f) treat all shareholders equitably and respect the exercise of their inspection rights; and

¹³ Good faith is understood as acting honestly, honorably and loyally according to generally accepted social standards. See also Legal External Circular 100-000006 of 2016 of the Office of the Superintendent of Companies.

¹⁴ Loyalty implies putting company interests before the personal interest of any administrator or that of a certain group of shareholders; it includes avoiding conflicts of interests and promptly disclosing potential conflicts of interest. See also Legal External Circular 100-000006 of 2016 Office of the Superintendent of Companies.

¹⁵ Diligence of a *good business man* is a widely-used concept related to the diligence an average businessman would apply under similar circumstances. The director is required to apply all the skills that he has, including specific expertise; it is expected that he possess the knowledge to carry out the role, make reasonable evaluations of different issues and take decisions in a reasonable manner. See also Legal External Circular 100-000006 of 2016 Office of the Superintendent of Companies.

¹⁶ Article 22 of Law 222 of 1995. The interest of the company goes first, in the understanding that is to the advantage of the shareholders as well; but this is not a peaceful position, sometimes the interests of shareholders conflict with the interests of the company and it is not easy for the Director to reconcile both.

¹⁷ Mariana Posse, Clayton Steele, “Colombia: The Publicly Traded Company s Administrator Checklist”. Available at: www.ibanet.org.

¹⁸ Corporate purpose defines the economic activity or line of business of the company and determines the powers of directors and their limitations.

- (g) abstain from participating, directly or indirectly, either to serve their personal interest or that of third parties, in any activities that unlawfully compete with the company or in any acts that may give rise to a conflict of interest, unless he does so under the prior authorization of the shareholders' meeting.

The duty of loyalty of every director is first and principally to the company; in the second place, to the shareholders; and in the last place, to third parties.

Liability arises when officers and directors fail to comply with their professional duties. The basic requirements of liability are:

- (a) an act by the director that breaches that duty;
- (b) wilful misconduct or negligence;
- (c) the existence of damage or harm; and
- (d) the causal nexus between the act by the director and the damage or harm.

Directors may incur contractual and non-contractual liability. According to Article 200 of the Code of Commerce, they are liable for any damage or harm inflicted through wilful misconduct or negligence. Negligence is presumed when a director breaches his duties or abuses his powers, or when he violates the law or the by-laws or when he proposes to distribute or actually distributes profits that are not supported [by the requisite fair financial statements] in violation of Article 151 of the Code of Commerce.

The following conducts are in breach of the duties and responsibilities of directors:

Conduct	Type of liability: individual or joint liability	Regulation
Officers and directors are liable for the debts of the insolvent company that the company cannot pay for the loss of assets caused by their negligence or wilful misconduct	Civil liability, individual directors in proportion to their specific involvement.	Article 82 of Law 1116 of 2006
To order, tolerate, make or conceal falsities in the financial statements of the company	Criminal liability, individual directors in proportion to their specific involvement.	Article 43 of Law 222
<p>Incorporate or use of the company to deceive or defraud creditors.</p> <p>To take the company to a state of financial crisis by means of fraud.</p> <p>To destroy company assets totally or partially.</p> <p>Embezzlement or squandering of assets, leading to the start of a process of mandatory liquidation of the company.</p> <p>Non-fulfilment, for no valid reason, of the reorganization agreement entered into with its creditors.</p> <p>Speculation of any liabilities, whether it be immediate or subsequent to the start of formalities, by purchasing them at a lower price.</p> <p>Diversion, reduction or total or partial concealment of assets.</p>	Both civil and criminal liability. Officers and directors may also be disqualified for ten years from performing any commercial activity; individual directors in proportion to their specific involvement.	Article 83 of Law 1116 of 2006

Conduct	Type of liability: individual or joint liability	Regulation
<p>Carrying out of simulated actions, or when expenses, debt or losses are simulated.</p> <p>Where a monetary claim has been abandoned, relinquished or compromised with no cause and at the expense of creditors.</p> <p>When credits from creditors are excluded knowingly, or inexistent liabilities are added.</p>		
<p>Officers and directors can be held jointly and severally liable for damage or harm inflicted to third parties through wilful misconduct or negligence.</p>	<p>Civil liability, joint (all directors with the company)</p>	<p>Article 200 of the Code of Commerce</p>
<p>In case of cessation of payments by the company; initiating new operations or continuing to trade when there is little prospect of being able to pay debts when they fall due; or to not provide full information of the situation to the shareholders, for them to take all necessary measures and avoid the insolvency of the company.</p>	<p>Civil liability, the officers and directors are jointly and severally liable for damages inflicted to shareholders and third parties.</p>	<p>Article 224 of the Code of Commerce</p>
<p>Breach of duties and responsibilities of directors, specially related to the financial statements of the company. In this case the creditors may sue the administrators, shareholders or members or controlling parties as secondarily liable parties.</p>	<p>Civil liability</p>	<p>Article 49 of Law 1116 of 2006</p>
<p>Company assets diminish by acts or omissions of administrators/directors.</p>	<p>Civil liability</p>	<p>Article 25 of Law 222 of 1995</p>
<p>Inside trading</p>	<p>Criminal liability</p>	<p>Article 258 of the Penal Code. Law 599 of 2000 as amended by Law 1474 of 2011</p>
<p>Transaction in the twilight period voided</p>	<p>Civil liability</p>	<p>Article 74 of Law 1116 of 2006</p>
<p>Credit not included in the proposed qualification and grading of credits¹⁹ and not disclosed in the financial statements of the company.</p>	<p>Civil and Criminal liability can arise for officers and directors who fail to comply with this obligation; and they can be held jointly and severally liable.</p>	<p>Article 26 of Law 1116 of 2006</p>
<p>Violate the prohibitions of Article 57 of the Code of Commerce, regarding restrictions to companies about information disclosed in financial statements.</p>	<p>Civil Liability, Criminal liability.</p>	<p>Article 58 of the Code of Commerce</p>

¹⁹ The credit qualification and grading project is a proposal in which each credit and its creditor is listed and each credit is classified as a credit of first, second, third, fourth or fifth class, according to the rules of Title XL of the Colombian Civil Code.

2.7 Liability under commercial law

A director may be liable to the company itself for breach of his duties; in this case, the company may claim director liability as a contractual right. Any shareholder or third party may bring an individual liability action against the director; and even the company itself, by decision of the shareholders' meeting, may bring a claim if, as a consequence of the conduct of the administrator / director, company assets have diminished.²⁰ If the action is not filed within three months of the shareholders' meeting, any administrator, the statutory auditor or any shareholder acting on behalf of the company may file it. Creditors whose claims represent at least 50% of the external liabilities of the company may also file this action.

When director liability is not related to insolvency proceedings, regular civil judges or Courts or the Office of the Superintendent of Companies are competent to hear the case.²¹

Different circumstances must be taken into account in relation to the director's conduct:

- (a) Related to the company: the size of it. Whether it is a micro, small, medium or big company. And the corporate purpose, the economic situation of the company at the time of the conduct, etc.
- (b) The director's personal circumstances: expertise, qualifications, experience, position, remuneration etc.
- (c) Related to the act: the amount of the transaction, the transaction relevance, the foreseeable risk of the transaction, the market situation etc.
- (d) Related to the conduct: the planning, the information available, advisors, etc.

These are duties that relate to director's diligence:

- (a) The duty to obtain the right information before taking any decisions.
- (b) The duty to discuss matters is important in relation to the board of directors' conduct.
- (c) The duty to secure supervision through external and internal audit processes.
- (d) The duty of prudence.

The general defences against civil and / or criminal actions available to directors and officers under general commercial law include:

- (a) The action was carried out in good faith. Directors have a subjective liability regime; therefore, they can be held liable only for gross negligence or wilful misconduct.
- (b) Reasonable behaviour of the director.
- (c) The intent to preserve the value of the company as a going concern.
- (d) The lack of causal nexus between the company's insolvency and the conduct of the director.

Directors who were not aware of the actions or of the failure to act or who voted against the relevant action, provided they do not carry out the actions, bear no responsibility.²²

Article 200 of the Code of Commerce prohibits companies from offering or setting indemnities, exonerations or limitations on a director's liability for any acts constituting presumed negligence. It does this by ordering that any such provision or stipulation must be considered as "non-written".

²⁰ Article 25 of Law 222 of 1995. "Corporate action claiming [management] liability: Under previous approval by the shareholders or members meeting, which can be adopted even if not included in the *meeting's points for discussion*, the company may bring corporate action against the managers (or executive officers). In this case, a meeting can be convened by a number of shareholders or members representing at least 20% of corporate capital shares. The decision will be made by one half plus one of the shares represented in the meeting and will imply removal of the manager (or executive officer)..." Available in Spanish online at: www.secretariasenado.gov.co.

²¹ Article 24 of the General Rules of Procedure. The differences that occur by reason of the company's contract are subject to the summary verbal procedure; the ordinary judge or the Office of the Superintendent of Companies are competent unless there is an arbitration clause which requires the company to submit the issues to the resolution of arbiters.

²² Article 200 of the Code of Commerce.

2.8 Non-contractual liability

Article 2341 of the Civil Code regulates non-contractual liability. Under this rule of the law, any person is entitled to file a claim or suit seeking redress or an indemnification for any damage or harm inflicted by anyone, including the directors of a company.

2.9 Liability under insolvency law

Law 1116 of 2006 regulates insolvency proceedings in Colombia. The Office of the Superintendent of Companies has judicial functions derived from Article 116, paragraph 3 of the Constitution. By these functions, the Office of the Superintendent is to act as a judge in insolvency and other insolvency-related proceedings including director responsibility and liability and avoidance transactions.

The insolvency judge, the Office of the Superintendent of Companies and regular civil Courts (the so-called *Juez Civil del Circuito*) have wide discretion in determining the extent of the personal liability of a director found liable for breach of his duties and responsibilities. However, the purpose of both insolvency law and the Code of Commerce is to compensate creditors for the loss caused by the director's conduct. However, the insolvency judge has wide discretion to determine the extent of a director's personal liability.

Colombian insolvency and commercial law provides for different but well-defined conducts that need to be proved against the director by the insolvency representative or by the creditors. It provide for different defences as well.

There are other defences that apply to all types of conducts described in Article 82 of Law 1116 of 2006. These include that the debtor's total assets, as a common guarantee for creditors, has not deteriorated.

Other defences are available for the director. Article 82 of law 1116 of 2006 provides that "...The said responsibility will not attach to the shareholders or members who were not aware of the actions or omissions or who voted against them, provided they do not carry out them ...". Note however, that this provision refers to the shareholders or members, and that the liability is the personal liability of the individual directors in proportion to their specific involvement.

Article 82 of Law 1116 of 2006 also provides in relation to directors that "...In cases of non-compliance or abuse of powers or functions, breach of the law or the by-laws, the negligence or fault of the person involved will be presumed..." This means that the director has the burden of proof and is required to prove the opposite.

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 Shareholders, statutory auditors, accountants and employees

Colombian insolvency law may impose liability also on shareholders, statutory auditors, accountants and employees who have been involved in the management of a company during the twilight period.

Under Article 58 of the Code of Commerce fines may be imposed on companies that violate the prohibitions of Article 57 of the Code of Commerce, regarding restrictions on the information that is disclosed in balance sheets. According to said provision, if it is not possible to establish who is responsible for the violation, the persons who prepared and audited the financial statements, i.e. the accountant and the statutory auditor, will be held liable for the fines imposed.

Article 26 of Law 1116 of 2006 provides: "...however, claims that were knowingly not included in the recognition and classification of credits and that were not recorded in the accounting books will entitle creditors to pursue at any time the administrators, accountants and statutory auditors as jointly and severally liable [with the debtor (the company)] for any accruing damages."

Article 82 of Law 1116 of 2006 provides: "...When the common guarantee of creditors is deteriorated by gross negligence or fraud of shareholders / members, administrators, statutory auditors, and employees, they will be civilly liable for the payment of any outstanding company debt..."

In addition, Article 83 of Law 1116 of 2006, provides this: "The administrators and shareholders of the debtor and natural persons [as a rule] will be disqualified from the exercise of any commercial trade for up to 10 years, when one or more of the following events or actions are proven..."

Such persons may be held personally liable in respect of any actions that they took as directors and which caused losses to the company and its creditors during their tenure.

3.2 Parent or controlling entity

Additionally, under Article 61 of Law 1116 of 2006 the parent or controlling entity may be held jointly and severally liable for the obligations of the subsidiary in cases of insolvency. This applies when the parent or controlling company is responsible for transactions that entitle a creditor to bring action seeking redress; and these transactions must have taken place for the benefit of the parent or controlling company or the subsidiary to the detriment of the company pursuing reorganization or judicial liquidation proceedings.

It is presumed that a company went bankrupt because of actions derived from corporate control, unless the parent or controlling entity or their shareholders, as the case may be, prove that bankruptcy occurred for other causes.

3.3 Third parties

In case of avoidance transactions, third parties who receive property as a result of a transaction that is avoidable or as a result of a transaction affecting creditors will be liable either to return such property or provide such compensation as the insolvency judge may order if they acted in bad faith.

Any person not related to the administration of the company, who is knowingly carrying on a business concern seeking to defraud creditors also may be liable.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Persons entitled to initiate proceedings

According to Article 74 of Colombian insolvency law (Law 1116 of 2006), in the course of insolvency proceedings, any creditor or the insolvency representative may initiate an avoidance action against the following acts executed by the company / debtor when such acts:

- (a) adversely affect any creditor; or
- (b) affect the priority of payments; and
- (c) the assets of the debtor are insufficient to satisfy all liabilities recognized in the insolvency proceedings.

4.2 General defences

The defences are as follows:

- (a) The transaction was not detrimental to creditors.
- (b) The transaction does not affect the priority of payments; or even if it does so, the transaction was consistent with normal commercial practices and was carried out in the ordinary course of business of the parties.
- (c) The assets of the debtor are sufficient to cover the total amount of the liabilities of the debtor.

Colombian insolvency law provides for different but well-defined avoidance transactions that need to be proved by the insolvency representative or by the creditors. In addition, it provides for various defences to such avoidance transactions.

4.2.1 The avoidance transactions

Such defences are - payment of obligations, transfers in lieu of payment, and any acts that imply the transfer, disposal, constitution or cancellation of liens or the setting of ownership restrictions on property when they are made to the detriment of the debtor's patrimony, or leases that block or hinder the reorganization proceedings. These acts must have taken place during the 18 months prior to the start of the insolvency proceeding; and there must be no evidence that the transferee or lessee acted in good faith. These transactions combine a twilight period (within 18 months) and bad faith.

The transaction may not be rescinded under an avoidance action when the counterparty did not know the debtor was insolvent at the time the transaction took place. According to Colombian insolvency law and jurisprudence, in this case the counterparty acted in good faith.

This approach requires a consideration of the intent of the parties to the transaction and other factors such as the debtor's financial situation (insolvent) at the time the transaction occurred. And this defence involves elements that are subject to dispute and require determination by the insolvency judge.

4.2.2 Gratuitous transactions

Such transactions executed within the 24 months prior to the start of reorganization proceedings.

In the case of gratuitous transactions such as gifts or donations, Colombian insolvency law adopted an objective approach. This approach determines that these transactions are avoidable within the 24 months before the start of the insolvency proceedings and that no defences are available to the parties.

For this type of transaction to be avoided, the insolvency representative or the creditor must prove only that it is a gratuitous transaction as defined by insolvency law and that it occurred within the above time period.

4.2.3 Amendments to the by-laws

If such amendments are effected within the 6 months prior to the start of insolvency proceedings when they diminish the assets of the debtor to the detriment of the creditors or modify the liability of the shareholders of the debtor. These transactions combine a twilight period (6 months) with the effect of the transaction (i.e. the amendment to the bylaws diminishes the assets of the debtor to the detriment of the creditors or modifies the liability of the shareholders).

In this case the defences are that the amendment of the bylaws did not reduce the assets; or that it did reduce them, but this did not occur to the detriment of the creditors; or that the amendment did not modify the liability of the shareholders.

4.3 Further credit

There are no restrictions for directors or other persons involved with the company's affairs to obtain credit during the twilight period. However, if the company is in cessation of payments, officers and directors must abstain from initiating new business operations / transactions. If the officers and directors fail to comply with this, they are jointly and severally liable for any damage or harm inflicted to the shareholders and third parties. The only way of acting properly is informing the creditor about the insolvency situation in advance of taking the additional credit.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Shareholders, directors, statutory auditors and employees

According to Article 82 of Law 1116 of 2006, any creditor of the debtor can bring action against shareholders, directors, statutory auditors and employees.

5.2 The debtor's administrators and shareholders

According to article 5 of Law 1116 of 2006, the insolvency judge²³ may issue a prohibition ex officio for up to ten (10) years. This prohibits administrators and shareholders to carry out and commercial activities under the terms set forth herein under Article 83 of Law 1116 of 2006.

²³ The Office of the Superintendent of Companies or the civil judge of the circuit, Article 6 of Law 1116 of 2006.

5.3 Administrators and accountants

Article 26 of Law 1116 of 2006 entitles creditors to pursue at any time the administrators, accountants and statutory auditors as jointly and severally liable with the debtor (the company) for any accruing damages.

5.4 Parent or controlling entity

According to Article 61 of Law 1116 of 2006 any party with an interest, the shareholders, the creditors, and the insolvency administrator (among others) may bring action against directors and other persons identified in Question 3 above.

5.5 Third Parties

In case of avoidance transactions, any creditor or the insolvency administrator, the promoter or the liquidator may bring action against directors and other persons identified in Question 3 above.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Conduct / act	Remedy available	Regulation
Officers and directors are liable for the debts of the insolvent company that cannot be paid by the company due to the loss of company assets caused by their negligence or wilful misconduct.	Payment of the unpaid debts of the insolvent company.	Article 82 of Law 1116 of 2006
To order, tolerate, make or conceal falsities in the financial statements of the company. Violate the prohibitions of article 57 of the Code of Commerce, regarding restrictions on companies in relation to information disclosed in balance sheets.	The penalty is up to 12 years of imprisonment. Fines imposed by the Chamber of Commerce, the Office of the Superintendent of Finance, or the Office of the Superintendent of Companies. Their imposition will not exclude the criminal liability of the persons involved.	Articles 289, 291 of the Penal Code (Law 599 of 2000) article 289 as amended by article 14, Law 890/04 and article 291 as amended by article 54, Law 1142/07. Article 58 of the Code of Commerce.

Conduct / act	Remedy available	Regulation
<p>Incorporate or use the company to deceive or defraud creditors.</p> <p>To take the company to a state of financial crisis by means of fraud.</p> <p>To destroy company assets totally or partially.</p> <p>Embezzlement or squandering of assets, leading to the start of a process of mandatory liquidation of the company.</p> <p>Non-fulfilment, for no apparent reason, of the reorganization agreement entered into with its creditors.</p> <p>Speculation of any liabilities, whether it be immediate or subsequent to the start of formalities, by purchasing them at a lower price.</p> <p>Diversion, reduction or total or partial concealment of assets.</p> <p>Carrying out of simulated actions, or when expenses, debt or losses are simulated.</p> <p>Where a monetary claim has been abandoned, relinquished or compromised with no cause and at the expense of creditors.</p> <p>When credits from creditors are excluded knowingly, or inexistent liabilities are added.</p>	<p>Criminal Liability.</p> <p>Fraud: Imprisonment for 32 to 144 months and fines (ranging from 66.66 to 1500 minimum monthly wages).²⁴</p> <p>Embezzlement and squandering of assets: Imprisonment for 16 to 54 months and fines (ranging from 13.33 to 300 minimum monthly wages).²⁵</p> <p>Abuse of trust: Imprisonment for 16 to 72 months and fines (ranging from 13.33 to 300 minimum monthly wages).²⁶</p> <p>Civil Liability. Disqualified to exercise any trade, for up to 10 years.</p>	<p>Article 246 of the Penal Code (Law 599 of 2000), as amended by article 33, Law 1474 /11</p> <p>Article 253 of the Penal Code (Law 599 of 2000) as amended by article 14, Law 890/04</p> <p>Article 249 of the Penal Code (Law 599 of 2000) as amended by article 14, Law 890/04</p> <p>Article 83 of Law 1116/06</p>
<p>Officers and directors can be held jointly and severally liable for damage or harm inflicted to third parties by wilful misconduct or negligence.</p>	<p>The director may be ordered to pay damages as redress for the harm inflicted.</p>	<p>Article 200 of the Code of Commerce</p>
<p>In case of cessation of payments by the company; initiating new operations or continuing to trade when there is little prospect of being able to pay debts when they fall due; or to not provide full information of the situation to the shareholders, for them to take all necessary measures and avoid the insolvency of the company.</p>	<p>The director may be ordered to pay damages as redress for the harm inflicted.</p>	<p>Article 224 of the Code of Commerce</p>
<p>Breach of duties and responsibilities of directors, specially related to the financial statements of the company. In this case the creditors may sue the administrators, shareholders or members or controlling parties as secondarily liable.</p>	<p>Payment of the unpaid debts of the insolvent company.</p>	<p>Article 49, Law 1116/2006</p>
<p>Company assets diminish by acts or omissions of administrators/directors.</p>	<p>Payment of the unpaid debts of the insolvent company.</p>	<p>Article 25, Law 222/95</p>

²⁴ The minimum monthly wage in Colombia is of USD\$230 approximately.

²⁵ The minimum monthly wage in Colombia is of USD\$230 approximately.

²⁶ The minimum monthly wage in Colombia is of USD\$230 approximately.

Conduct / act	Remedy available	Regulation
Inside trading	Imprisonment for 1 to 3 years and fines (ranging from 5 to 50 minimum monthly wages). ²⁷	Article 258 of the Penal Code (Law 599 of 2000) as amended by article 18, Law 1474 of 2011
Transaction in twilight period voided	Rights of losing defendant will be struck off from the register as well as those of his assignees, if any; the company (the debtor) is registered as the new holder of the rights it is entitled to. Insolvency judge to order those who have made a contract in bad faith with the debtor and his assignees to return the assets that they acquired to the company.	Article 75 of Law 1116 of 2006
Credit not included in the proposed qualification and grading of credits ²⁸ and not disclosed in the financial statements of the company.	The director may be ordered to pay damages as redress for the harm inflicted.	Article 26 of Law 1116 of 2006

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Obligation to provide information

Under Colombian insolvency law, the debtor and the creditors must cooperate with the insolvency judge and any insolvency administrator. That principle of insolvency law is set out as follows:

“4. Information: Under this principle, the debtor and the creditors must provide all information in a timely, transparent and comparable manner, allowing access to it at any time during the proceedings”²⁹

According to the above principle, the insolvency judge may:

“1. Request or obtain, as he deems convenient, the information he needs for the adequate direction of the insolvency process”³⁰

²⁷ The minimum monthly wage in Colombia is of USD\$230 approximately.

²⁸ The credit qualification and grading project is a proposal in which each credit and its creditor is listed and each credit is classified as credit of first, second, third, fourth or fifth class, according to the rules of Title XL of the Colombian Civil Code.

²⁹ Article 4 Law 1116 of 2006.

³⁰ Article 5 Law 1116 of 2006.

If the director or the statutory auditor with no reasonable excuse fails to comply with any obligation imposed by the insolvency judge under their duty to cooperate, they will be held liable and the insolvency judge may order the removal of the director or the statutory auditor, as the case may be, for failure to comply with the judge's orders, or with the duties and obligations set by the law or the bylaws. The judge will do this either in a procedural manner, or upon request from the creditor, through a justified ruling or order by which it will appoint a replacement.”

If the creditors request the initiation of the insolvency proceedings, and the insolvency judge requires the debtor to provide information, the corresponding authority will order the legal representative of the company to provide the requisite documentation within 30 working days. Should this requirement go unfulfilled, the insolvency judge must order that mandatory liquidation proceedings are started, or that the administrators are removed immediately.³¹

Additionally, the directors must submit all the information needed by the insolvency administrator to present the credit and voting rights qualification and grading project. This includes any claims generated from the date on which the insolvency proceeding initiation request was filed with the insolvency judge through the date on which the proceeding Initiates officially.³²

In general, the duties of any director to government authorities include submitting truthful information, providing documents and answers to judicial requests, allowing surveillance of the company by the Office of the Superintendent of Companies or any other competent authorities.³³

7.2 Human rights

The director of the company may choose to remain silent, refuse to produce documents, deny access to company facilities without a search warrant, refuse to give testimony or to answer questions or he may exercise any other rights that a “suspect” has in accordance with the principle of due process of law as regulated under article 29 of the Constitution.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

In relation to criminal liability, Article 83 of the Criminal Code sets a general limitation period equal to the same period of time of the maximum penalty when the penalty is imprisonment. In any case, the limitation period cannot be less than 5 years nor more than 20 years, counted from the date on which the underlying criminal offence took place or ended. When the criminal penalty is a fine, the limitation period is 5 years only.

The general limitation period for any civil action against directors is 5 years.

Individual tort actions have a statute-of-limitations period of 10 years.

8.1 Administrative authorities

Penalties are imposed by the Office of the Superintendent of Companies and may be challenged through a motion for reconsideration. If the penalty is not reversed, the company may bring suit against the final ruling of the Office of the Superintendent before the Courts.

³¹ Article 14 of Law 1116 of 2006.

³² Article 19 of Law 1116 of 2006.

³³ *Group Insolvency, consolidation of debt and directors' duties and liabilities in Colombia*, by Daniel Posse, Juan Pablo Bonilla and Maria Carolina Sarmiento, Posse Herrera Ruiz; available at: global.practicallaw.com.

8.2 Insolvency judicial authorities

If the penalty is imposed by the Office of the Superintendent of Companies, it may be challenged through a motion for reconsideration filed with the same authority acting in the same instance. If the penalty is not reversed, the director may appeal from the final ruling of the Office of the Superintendent before the Tribunal Superior de Bogotá (the Higher Administrative Court of Bogotá).³⁴

If the penalty is imposed by insolvency judges in the course of insolvency proceedings, it may be challenged through a motion for reconsideration filed with the same authority acting in the same instance only.

8.3 Regular judicial authorities³⁵

An appeal must be filed within three days from notification of the challenged decision with the same Court issuing the decision. This Court will rule on the admissibility of the appeal. If an appeal is held to be admissible, the case file will be sent to the higher (appellate) Court, and the parties will be entitled to ask for the production or collection of any further evidence they deem necessary.

Where the appeal is to be decided by a *Tribunal Superior* or by the Supreme Court of Justice, a date and time for a hearing will be fixed. At such hearing, the parties have one opportunity to address the Court for a maximum of 30 minutes; they may also submit a summary of their statements within the three days following the hearing. Finally, the competent Court will issue its decision.³⁶

QUESTION 9

9. Foreign corporations

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

A foreign company must set up a branch office to carry out permanent activities in Colombia. Branches are considered to be local representation of the foreign company. Therefore, no separate legal entity is created when a branch office is registered, and the acts of the branch bind the foreign company directly.

All the duties of a director of a domestic company apply to the statutory representative of the branch of the foreign company. The following actions violate the specific duties and responsibilities of the directors of a foreign company:

Conduct	Type of liability / remedy	Regulation
Failure by a foreign company to apply the assigned capital of the branch office to the stated corporate purpose of the branch under Article 491 of the Code of Commerce which reads as follows: "When a foreign company does not invest the assigned capital in the activities that pertain to the corporate purpose of the branch, the competent authority will impose successive fines (...) upon the statutory representative so that he applies said capital to the assigned purpose. [These fines will be applied] notwithstanding any other penalties set in this title".	Civil liability, the remedy available is a fine by the Competent Office of the Superintendent.	Article 491 of the Code of Commerce

³⁴ Paragraph 3 article 24 and article 31 of the General Procedure Code.

³⁵ *Litigation 2016, Colombia*, by Eduardo Zuleta, William Araque and David Ricardo Araque-Quijano, Gómez-Pinzón Zuleta (Bogotá). Available at <http://latinlawyer.com/reference/topics/60/jurisdictions/8/colombia>.

³⁶ Article 320 et. seq. of the General Rules of Procedure.

QUESTION 10

10. Insurance

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

The main purpose of directors' and officers' (D&O) insurance is to protect their assets against claims, investigations and losses that will eventually be paid by the insured for any wrongful act.

Directors' and officers' insurance is available for both damages and the costs of defending civil claims, unless such acts amount to wilful misconduct or gross negligence.

Insurance is also available to protect officers and directors from claims that arise while operating a financially distressed company.

The information provided in this country chapter is correct as at 06/04/2017

ENGLAND AND WALES

QUESTION 1

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

(a) How are directors identified / defined?

(b) What is the length of the period ending with formal insolvency proceedings during which transactions entered 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 A “director” is partially defined in the Insolvency Act 1986 (as amended) (IA 1986)¹ and the Companies Act 2006 (CA 2006)² as including any person occupying the position of a director “by whatever name called”. In addition, English common law has treated as directors persons who, although not formally or properly appointed a directors, act as if they were legally directors. Such directors are termed “*de facto*” directors. Besides directors as so defined, certain provisions of IA 1986 (and CA 2006) will apply also to other officers of the company and to “shadow directors”. For an explanation of *de facto* and shadow directors see paragraph 3.2 below.³
- 1.1.2 As a general rule, English law focuses on two questions in relation to the start of the twilight period. First, in connection with a range of ‘clawback’ provisions⁴ the key issue is whether the company was unable to pay its debts at the time (or as a result) of the relevant transaction. A company will be deemed unable to pay its debts if one or more of a number of conditions is satisfied.⁵ One is where a “statutory demand” had been made by a creditor for a sum in excess of £750 which remains unpaid for 21 days and another is where Court-ordered execution on the company’s assets is unsatisfied. These are reasonably clear-cut conditions. But there are two further possible routes to showing inability to pay debts:
- (a) where the Court is satisfied that the company is unable to pay its debts as they fall due – the so-called “cash-flow” test or “short-term cash-flow” test; and
 - (b) where the Court is satisfied that the value of the company’s assets is less than the company’s liabilities (taking into account its contingent and prospective liabilities) – the so-called “balance sheet” test or the “long-term cash-flow” test.⁶
- 1.1.3 But even if a company is unable to pay its debts at the time of a transaction, the law does not have an endless look-back period. For a transaction to be vulnerable there usually has to be an “onset of insolvency” – that is, an administration or liquidation of the company must commence – within a period of six months to two years from the date of the transaction (depending on the particular clawback provision and whether the counterparty is “connected” with the company).⁷

¹ Section 251 IA 1986. Hereafter all references to section or schedule numbers are to IA 1986 unless otherwise indicated.

² Section 250 CA 2006.

³ In this chapter, the term ‘directors’ will unless otherwise stated be used to mean directors validly appointed pursuant to a company’s constitution (its memorandum and articles of association, say) and *de facto* directors. However, as discussed in paragraph 3.2 below, the UK Supreme Court has recently suggested that those caught by the term “*de facto* director” may not necessarily be the same in all legal situations where the term director is used. Specific reference will be made to shadow directors or other officers if the relevant law under consideration pulls them within its ambit. Also when referring to directors this Chapter, for convenience alone, uses the masculine pronoun ‘he’. A director can of course be a ‘she’ and all references to the masculine should be read as including the feminine. Indeed, current corporate governance thinking suggests that, in general terms, more female directors should be being appointed.

⁴ Laws entitling the insolvency office-holder (such as the liquidator or administrator) to claim (back) 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.

⁵ Section 123.

⁶ These two aspects of inability to pay debts have recently been considered and reviewed by the UK Supreme Court in *BNY Corporate Trustee Services Ltd v Neuberger Berman Europe Ltd (on behalf of Sealink Funding Ltd)*; *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc* [2013] UKSC 28. The Court stated the cash-flow test is concerned with ability to meet debts currently due and debts falling due in the reasonably near future. What the reasonably near future was would need to be determined on a case by case basis based on all the circumstances. As regards the balance sheet test as it has historically been called – asset compared to liabilities – the Court rejected the idea of using an accounting or auditing approach and taking a snapshot of the accounting balance sheet at the relevant time (the time of the transaction). Instead they said the test was another way of looking at inability to pay debts. A long-term cash-flow test one might say. The leading judgment in the Supreme Court noted that “it is ... very far from an exact test” and that the burden of proof (under s123 IA) rests on the person alleging the inability to pay debts and concluded: “Essentially, section 123(2) requires the court to make a judgment whether it has been established that, looking at the company’s assets and making proper allowance for its prospective and contingent liabilities, it cannot reasonably be expected to meet those liabilities. The more distant the liabilities, the harder this will be to establish.”

⁷ For more detail see paragraphs 1.1.8 and 1.1.9 and the answers to Question 4.

- 1.1.4 The second half of Question 1(b) brings into focus the concepts of *fraudulent trading* and *wrongful trading*. These are considered in detail in the answers to Question 2 and what follows here is merely an overview. A party commits fraudulent trading if, for example, he dishonestly incurs credit knowing that it is unlikely to be repaid in full. It attracts civil and criminal sanctions. In the civil sphere, it applies where there is a subsequent administration or liquidation which, in practice, will no doubt be an insolvent one. From the design of this provision, it can be seen that there is no set time limit before administration or liquidation within which fraudulent trading is relevant. In practice, the further back one goes from the commencement of the formal insolvency, the less likely it will be that the insolvency was inevitable, or even likely, making the fraudulent trading provision less likely to be triggered. The criminal offence of fraudulent trading has no requirement of a subsequent administration or liquidation.
- 1.1.5 As regards wrongful trading, for current purposes it is sufficient to note that the law focuses on the time at which a director knew or should have realised that it was unreasonable to think that the company would avoid insolvent liquidation or insolvent administration (that is, a formal insolvency where creditors are not paid in full). From that moment, a director will potentially be personally liable unless he does everything possible to minimise losses to creditors. For wrongful trading to be relevant, there has to be a subsequent insolvent administration or liquidation but, like fraudulent trading, there is no set time limit for that to occur. Again, however, the further back in time one goes from the start of the formal insolvency, the less likely in practice that there was no reasonable prospect of the company avoiding an insolvent administration or liquidation.
- 1.1.6 Besides the above considerations, it is worth mentioning that a director has a statutory duty to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole but that this duty subtly alters when a company is in the zone of insolvency.⁸ In these circumstances, the law recognises the economic reality of the company's position⁹ and the directors must exercise their powers and discharge their duties having regard to the interests of the creditors of the company.
- 1.1.7 The twilight period for directors can be said to terminate when the formal insolvency procedure commences as the directors' powers to bind the company either cease or are suspended as against the incoming administrator or liquidator.
- 1.1.8 The rules regarding the date(s) when a formal insolvency (administration or liquidation) starts are set out in the answers to Question 4. As a brief summary, the onset of insolvency occurs for clawback purposes on the date:
- (a) in the case of a Court-based liquidation or administration, when the liquidation petition or administration application is filed with the Courts;
 - (b) the resolution to wind the company up is passed by the company, in the case of a voluntary liquidation; and
 - (c) the notice of intention to appoint is filed in Court or, if no such notice is filed, the date on which the notice of appointment is filed in Court, in the case of an administrator appointed out of Court.
- 1.1.9 The various vulnerability periods for English law clawbacks, being periods prior to the commencement of the formal insolvency within which transactions have to have occurred to be caught, are as follows:
- (a) preferences (e.g. security, charges, payments) – six months, or two years if the preferred person is connected (Ss 239 and 240(1) (a) and (b));¹⁰
 - (b) voidable floating charges – 12 months, or two years if the holder of the floating charge is connected (S 245(3));

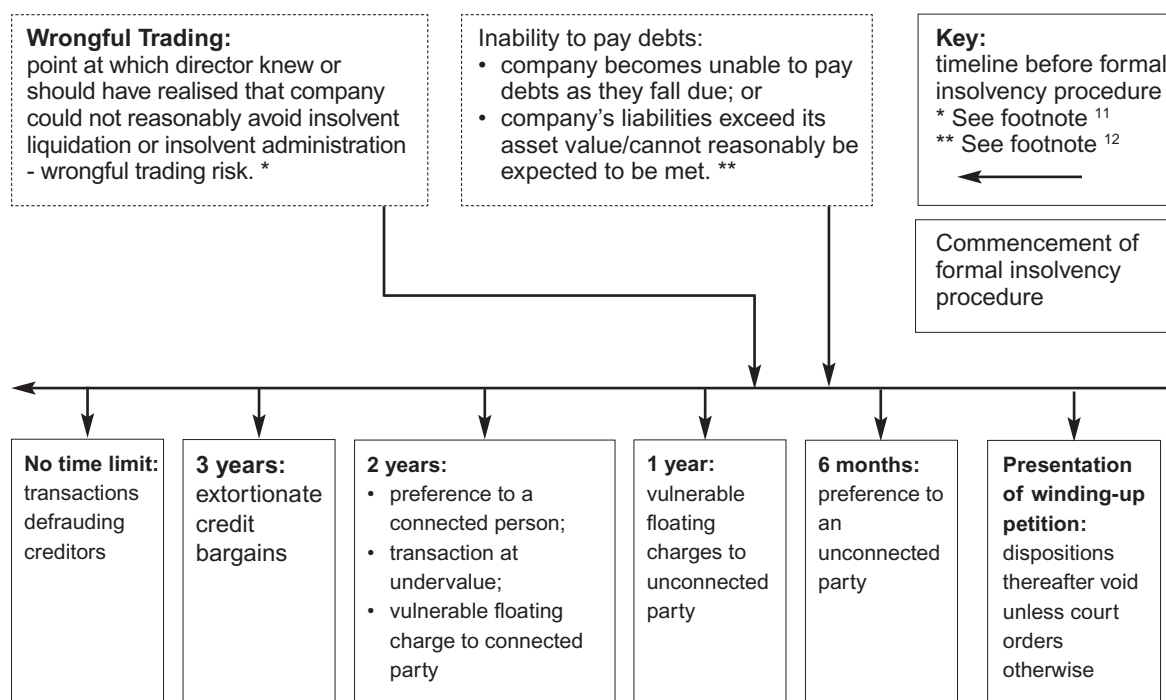
⁸ Section 172(3) CA 2006.

⁹ That the shareholders' funds are exhausted and it is now the creditors' money that the directors are 'playing with'.

¹⁰ In relation to individual transactions the length of the period during which they can be attacked may depend upon whether or not the counterparty to the transaction was connected with the company. Connected persons include directors (and shadow directors upon whose instruction the directors customarily act) and any "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. See sections 249 and 435 for the (dense) detail.

- (c) transactions at an undervalue (e.g. guarantees, sales at materially less than market value, gifts) – 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); and
- (f) dispositions made after winding-up petition presented – from the commencement of winding-up (S 127).

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



1.2 Summary

- 1.2.1 If a company is unable to pay its debts and, within a vulnerability period (usually six months or two years), enters a formal insolvency procedure (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. There are statutory defences. The detail is discussed below in Question 4.
- 1.2.2 Where a director knows (or should know) that insolvent liquidation or insolvent administration 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 creditors.

¹¹ There is no hard date when wrongful trading may commence: the arrowed date in this timeline is merely one possibility.

¹² Similarly, there is no fixed date when a company becomes unable to pay its debts, so the arrowed date here is again hypothetical.

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 may there otherwise be adverse consequences for the director?

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

- (i) Is the director's liability considered to be civil, criminal or both?
- (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
- (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?
- (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 trading¹³

- (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.¹⁴ The elements of wrongful trading are as follows:
- (i) it applies to directors or shadow directors¹⁵ of a company;
 - (ii) it applies where a company has at some point gone into insolvent liquidation or insolvent administration (that is where the liabilities exceed the assets in the liquidation or administration so that creditors go at least in part unpaid);
 - (iii) it applies to a director or shadow director who knew or ought to have concluded that at some point in time there was no reasonable prospect of the company avoiding insolvent liquidation or insolvent administration;¹⁶
 - (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.¹⁷ 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;

¹³ Sections 214 and 246ZB.

¹⁴ In general terms, English law and practice supports a "rescue culture". In such a culture, 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 and earlier formal insolvencies rather than more rescues, turnarounds and corporate recoveries. But there does need to be protection of creditors from acts of irresponsible management and the wrongful trading provision does require directors to focus their minds on the impact their actions and decisions have on creditors during this time and to act to a reasonable standard.

¹⁵ See paragraph 3.2 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 controls what the directors do. It will also include parent companies who decide what their subsidiaries do and they may in practice be less 'shadowy' about that influence.

¹⁶ This will depend upon rational expectations as to the future. Examples of acting otherwise than on rational expectations as to the future include: where there has been "confusion between aspiration and actuality" (*Re Onslow Ditching Ltd* [2011] EWHC 257 (Ch)); "wilfully blind optimism" (*Langreen Ltd (in Liquidation)* (2011) LTL 26/10/2011); and unreasonable hope that "everything would turn up" (*Singla v Hedman* [2010] EWHC 902 (Ch)).

¹⁷ The court stressed the objective element of the test in *Singla v Hedman* [2010] EWHC 902 (Ch) and refused to accept the argument that there was a lower standard of responsibility in an inherently risky business (such as the film industry).

- (v) once it can be said of any director or shadow director that he knew or should have realised that insolvent liquidation or insolvent administration was the only reasonable prospect then he is in the wrongful trading zone and may be liable for failure to take every step to minimise losses to creditors.¹⁸ 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;
 - (vi) Liquidators and administrators can now assign a claim for wrongful trading (to, say, a purchaser) meaning that such claims can be pursued by persons other than the liquidator or administrator.¹⁹
- (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.²⁰ However, the essence of the law is to compensate creditors for the loss caused by the director's conduct.²¹
 - (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) First, there is no wrongful trading where the director or shadow director did not realise and could not have been expected to realise, that there was no reasonable prospect of avoiding insolvent liquidation or insolvent administration.²² Secondly there is a statutory defence that, if insolvent liquidation or insolvent administration 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.²³

2.2 Fraudulent trading²⁴

- (a) This applies where a company is in liquidation or administration and it is shown that the business of the company has "been carried on with intent to defraud creditors of the company or the creditors of any other person or for any fraudulent purpose". The elements of the concept are therefore, as follows:
 - (i) there has to be a liquidation or administration in progress;²⁵

¹⁸ *Re Robin Hood Centre Plc* [2015] EWHC, 2289 (Ch) referred to factors which fall to be considered by directors and kept under review with the "every step" requirement in mind, such as ensuring the company had proper up to date accounting information (e.g. budget, cash flow forecast and outcomes), that there was a suitable business plan including plans for minimising loss, (for example by cost-cutting), keeping creditors informed, doing deals with suppliers and customers as appropriate, ensuring regular monitoring of all these aspects, taking professional advice (legal and financial) and having formal insolvency fallback plans prepared.

¹⁹ Section 246ZD.

²⁰ *Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC 520.

²¹ One test for calculating the loss is to look at the amount by which the company's assets are depleted by the conduct of the director after he became aware or ought to have become aware that there was no reasonable prospect of the company avoiding insolvent liquidation. The loss is not necessarily the amount of the new debt incurred or the cash paid out during the twilight period: In the matter of *Marini Limited (The liquidator of Marini Limited v Dickinson)* [2003] EWHC 334 (Ch). See also *Re Produce Marketing Consortium Ltd (No. 2)* supra and *Re Bangla Television (in liquidation), Valentine v. Bangla Ltd* [2009] EWHC 1632 (Ch). In *Re Ralls Builders Limited (in liquidation)* [2016] EWHC 243 (Ch), the judge took as his starting point the answer to the question whether by continuing trading (and not initiating a formal insolvency procedure) the company had suffered loss – measured by whether the net deficiency to unsecured creditors increased or reduced over the period. Having concluded there had been no net increase in the shortfall to unsecured creditors, the judge declined to make an award for wrongful trading against the directors.

²² In *Re Cubelock* [2001] BCC 523 the court commented that "the law has to leave room for cases where it was acceptable for the directors to take the view that their company, though insolvent in balance sheet terms for the present, was going to trade its way back into profit so that all creditors would be paid". In *Re Hawkes Hill Publishing Co Ltd (in liquidation)* [2007] All ER (D) 422 the court stated that the answer to whether a director knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation did not depend on a snapshot of the company's financial position at any given time but on rational expectations of what the future might hold; directors were not expected to be clairvoyant. This was followed in *Earp v. Stevenson* [2011] EWHC 1436 (Ch). The courts have also said that care should be taken not to rely on the wisdom of hindsight and proper regard has to be had to the difficult choices which often confront directors when deciding whether to continue to trade and on what basis (*In the matter of Idessa (UK) Ltd (in liquidation) (Burke v Morrison)* [2011] EWHC 804 (Ch)).

²³ In *Re Ralls Builders Ltd (in liquidation)* supra, on the facts there was no loss caused by continued trading. However, the make-up of the creditor constituency changed over the period: there were winners and losers. The judge held that if there had been loss caused by the continued trading (if the net creditors had increased) this cause of an increased loss to some creditors would have meant the directors would not have been able to rely on the defence of taking 'every step' to minimise loss to creditors – a 'high hurdle' – as that concept involved minimising the risk of loss to individual creditors.

²⁴ Section 213 and 246ZA.

²⁵ This is as regards the civil sanction. There is no such requirement for the criminal offence contained in section 993 CA 2006.

- (ii) there has to have been dishonesty in the running of the business (or reckless indifference as to whether or not creditors were defrauded) as that is the meaning of defrauding creditors or carrying on a business for a fraudulent purpose.²⁶ The dishonesty must have been with the intention of defrauding creditors and not, for example, of avoiding some other liability;
 - (iii) as dishonesty is involved, the standard of proof is that of ‘beyond reasonable doubt’, even in a case of civil liability;
 - (iv) it applies to persons²⁷ 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, and it could in theory be wide enough to catch a financier who funded the fraudulent trading knowing that it was being done dishonestly;²⁸
 - (v) as is the case with wrongful trading, liquidators and administrators can now assign their right to a claim for fraudulent trading meaning that such claims can be pursued by persons other than the liquidator or administrator.²⁹
- (b) (i) Liability may be criminal³⁰ or civil.
- (ii) The Court enjoys a wide discretion to compensate for the loss caused to the company by the director’s conduct but for the civil law offence the Court may not include a punitive element in the award of damages made.³¹
 - (iii) As with wrongful trading, there should be an element of proportionality albeit that the Court’s discretion is very wide.³²
 - (iv) There is no specified period.
 - (v) The main defence is that the party concerned was not dishonest. In practice, the party may be able to admit to incompetence, imprudence or even folly as long as he honestly believed that, for example, any new credit incurred would ultimately be repaid in full. However, simply turning a blind eye to the obvious may amount to fraudulent trading. But it is worth noting that it was rare and remains rare for persons to be found liable for fraudulent trading. Historically, this has resulted from the difficulty of proving dishonesty and, now, wrongful trading will on most sets of facts be easier to prove.

2.3 Fraud in anticipation of winding-up³³

- (a) Where a company goes into liquidation, personal liability will attach to a past or present “officer”³⁴ of the company who has within the previous 12 months (to summarise):
- (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, falsified or made a false entry any records of the company (or relating to the company’s property of affairs);
 - (iii) fraudulently parted with, altered or made any omission in any document affecting or relating to the company’s property or affairs; or

²⁶ Incurring new credit knowing it will not be repaid in full and where the creditor is unaware of this is a fact pattern which may trigger this provision.

²⁷ In *Bilta (UK) v Nazir and others* [2015] UKSC 23, it was held that “any person” (to which section 213 applies) was not confined to persons within UK jurisdiction (ie to those involved in fraudulent trading activities in England), but that section 213 has extra-territorial effect.

²⁸ *Re Bank of Credit and Commerce International SA (No.2), Banque Arabe et Internationale D’Investissement SA v Morris* [2000] All ER (D) 1437.

²⁹ Section 246ZD.

³⁰ Section 993 CA 2006. Section 213 is concerned only with civil liability.

³¹ *Morphitis v Bernasconi* [2003] All ER (D) 33 and *Morris v Bank of India* [2004] All ER (D) 378. An element of interest may be included in any award. Under the criminal law provision – section 993 CA 2006 – there may be a punitive element.

³² The liability of each director should be fixed separately and the contribution to be made by each director need not be the same but the court can declare that liability should be joint and several: *Re Overnight (No 2)* [2010] EWHC 613.

³³ Section 206.

³⁴ There is no comprehensive definition of an “officer” in either IA 1986 or CA 2006. However, section 1173(1) CA 2006 (incorporated into the IA 1986) states that an officer in relation to a body corporate will include “a director, manager or secretary”. 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 seems reasonable to conclude that such a person will not be included as an officer for that provision. For a discussion of the meaning of “manager”, see footnote 123 to paragraph 3.3.1 below.

- (iv) pawned, pledged or disposed of any property of the company which has been obtained on credit and not fully paid for – unless such action was in the ordinary course of business.
- (b) If any of (i) – (iv) above is satisfied:
 - (i) Liability is criminal.
 - (ii) A person guilty of the 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; and
 - (v) The following defences exist.
 - (A) that there was no intent to defraud or to conceal;³⁵ and
 - (B) that there was no intent to defeat the law.

2.4 Transactions in fraud of creditors³⁶

- (a) This applies where a company goes into liquidation and the offence is made out if an officer³⁷ of the company:
 - (i) has made or caused to be made any gift or transfer of, or charge on, or has caused or connived at the levying of any execution against, the company's property, or
 - (ii) has concealed or removed any part of the company's property since, or within two months before, the date of any unsatisfied judgment or order for the payment of money obtained against the company.
- (b) (i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.
- (ii) Please see (i) above.
- (iii) Please see (i) above.
- (iv) The impugned transaction must have occurred during the five years before the commencement of the winding-up.
- (v) Proof of absence of intent to defraud the company's creditors amounts to a defence.

2.5 Misconduct in course of winding-up³⁸

- (a) Where a company is in liquidation, a past or present officer³⁹ 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;

³⁵ On the question of proof, it was held in *R v Carass* [2002] 1 WLR 1714 that: "It is a defence for a person charged... to adduce evidence sufficient to raise an issue that he had no intent to defraud unless, if he does so, the prosecution proves the contrary beyond reasonable doubt" and accordingly the evidential burden was not incompatible with the right to a fair trial under the Human Rights Act 1998. On human rights aspects generally, see further at paragraph 7.8 below.

³⁶ Section 207.

³⁷ See footnote 34 above. A person will only be liable if he was an officer of the company at the time of the winding-up.

³⁸ Section 208.

- (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;
 - (iv) after the commencement of the winding-up, prevents the production of any records relating to the company's property or affairs; or
 - (v) attempts to account for any part of the company's property by fictitious losses or expenses, or attempted to do so at a meeting of the company's creditors within 12 months of the commencement of the winding-up.
- (b) If any of (i) – (v) above is satisfied:
- (i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.
 - (ii) Please see (i) above.
 - (iii) Please see (i) above.
 - (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 that is activity in the twilight period. All of the other offences under this provision only apply when a company is being wound up. and
 - (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 state of affairs of the company or to defeat the law is a defence to a charge under 2.5(a)(iv) above.

2.6 Falsification of company's books⁴⁰

- (a) An officer⁴¹ 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 any of the conditions in (a) above is satisfied.
 - (i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.
 - (ii) Please see (i) above.
 - (iii) Please see (i) above.
 - (iv) This offence can only occur while the company is being wound up. and
 - (v) Absence of intent to defraud or deceive will amount to a defence.

2.7 Material omissions from statement relating to company's affairs⁴²

- (a) When a company is being wound up, a past or present officer⁴³ of the company commits an offence if he makes any material omission in any statement relating to the company's affairs and this includes omissions in any such statement prior to the winding-up.

³⁹ See footnote 34 above.

⁴⁰ Section 209.

⁴¹ See footnote 34 above.

⁴² Section 210.

⁴³ See footnote 34 above.

- (b) If the requirements of 2.7(a) are satisfied:
- (i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.
 - (ii) Please see (i) above.
 - (iii) Please see (i) above.
 - (iv) This offence applies when a company is being wound up to omissions in any statements relating to the company's affairs, whether made during or before the winding-up. and
 - (v) Absence of intent to defraud is a defence.

2.8 False representations to creditors⁴⁴

- (a) When a company is being wound up, any past or present officer⁴⁵ of the company commits an offence if he makes any false representation or commits any other fraud for the purpose of obtaining the consent of the company's creditors or any of them to an agreement with reference to the company's affairs or to the winding-up.
- (b) If the requirements of 2.8(a) are satisfied:
- (i) The liability under this provision is criminal and the answers to 2.3(b)(ii) and (iii) above will apply.
 - (ii) Please see (i) above.
 - (iii) Please see (i) above.
 - (iv) This offence applies to false representations made when a company is being wound up and at any time prior to the winding-up. and
 - (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 Misfeasance⁴⁶

- (a) A past or present officer⁴⁷ of a company in liquidation who has misapplied or retained, or become accountable for, any money or other property of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty including negligence in relation to the company the direct consequence of which is misapplication or loss of assets will incur liability.⁴⁸
- (b) An action for misfeasance may be brought not only by a liquidator of the company but also a creditor of the company.⁴⁹ The English Courts have seen a regular stream of cases for misfeasance brought by liquidators but also by creditors such as Her Majesty's Revenue and Customs (HMRC), the UK government's tax division. Different types of plaintiff, differently resourced defendants (and accordingly different standards of legal argument and different capacities to appeal decisions), different cases cited in arguments before the Courts, different fact patterns and the making of legal concessions by parties in different cases has led to different strains of legal authority in the decided cases. Overlapping with the field of preference, the cases often involve payments by the insolvent company in the twilight period. Questions that have arisen in the cases include:

⁴⁴ Section 211.

⁴⁵ See footnote 34 above.

⁴⁶ Section 212. Note that this section does not create a new liability, just a simpler procedure and a statutory remedy against officers (and others) who breach their duties (statutory, common law or fiduciary).

⁴⁷ See footnote 34 above.

⁴⁸ See *Re Idessa (UK) Ltd (in liquidation) (Burke v Morrison)* supra for an example of misfeasance (and examples of the duties, a breach of which, will constitute misfeasance). They include making distributions not out of the profits available for that purpose, making loans to directors of the company or of its holding company and funding of a director's expenditure (unless pre-approved and for the purpose of enabling him to properly perform his duties as an officer of the company).

⁴⁹ Or, with the leave of the court, a contributory (for example a shareholder whose shares are not fully paid up and therefore liable to contribute the balance not paid up on the shares).

- (i) If a director authorises a payment by a company to one creditor in a class ahead of (or in 'preference' to) other creditors in the class which has the effect of improving the position of the recipient (because in an insolvency the creditor would only have been repaid in part), is he liable for breach of duty?
- (ii) Does it make a difference if the payment is or is found to be a technical preference under S 239?⁵⁰
- (iii) Is it relevant to a breach of duty allegation of this type that there may be no loss to the company because a valid creditor has been paid?
- (iv) Is the correct analysis that a payment in breach of duty is an abuse of power by an agent (the director on behalf of the company, his principal) of which the payee has to be on notice for the payment to be attacked?
- (v) If the payee is on notice, is the payment void or merely voidable?
- (vi) Alternatively, is the correct analysis that the wrongful payment is a misapplication of trust property by a fiduciary (by the director of company monies) and so loss to the company is irrelevant as the remedy is to require restoration of company property by the misfeasant fiduciary (the director)?

The answers to these questions seem currently to be as follows (following the above numbering):

- (i) If the payment was (A) made for a proper corporate purpose and (B) this was done in the interests of the company's creditors – say it was made to a crucial supplier who was going to cease supplying to the business – it is likely not to be a breach of duty by the directors making/authorising/directing the payment. If either (A) or (B) is not satisfied, then it is likely to be a breach of duty on the director's part.⁵¹
- (ii) The seminal and leading case in this area is the Court of Appeal decision *West Mercia Safetywear Limited v Dodd*⁵² (*West Mercia*) where directors were found liable in misfeasance for causing a fraudulent preference⁵³ comprising a payment to a connected company which payment could not be recovered from the payee. Some cases suggest that the *West Mercia* doctrine may be limited to cases where the recipient of the preference is connected to the company or its directors or that it is not sufficient in seeking to prove breach of duty merely to show that a preference has been made.⁵⁴ Other cases suggest there is a clearer correlation.⁵⁵ The burden of proof is often important. Where the preference is of a connected person there is a presumption that one of the conditions of preference – the desire of the company to prefer the recipient – is satisfied. But, on the same facts, there is no such presumption in a misfeasance claim.⁵⁶ However, in a misfeasance claim, where the director or a connected person is the recipient, the burden of proof shifts to the director to show that the relevant payment was proper.⁵⁷

The point behind this question (question (ii) above) is that even when a company commits a preference by, say, repaying a director's debt of £100 during the twilight zone, its balance sheet is unaffected in that it has £100 less cash but also £100 fewer creditors: the company has suffered no loss.⁵⁸ However, the Courts have accepted other arguments rendering directors liable for misfeasance in these circumstances. First, there is a line of authority that puts directors in the position of fiduciaries – trustees – of the assets (including money) of the company. Misapplication of trust funds (making a payment for an improper purpose) is remedied not by assessing loss but by requiring the trustee to restore to the company the

⁵⁰ See paragraph 4.4 below for an explanation of the law of preference.

⁵¹ *Re GHLM Trading Limited* [2013] EWHC 61 (Ch); *Re HLC Environmental Projects Limited (in liquidation)* [2013] EWHC 2876 (Ch).
⁵² [1988] BCLC 250.

⁵³ Under the law prior to IA 1986 - which replaced "fraudulent preference" with "preference".

⁵⁴ *Re Brian D Pierson (Contractors) Ltd* [1999] BCC 26; *Re GHLM Trading Limited* supra; *Knight v Frost* [1999] BCC 819.

⁵⁵ *Re Palmier plc* [2009] 983 (Ch) where counsel conceded the point and the judge said the concession was rightly made; *Re HLC Environmental Projects Limited (in liquidation)* supra

⁵⁶ In *Re Brian D Pierson (Contractors) Ltd* supra, the preference presumption was rebutted (the directors produced evidence rebutting the presumption) but the judge commented that, even if preference had been proved by the liquidator (relying on the presumption) that did not mean the liquidator had positively proved misfeasance.

⁵⁷ *Re HLC Environmental Projects Limited (in liquidation)* supra; *Re GHLM Trading Limited* supra; *Idessa (UK) Ltd (in liquidation)* (*Burke v Morrison* supra).

⁵⁸ *Re GHLM Trading Limited* supra. The average creditor will be worse off in an ensuing liquidation as his dividend will be slightly reduced but the company's balance sheet is unaffected.

misapplied monies.⁵⁹ Another approach is to say that where agents – such as directors – contract to bind their principal or carry out an act on behalf of the principal and in either case so doing is in excess or an abuse of their authority as agents and the counterparty (the recipient of the preference) is on notice of that fact the contract is void (or at least voidable).⁶⁰ In one case the Court indicated that redress will be forthcoming where a director profits from a preferential payment (not attackable as a technical preference under S 239, IA 1986) that he caused the company to make. The Court did, however, note that identifying the existence or quantum of profit can be problematic where the company has not entered into a formal insolvency procedure as was the position on the facts of the case.⁶¹

The West Mercia doctrine covers a wider area than just preferential payments. When a company is in the zone of insolvency (to use a neutral phrase) directors' duties generally to the company undergo a change. Whereas in solvent times the duty to the company requires regard to be had to the interests of members, when insolvency looms the duty of the directors involves having regard to the interests of the creditors rather than the members. The decided cases have used various terms to describe the time at which this change occurs without distinguishing between them. The terms include that the company is 'on the verge of insolvency', 'in a parlous financial state', that its financial position is 'precarious', 'doubtful' or 'marginal' and that it faces 'a real (as opposed to remote) risk of insolvency'. The latter phrase would seem to put the time of the switch from members' interests to creditors' interests at an earlier time than the other formulations. The point had to be faced head on by the court in *Bti 2014 Llc v Sequana S.A.*⁶² Rose J rejected the 'real risk of insolvency' formulation which she felt would result in too early a switch from members' to creditors' interests. She approved a dictum of Norris J in *Roberts v Frohlich*⁶³ where the judge referred to the doctrine applying to 'a company of doubtful solvency where a long term view is unrealistic' (Rose J's emphasis). The approach of Norris J and Rose J – which seeks to avoid setting too early a date from which directors need to think primarily or exclusively of the interests of creditors – received support in the judgment of HHJ David Cooke in the subsequent case of *Dickenson v NAL Realisations* [2017] EWHC, 28 (Ch).

- (iii) See (ii) above.
 - (iv) See (ii) above.
 - (v) See (ii) above.
- (c) (i) The liability here 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 a wide discretion with respect to the orders it may make under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability.
 - (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.⁶⁴

⁵⁹ *Re Palmier plc supra*; *Re HLC Environmental Projects Limited (in liquidation) supra*.

⁶⁰ *Re GHLM Trading Limited supra*. The conduct complained of in the case was the directors causing the financially distressed company to enter into a contract to transfer physical stock of the company in settlement of company debts owed to a connected party which was on notice of the abuse of power by the directors. The judge in the case said he thought the contract was void although he also analysed what the position would be if it were merely voidable. The outcome in practice would have been the same, he said.

⁶¹ *Re GHLM Trading Limited supra*.

⁶² [2016] EWHC 1686 (Ch).

⁶³ [2011] EWHC 257 (Ch).

⁶⁴ Section 1157 CA 2006 which was considered in *McGivney Construction Ltd v Kaminski* [2015] CSOH 107 and *Hedger v Adams* [2015] EWHC 2540 (Ch) and the predecessor of section 1157 (section 727 Companies Act 1985) was considered in *Re Loquitur* [2003] 2 BCLC 442 and *Re MDA Investment Management Ltd* [2005] BCC 783. The cases show that the applicability of this defence is inevitably fact-specific. There is an apparent inherent illogicality in a defence which requires reasonableness of conduct to provide relief from liability for activity which itself involves unreasonable behaviour on the part of the director. It may be that different standards of reasonableness apply.

2.10 Re-using a prohibited company name⁶⁵

- (a) In the consultations and discussions on UK insolvency law which led ultimately to IA 1986, a number of creditor groupings complained about certain conduct of directors which was going unpunished and was known as the “Phoenix Syndrome”. A typical scenario was for directors to run their company into the ground at the expense of creditors, put the company into liquidation, buy the business back from the liquidator via a new corporate vehicle and then trade on under the same business name having left their creditors behind (and unpaid). The 1986 legislation addressed this problem in a number of ways. Insolvency practitioners such as liquidators became regulated for the first time. The threat of withdrawal of their licence to practice was intended to encourage liquidators to be unwilling to be involved in any impropriety in any re-purchase of the business by the directors. Wrongful trading was introduced to encourage directors not to run a company into liquidation at the expense of creditors by making personal liability a real possibility if they did not take action earlier. To give the directors a rescue tool to use to save their company rather than put it into liquidation, the turnaround procedure of administration was made available. The final piece of the jigsaw was a provision to prohibit the use of the old business name by the directors in their new vehicle save in specific circumstances.

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 insolvent liquidation is prohibited from being concerned in another company which uses the insolvent company’s name or a name similar to that name so as to suggest an association with it. The extent of the prohibition is that, except with the leave of the Court, a director (or a shadow director) is not permitted for a period of five years from the date of the commencement of the relevant liquidation:

- (i) to be a director of any company that is known by a “prohibited name”;
- (ii) in any way, whether directly or indirectly, to be concerned or take part in the promotion, formation or management of such a company; or
- (iii) in any way, whether directly or indirectly, to be concerned with or take part in the carrying on of a business carried on (otherwise than by a company) under a prohibited name.⁶⁶

A “prohibited name” is:

- (i) a name by which the company which went into insolvent liquidation was known at any time during the 12 months prior to the commencement of the liquidation; or
- (ii) a name so similar to that name as to suggest an association with the company in insolvent liquidation. This would include a trading name as well as a registered name.

- (b) (i) Liability may be criminal,⁶⁷ civil⁶⁸ or both.
- (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 using the prohibited name; and
- (B) in relation to a person who acts on or was willing to act on instructions given by someone whom he knows to be acting in contravention of S 216, personal liability can be incurred in respect of such debts and other liabilities of the new company as are incurred at a time when he was acting on or was willing to act on those instructions.
- (iii) Liability may arise where the re-use of the company name took place without the consent of the Court during the period of five years beginning with the day on which the company went into liquidation if the re-used name is the same as the name used by the insolvent company during the 12 month period ending with the liquidation or is so similar to that name as to suggest an association with it.

⁶⁵ Sections 216 and 217.

⁶⁶ An established company (for example a member of the same group of companies) may also have a prohibited name or may change its name to a prohibited name, with the result that a director may be caught by this provision. It was held in *Ricketts v AD Valorem Factors Ltd* [2004] B.C.C. 164 that “...if the name of the second company was a prohibited name within the natural and ordinary meaning of the language of s.216(2) then it was caught by the legislation even if it was not a “Phoenix Syndrome” case and even if the sanctions of criminal liability seem to be harsh”.

⁶⁷ Section 216.

⁶⁸ Section 217.

- (iv) The Court is empowered to grant dispensations from the prohibition imposed under this provision which it is more likely to do if the insolvency is not linked to any blameworthy conduct on the part of the director and/or there is little risk to the public. The legislation⁶⁹ provides for the following exemptions:
- (A) where 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;⁷⁰
 - (B) for an interim period, whilst an application for permission to act is made to the Court;⁷¹ and
 - (C) where the other 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.⁷²

2.11 Destroying, mutilating etc. company documents⁷³

- (a) There are many legal duties affecting directors which apply whether or not formal insolvency occurs. But in the twilight zone, the pressures on directors may bring such duties into sharper focus. A company legislation provision provides that any officer⁷⁴ 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 a 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.
- (i) Please see (i) above.
 - (ii) Please see (i) above.
 - (iii) There is no time period within which the relevant act must have been undertaken in order for liability to attach to a director.
 - (iv) Absence of an intention to conceal the company's state of affairs or to defeat the law is a defence.

2.12 Fiduciary duties owed to the company

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

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

⁶⁹ Rules 4.228-4.230 of The Insolvency Rules, made under the authority of IA 1986 (IR).

⁷⁰ Rule 4.228 IR 1986.

⁷¹ Rule 4.229 IR 1986.

⁷² Rule 4.230 IR 1986.

⁷³ Section 450 Companies Act 1985 (as amended by section 1124 CA 2006).

⁷⁴ See footnote 34 above.

The codified duties are:

- (i) duty to act within powers;⁷⁵
- (ii) duty to promote the success of the company for the benefit of its members as a whole;⁷⁶
- (iii) duty to exercise independent judgement;⁷⁷
- (iv) duty to exercise reasonable care, skill and diligence;⁷⁸
- (v) duty to avoid conflicts of interest;⁷⁹
- (vi) duty not to accept benefits from third parties;⁸⁰ and
- (vii) duty to declare any interest in a proposed transaction or arrangement.⁸¹

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

However, the duty to promote the success of the company has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interest of creditors of the company.⁸² This is a reference to the common law rule that, once a company becomes insolvent or nears insolvency, the interests of the creditors are paramount over those of the members of the company. Thereafter the directors' duties are subject to an overriding duty to have regard to the interests of the general creditors of the insolvent company.⁸³

- (b) (i) Liability for breach of these duties is civil. S 178 CA 2006 provides that the consequences of breach (or threatened breach) of Ss 171 to 177 (the statutory duties referred to above) are the same as would apply if the corresponding common law rule or equitable principle applied. The duties in those sections (with the exception of the duty to exercise reasonable care, skill and diligence) are, accordingly, enforceable in the same way as any other fiduciary duty owed to a company by its directors. No express provision has been made in respect of the duty to exercise reasonable care, skill and diligence but remedies for breaches of this duty are provided by common law.
- (ii) Liability is for all loss to the company occasioned by the breach of duty subject to the usual rules of recoverability which depend on considerations of causation and remoteness of damage.
- (iii) Liability for breach of fiduciary duty is joint and several for the entire loss in the first instance. The Court can, however, allocate contributions as between the defendant directors taking into consideration their respective levels of culpability for what has taken place.⁸⁴
- (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:

⁷⁵ Section 171 CA 2006.

⁷⁶ Section 172 CA 2006.

⁷⁷ Section 173 CA 2006.

⁷⁸ Section 174 CA 2006.

⁷⁹ Section 175 CA 2006.

⁸⁰ Section 176 CA 2006.

⁸¹ Section 177 CA 2006.

⁸² Section 172(3) CA 2006.

⁸³ Confirmed in *Re Idessa (UK) Ltd (in liquidation) (Burke v Morrison)* supra (post the statutory codification of directors' duties), following the pre-codification cases of *West Mercia Safetywear Ltd v Dodd* supra and *Re MDA Investment Management Ltd* supra. See also above at paragraph 2.9, particularly as regards how close to insolvency the company has to be for the duty to have regard to creditors' interests to kick in.

⁸⁴ Section 1, Civil Liability (Contribution) Act 1978.

- (A) he acted honestly;
- (B) he acted reasonably; and
- (C) he ought fairly to be excused from liability in all the circumstances.⁸⁵

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

2.13.1 A director must exercise reasonable care, skill and diligence in fulfilling his functions.⁸⁶ The standard expected is assessed by reference to both an objective test and a subjective test, as a director has to exercise the care, skill and diligence that would be exercised by a reasonably diligent person with (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions entrusted to the director in relation to the company (the objective test), and (b) the general knowledge, skill and experience that the director has (the subjective test). So, the director must meet the higher of these two tests.⁸⁷

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

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

2.13.3 The standard of care required from a non-executive director is the same as that required from an executive director. But there will be some differences in the role which a non-executive will be expected to fulfil.⁸⁸ So, the required standard may differ in application due to the difference in the role or the functions which non-executives are expected to fulfil. For example, it is commonly acknowledged that executive directors have more day to day responsibility for the running of a company and non-executive directors cannot generally dedicate themselves to their role on a full time basis.

2.13.4 For listed companies, corporate governance developments provide some guidance as to the role that directors are expected to fulfil. The UK Corporate Governance Code (September 2014) issued by the Financial Reporting Council (FRC) provides guidance in this respect. In relation to non-executive directors, a key principle is that they should constructively challenge and help develop proposals on strategy. They should scrutinise the performance of management in meeting agreed goals and objectives, monitor the reporting of performance and satisfy themselves as to the integrity of financial information. They are responsible for determining executive remuneration and have a prime role in relation to appointments and succession planning. They must join with the executives in leading the company, and they must be able to allocate sufficient time to their position to discharge their responsibilities. They also have a key role to play in relation to risk management and internal control (see the FRC Guidance on Internal Control of September 2014 – formerly known as the Turnbull Guidance).

⁸⁵ Section 1157 CA 2006 (as mentioned in paragraph 2.9(c)(v) above in the context of the misfeasance remedy in section 212 IA 1986).

⁸⁶ Section 174 CA 2006.

⁸⁷ However, it was stated in *Re HLC Environmental Projects Ltd* supra that in some circumstances a purely objective test would apply in relation to section 172 of the CA 2006: (a) first, in considering whether creditors' interests were 'paramount'; (b) the subjective test only applies where there was evidence of actual consideration of the best interests of the company by the relevant directors, so that where there was no such evidence the proper test was objective: whether an intelligent and honest man in the position of a director of the company could, in the circumstances, have reasonably believed that the transaction was for the benefit of the company; and (c) where there was a very material interest, for example a large creditor's interest which was unreasonably overlooked by the directors in forming their view, the test becomes objective. Also it was stated in *Richmond Pharmacology Ltd v Chester Overseas Ltd* [2014] EWHC 2692 (Ch) that both sections 174 (exercising care and skill) and 175 (avoiding conflicts of interest) CA 2006 impose an objective test.

⁸⁸ In *Equitable Life Assurance Society v Bowley* [2003] B.C.C. 829, it was noted that: "There is a considerable measure of agreement about the duty owed in law by a non-executive director to a company. In expression it does not differ from the duty owed by an executive director but in application it may and usually will do so."

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

2.13.6 An executive director will normally also have a service contract which should provide further clarification of his role and duties.

2.14 Incurring further credit

2.14.1 The incurring of further credit may be part of the factual matrix for one of the grounds of liability discussed above, for example (and most probably) wrongful or fraudulent trading. For further discussion see the answer to Question 4(c) below.

2.15 Liability of directors to disqualification

2.15.1 The relevant legislation is the Company Directors Disqualification Act 1986 (as amended by the Small Business, Enterprise and Employment Act 2015) (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 1986,⁸⁹ in practice almost all disqualification orders where there has been an insolvency are made on the basis of conduct evidencing a person's 'unfitness' to act as director,⁹⁰ 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 another insolvency regime such as administration or administrative receivership. There is no provision in the CDDA 1986 for automatic disqualification: an application to Court for an order is required. Disqualification orders can also be made by the Court of its own volition where the person concerned has been held liable to make a contribution to the assets of a company in administration or liquidation on the grounds of fraudulent or wrongful trading.⁹¹

2.15.2 Since 1 April 2001, directors against whom disqualification proceedings would have otherwise been brought on the basis of 'unfitness' can instead voluntarily give an undertaking that they will not act as a director or be involved in the formation of a company for a set period of time.⁹²

2.15.3 Apart from the case where a disqualification order is made as part of the sentence imposed following conviction for a crime, disqualification proceedings have been consistently held to be civil and not criminal in nature, both by UK Courts and by the European Court of Human Rights (see further at paragraph 7.8 below). There is also, generally speaking, no anterior time limit in respect of the conduct of a director which can be examined. The only exception is where the disqualification order follows consequentially upon some other Court ruling, such as a finding of wrongful trading, to which a limitation period applies.

Acts potentially giving rise to a disqualification order

2.15.4 As noted above, in all but a few instances, the ground on which an order is made is a finding of 'unfitness' based on the person's conduct in relation to one or more companies or overseas companies which has become insolvent (i.e. gone into administration, administrative receivership or insolvent liquidation). There is no statutory definition of 'unfitness'. Instead, the CDDA 1986 sets out in schedule 1 a list of matters to be taken into account in particular by the court in deciding whether a director is unfit. The same matters are to be taken into account by SSBEIS in deciding whether or not to commence disqualification proceedings against a person. In all cases these are: the person's responsibility for causing any material contravention by the company or overseas company of any applicable legislative or other requirement; the extent of the responsibility of the person for the insolvency of the company/overseas company; the frequency of the conduct under the previous two heads; and the nature and extent of any loss or harm (or potential loss or harm) caused by the person's conduct in relation to the company or overseas company. Where the person concerned is or was a director (and not, say, just a person who gave instructions to

⁸⁹ For example, conviction of an indictable offence in connection with the management of a company (section 2 CDDA 1986) and persistent contravention of companies legislation (sections 3 and 5 CDDA 1986).

⁹⁰ Section 6 CDDA 1986.

⁹¹ Section 10 CDDA 1986. It is even possible for the disqualification proceedings and the wrongful trading allegations to be heard at the same hearing.

⁹² Section 1A CDDA 1986.

a disqualified person acting as director) there are further matters: any misfeasance or breach of fiduciary duty by the director; any material breach of any legislative or other obligation by the director, applicable as a result of his directorship of a company or overseas company; and the frequency of conduct of the director under the previous two heads. This is a shorter, more general list of matters – introduced by the Small Business Enterprise and Employment Act 2015 in substitution for the original schedule from 1986 – than was the case previously. The previous list was more detailed and specific and it remains to be seen whether these new, general heads will lead to any difference in the approach of the courts to disqualification cases. The list of matters in the schedule is not exhaustive. Conduct featured in decided disqualification cases include continuing to trade when the director knew, or should have known, that the company was insolvent and its position deteriorating irremediably, failing to account to the Inland Revenue for tax and social security moneys deducted from employees' wages, following a policy of discriminatory payment between creditors, drawing excessive remuneration and making excessive expenses claims.

- 2.15.5 In determining whether a director is unfit, the Court considers the cumulative effect of the allegations proved against him.
- 2.15.6 Although it is a common feature in most cases that the director has displayed a lack of commercial probity, gross negligence or serious incompetence, this is not always so. Following the collapse of the Barings banking group, for instance, many of its most senior board members were disqualified because they had not ensured that there were adequate internal control and monitoring systems in place.
- 2.15.7 That said, the Courts have expressed caution at holding that a director is unfit based on conduct that does not amount to a breach of any duty (contractual, tortious, statutory or equitable) to anyone, and is not dishonest.⁹³

Length of disqualification

- 2.15.8 The period of disqualification imposed is fixed in the discretion of the Court by reference to the person's own degree of responsibility and blameworthiness (subject, in the case of disqualification based on unfitness, to a minimum period of two years and, generally, to a maximum of fifteen 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:^{94 95}
- (a) a period of from 10 to 15 years is merited only in the most serious cases. It is usually always 'serious' where the person concerned is already subject to a disqualification order;⁹⁶
 - (b) two to five years' disqualification is justified where the case is, relatively, not very serious;⁹⁷ and
 - (c) a middle 'bracket' of six to ten years for cases falling between (a) and (b).⁹⁸
- 2.15.9 The same period of disqualification (two to fifteen years) applies in relation to disqualification undertakings but, given the director's co-operative approach inherent in such an arrangement, one would expect a slightly lesser period of disqualification to be agreed upon in practice.
- 2.15.10 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 to the effect that the person is liable to make a contribution payment. But the converse is not the case: where proceedings are commenced for the purpose of obtaining a disqualification order, there is no jurisdiction for the Court to make a finding of wrongful or fraudulent trading.⁹⁹

⁹³ *Secretary of State for Trade and Industry v Goldberg* [2003] All ER (D) 369.

⁹⁴ *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch. 164.

⁹⁵ Perhaps unsurprisingly the distribution of disqualification order lengths falls into a bell curve, as shown by the figures published in the Insolvency Service Enforcement Outcomes (see for example the Insolvency Service Enforcement Outcomes (Experimental Statistics): January to March 2016 published 12 May 2016).

⁹⁶ *Official Receiver v Stern* [2001] All ER (D) 278 and *Re Mea Corporation Ltd* [2006] EWHC 1846 (Ch) are examples.

⁹⁷ *Secretary of State for Trade and Industry v Goldberg & McAvoy* supra is an example.

⁹⁸ In the matter of *Skyward Builders plc (O.R. v Mullarkey)* [2002] All ER (D) 367 and *Secretary of State for Business, Enterprise and Regulatory Reform v Poulter* [2009] BCC 608 are examples.

⁹⁹ See paragraph 2.15.15 below regarding the recently introduced power of the disqualification court to make a separate compensation order.

- 2.15.11 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.
- 2.15.12 In addition to those who have been formally appointed directors, and save where the conduct on which disqualification is based is a criminal offence¹⁰⁰ or fraudulent trading,¹⁰¹ a disqualification order may only be made against *de facto* directors, shadow directors¹⁰² and former directors.¹⁰³ A financing bank, holding company or other third party (including counterparties to voidable transactions) will not be liable unless its conduct brings it within one of these three categories.
- 2.15.13 Where a person has been disqualified, someone who has exercised influence over the disqualified person by giving him directions or instructions in connection with acts and matters comprising the basis for making the disqualification order, that directing or instructing person may himself be disqualified.
- 2.15.14 Enforcement is in practice (and, in the case of disqualification based on ‘unfitness’, by express provision) almost entirely in the hands of government or regulatory authorities. The only likely exception would be where a disqualification order is made consequentially upon a finding of wrongful trading, in which case the proceedings would have been instituted by the company’s administrator or liquidator or an assignee from either. Office-holders, such as liquidators (and administrators and administrative receivers), 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 to which they have been appointed to assist the government agency in determining whether it is expedient in the public interest to bring disqualification proceedings on the ground of unfitness against any particular director or to require an undertaking from the director in lieu of court proceedings. The office-holder must update the report if he obtains new, relevant information.

Compensation orders

- 2.15.15 A recent development in English disqualification law has been to give the Court hearing the application for disqualification the power to require the disqualified person to pay a contribution to the assets of the relevant company with the effect of reducing the shortfall to creditors. The Court (on application by the Secretary of State) may make a compensation order against any person subject to a disqualification order or a disqualification undertaking under the CDDA 1986, where the conduct for which the person is subject to the order or undertaking has caused loss to one or more creditors of an insolvent company of which the person has at any time been a director.¹⁰⁴ A compensation order may require a director to pay an amount as a contribution to the assets of the relevant company or for the benefit of a particular creditor or creditors or a class or classes of creditors.¹⁰⁵ Compensation undertakings may also be accepted by the Secretary of State.¹⁰⁶

Limitation periods

- 2.15.16 Disqualification proceedings on the ground of unfitness may only be commenced within three 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.

Duty to co-operate

- 2.15.17 Directors and others concerned in an insolvency are placed under a general duty to provide information to a liquidator, administrator or administrative receiver and to co-operate with him¹⁰⁷ 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 statutory provisions are set out in the answers to Question 7 below.

¹⁰⁰ Section 2 CDDA 1986.

¹⁰¹ Sections 4 and 10 CDDA 1986.

¹⁰² Confirmed most recently in *Re UKLI Ltd, Secretary of State for Business, Innovation and Skills v Chohan and others* [2013] EWHC 680 (Ch).

¹⁰³ Section 8ZA, 8ZC, 8ZD and 8ZE CDDA 1986.

¹⁰⁴ Section 15A CDDA 1986. In the case of a person subject to a disqualification order under section 8ZA or 8ZD CDDA 1986 or a disqualification undertaking under section 8ZC or 8ZE CDDA 1986 the reference to conduct is a reference to the conduct of the main transgressor in relation to whom the person has exercised the requisite amount of influence.

¹⁰⁵ Section 15B(1) CDDA 1986.

¹⁰⁶ Section 15B(2) CDDA 1986.

¹⁰⁷ Section 235 and note also section 236 where the court can be requested to order the provision of information.

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period
- (a) In addition to those persons referred to in Question 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 Introduction

- 3.1.1 Subject to the detail of 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. The management of a company's affairs is the responsibility of its directors but English law takes a wide view of this term and it is capable of including persons who, while not formally appointed as directors, may have acted as a director or otherwise played a role in the company's management during the twilight period. Such 'de facto' directors may be held personally liable in respect of their actions in this respect on the same basis as legally appointed directors. Other persons may exert control over a board of a company and issue it with directions or instructions and these 'shadow directors' may also face the same liabilities as directors. Both these concepts are explained below. In addition, "officers" of the company – a term which can include persons other than these various types of directors – may also face personal liability in certain situations.
- 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 (or make a payment) to the company as a result of being a party to a transaction at undervalue, a preference, a transaction defrauding creditors, or the carrying on (or knowingly being party to the carrying on) of business with intent to defraud creditors. In addition, under general equitable principles of English law, a third party who had knowledge of a breach of duty by a director when entering into a transaction and either fraudulently assisted in that breach and/or received property from the company with knowledge of that breach may be held liable as a constructive trustee of such property and liable to return it or to pay compensation to the company. A table summarising those, other than the directors of a company, who may be liable in respect of actions taken in the twilight period is set out at paragraph 3.5 below.

3.2 De facto and shadow directors

- 3.2.1 At both common law and under statute, English law has widened the scope of those who may be regarded as directors or treated in the same way as directors. In particular, the common law has developed the concept of "de facto" directors – directors who, notwithstanding that they may not have technically been appointed as directors as a matter of company law are, as a result of their actions and the functions they carry out, treated as directors. Secondly, under statute and to catch figures who, although not on the board nor apparently taking day to day decisions at the company, are in fact pulling the strings, there is the concept of the "shadow director".
- 3.2.2 The two concepts are not mutually exclusive in the sense that a person can be both a shadow director and a de facto director (with one possibly shading into the other). Both concepts, as discussed below, involve the exercise of real influence in the corporate governance of a company. That influence may sometimes be concealed and sometimes open; in some cases it may be a mixture of both. Neither the role of a shadow director nor a de facto director need extend over the whole range of the company's activities so, for example, a person may assume the functions of a director (a de facto director) as regards one part of the company's activities (say, marketing) and give directions to the board (as a shadow director) as regards another (say, finance). The same sort of evidential indicia are likely to be relevant to establishing both shadow

and *de facto* directorships and in that sense the differences between the two concepts may have previously been overstated by the Courts.¹⁰⁸

De facto directors

- 3.2.3 There is no one definitive test for deciding what constitutes a *de facto* director.¹⁰⁹ In the misfeasance context of wrongful disposition of a company's assets, the Supreme Court has endorsed the following formulation:¹¹⁰

"...in order to make him liable for misfeasance as a *de facto* director the person must be part of the corporate governing structure and the claimants [have] to prove that he assumed a role in the company sufficient to impose on him a fiduciary duty to the company and to make him responsible for the misuse of its assets."

The cases give examples of aspects of conduct by the person under consideration which should be taken into account by the Court deciding whether he is or is not to be described as a *de facto* director.

- 3.2.4 A *de facto* director is often one who presumes to act as a director and is treated as such by the rest of the board even though he may never have been formally appointed a director or there is a defect in the technicalities of his appointment (for example he was appointed at a meeting at which a quorum was not present). A *de facto* director must have been part of the corporate governing structure and participated in directing the affairs of the company in relation to the acts/conduct complained of; he must either have been the sole person directing the affairs of the company or a substantial or predominant force (in order to evidence influence) and, if there were others, he operated on an equal footing with them; his functions/acts should be ones that could only be undertaken by a director (and not ones which could have been performed by a manager or other employee); it will be relevant but not necessary that he (or others) held himself out as a director and his role may relate to only part of the affairs of the company so long as that part is the part of which complaint is made.¹¹¹ The cumulative effect of the person's activities is relevant as is context.¹¹² "Director" is defined in S 250 CA 2006 to include any person occupying the position of director, by whatever name called. Thus, if someone were to be called an "observer" on the board but in fact took director-type decisions, then the Court may be prepared to conclude that that person is a *de facto* director.
- 3.2.5 *De facto* directors owe the same duties to the company as directors who have been formally appointed. The Court of Appeal in *Smithton Limited v Naggar*¹¹³ held that a defendant does not avoid liability even if he, in good faith, thought he was not acting as a director because the question whether or not a person acts as a director is answered objectively and irrespective of motivation or belief. Two important considerations highlighted by the Court of Appeal are (a) whether the company considered the defendant to be a director and held him out as such; and (b) whether third parties considered that he was a director.¹¹⁴
- 3.2.6 *De facto* directors who have ostensible authority are able to bind the company in making contracts with third parties who act in good faith.¹¹⁵ But *de facto* directors may be liable in damages for breach of an implied warranty of authority if they purport to act on behalf of the company when no such authority exists and the third party suffers loss.

¹⁰⁸ *Re Mea Corporation Ltd* [2006] EWHC 1846 (Ch) and *Re UKLI Ltd* [2013] EWHC 680 (Ch).

¹⁰⁹ *Smithton Limited v Naggar* supra referencing *HMRC v Holland* [2010] 1 WLR 2793.

¹¹⁰ *HMRC v Holland* supra at paragraph 93 (Lord Collins).

¹¹¹ *Re UKLI Ltd* supra, *Gemma Ltd v Davies* [2008] BCC 812 and *HMRC v Holland* supra. The *Holland* decision by the Supreme Court contains a helpful discussion of what constitutes a *de facto* director (including a review of previous case law). The review of the genesis and development of the concept by Lord Collins identified a relatively recent significant expansion of its range through a series of judicial decisions. His Lordship suggested the full ramifications of this judge-led evolution had not yet been fully identified and commented that: "it does not follow that " *de facto* director" must be given the same meaning in all of the different contexts in which a "director" may be liable." He limited his judgment on the meaning of the term to the factual situation in the case before him (the fiduciary duty of a director not to dispose wrongfully of the company's assets). This foreshadows further development of the concept in future cases. The *Holland* decision is also interesting for its consideration of when an individual (sole) director of a corporate director will be deemed a *de facto* director of the company in respect of which the corporate director is a director.

¹¹² "A single act might lead to liability in an exceptional case" per Arden LJ in *Smithton Limited v Naggar* supra at paragraph 41.

¹¹³ *Supra*.

¹¹⁴ Per Arden LJ in *Smithton Limited v Naggar* supra at paragraph 39.

¹¹⁵ Section 40 CA 2006 and section 250 CA 2006: in circumstances where the company would be considered to have represented to third parties that the relevant person has authority to bind the company.

Shadow directors

3.2.7 A shadow director is a creature of statute defined in S 251 and in S 22(5) of the CDDA 1986¹¹⁶ as: “a person in accordance with whose directions or instructions the directors of a company are accustomed to act (but so that a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity).” Unlike a *de facto* director, a shadow director may well not claim or purport to act as a director, and will likely even claim not to be a director. However, as noted above, the two concepts are not mutually exclusive in the sense that, on some fact patterns, a person may fail to be treated as being in both categories. Shadow directors owe the same fiduciary duties to the company as directors who have been formally appointed, at least to the extent that they direct and instruct the *de jure* directors.¹¹⁷

3.2.8 There are a number of elements to 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 <i>advice</i> 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 is likely to make someone a shadow director?

3.2.9 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, the case law, various extra-judicial pronouncements and official guidance from the Insolvency Service calmed such fears and 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 often engage in when a customer is in financial difficulty, it is unlikely that the following actions in themselves will lead to a bank being found to be a shadow director:

- (a) sending an investigating team to review the company’s current financial condition;
- (b) requiring a reduction in existing overdraft facilities;
- (c) requiring security or further security in respect of amounts outstanding;
- (d) calling for information, valuations of fixed assets, accounts, cash flow forecasts, etc;
- (e) requesting the customer’s proposals for the reduction of indebtedness, including the submission of a business plan, schedule of proposed asset sales, etc; and
- (f) noting the desirability of strengthening management, of seeking fresh capital, etc.¹¹⁸

3.2.10 On the other hand, the disqualification unit of The Insolvency Service has indicated that it will look at the following areas when assessing whether an individual has acted as a *de facto* or shadow director:¹¹⁹

- (a) whether the person was a signatory to the company’s bank account;
- (b) whether memoranda of interviews with bank officials point toward shadow directorship or *de facto* directorship;

¹¹⁶ There is a similar definition for Companies Act purposes in section 251 CA 2006.

¹¹⁷ *Vivendi SA v Richards* [2013] BCC 771.

¹¹⁸ See also *Ultraframe (UK) Ltd v Fielding* [2005] WL 1801204 (27 July 2005) (Ch D) at page 222/223 “...where the alleged shadow director is also a creditor of the company, he is entitled to protect his own interests as creditor without necessarily becoming a shadow director.”

¹¹⁹ Response to an enquiry made of the Insolvency Service.

- (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.

3.2.11 A review of the statutory definition of, and the requirements for, shadow directorship was carried out by the Court of Appeal in *SSTI v Deverell*.¹²⁰ Morritt LJ, delivering the unanimous decision of the Court and after reviewing the previous case law, set out a number of propositions.

- (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 activities.
- (c) The Court will decide if a particular communication from a potential shadow director whether by words or conduct is to be classified as a direction or instruction by an objective analysis in the light of all the 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 or not 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 constitute 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 was 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”.
- (g) The shadow director need not “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.

¹²⁰ [2001] Ch. 340.

3.2.12 It is clear that in recent years the Courts have sought to move away from a narrow legalistic ('tick the box') approach to the analysis 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".¹²¹

3.2.13 With effect from 26 May 2015, companies registered under CA 2006 are required to maintain a register of people with significant control over the company - a *PSC Register*.¹²² A person would exercise "significant influence or control" if they are significantly involved in the management and direction of the company which would be the case for a person who falls within the definition of "shadow director".¹²³

3.3 Officers

3.3.1 As has been seen in the answers to Question 2 above, liability is sometimes imposed on an "officer" of a company. As noted above,¹²⁴ there is no specific comprehensive statutory definition of this term. Instead, the persons covered by the term depends on the statutory provision in question. S 1173(1) CA 2006 states that the term "officer" *includes* a director, manager¹²⁵ or secretary of a company. Others who may be officers of a company for some purposes include auditors¹²⁶ and administrators. Receivers, including administrative receivers, will not be officers of a company.¹²⁷

3.3.2 In *Bilta (UK) Ltd (In liquidation) v Nazir*,¹²⁸ the defendant officer ran the argument that the company pursuing the claim was itself responsible for the defendant's wrongdoing. The Court held that even though the officer was "the directing mind and will of the company", it would be unjust for the company to be identified with its officers such that a defence to a claim for breach of an officer's duty could lie by attributing to the company the very misconduct by which the officer had damaged it.

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 company¹²⁹ (although necessarily this will in practice almost always be in respect of the post-twilight period).

3.4.2 Third parties who receive property as a result of a transaction at undervalue, a preference or as a result of a transaction defrauding creditors may be liable either to return such property or provide such compensation as the Court may order.¹³⁰

3.4.3 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 commencement of the winding-up will be void. Such a Court (or 'compulsory') winding-up involves presentation of a petition to the Court followed by the making of an order for winding-up by the Court at a subsequent hearing. When the order is made the 'commencement' of the winding-up effectively backdates to the date of presentation of the petition. In an ordinary case this means that the directors remain in control of the company's affairs between petition and order but dispositions of the company's property in this period may be void without the express sanction of the Court if a winding-up order is in due course made by the Court. A recipient of company property under a void transaction will be required to return it to the liquidator.

¹²¹ *Ultraframe (UK) Ltd v Fielding* supra.

¹²² Schedule 1A CA 2006 and Department of Business, Innovation and Skills' publication 'Statutory Guidance on the meaning of "significant influence or control" over companies in the context of the Register of People with Significant Control', p. 1.

¹²³ *Ibid*, p.6.

¹²⁴ See the explanation of the definition of "officer" in footnote 34 above.

¹²⁵ The term "manager" is not defined in either CA 2006 or IA 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) which place liability on, or provide a remedy against, any person who has been "concerned in the ... management of the company".

¹²⁶ See *Re Thomas Gerrard & Son Limited* [1968] Ch 455. However, it is unclear whether an auditor will be considered an officer in all circumstances and auditors are expressly excluded from the definition in some statutory provisions.

¹²⁷ *Re B Johnson & Co. (Builders) Limited* [1955] Ch 634

¹²⁸ [2015] UKSC 23.

¹²⁹ In respect of administrators, liability is under paragraph 75 of Schedule B1 to IA 1986. In respect of liquidators and administrative receivers, liability is under section 212. The two provisions are essentially the same except that, under the former, the company need not be in liquidation.

¹³⁰ Section 241; there are defences for persons who are more remote from the vulnerable transaction in question. See, generally, the answers to Question 4 below.

3.4.4 Any person who is knowingly party to the carrying on of a business with intent to defraud creditors may be liable for fraudulent trading.¹³¹ It is not necessary for that person to have performed a managerial or controlling role within the company; it will be enough if that person has participated in the fraudulent trading, in the sense of taking some positive step. An employee who merely carries out orders will not be liable.¹³²

3.4.5 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 and/or any profits made.¹³³ The legal rules relating to dishonest assistance¹³⁴ and/or knowing receipt of property are applicable in any circumstance and not only in respect of actions taken during the twilight period. The power of the English Court in this area arises under what is termed 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 <i>de facto</i> ¹³⁵ and 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 (including 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	Officer of company at time of fraud	Same as for director
Misconduct in course of winding-up	Any past or present officer (including 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 (including shadow director)	Same as for director
False representation to creditors	Any past or present officer (including shadow director)	Same as for director
Misfeasance	Any past or present officer; liquidator; administrator; administrative receiver; any person involved in the formation, promotion or management of the company	Same as for director
Restriction on re-use of company name	Shadow director and <i>de facto</i> director within 12 months of company's liquidation	Same as for director

¹³¹ Section 213(2) ; see paragraph 2.2 above.

¹³² *BCCI v Christopher Morris* supra.

¹³³ *Novoship (UK) Ltd v Mikhaylyuk* [2011] 4 EWCA Civ 908.

¹³⁴ *Royal Brunei Airlines v Tan* [1995] 2 AC 378 at 387.

¹³⁵ *Re Idessa Ltd (in liquidation)*, (*Burke v Morrison*) supra

Offence / activity	Persons liable	Extent of liability
Personal liability for contravention of restriction on re-use of company name	A person involved in the management of the company	Same as for director
Transaction at undervalue	Recipient of property/ benefit	Restoration of position as if transaction had not occurred; may include return of property received and/or requirement to pay compensation to the company.
Preference	Recipient of preference	Restoration of position as if transaction had not occurred; may include return of property received or removal of specific benefit received.
Transaction defrauding creditors	Recipient of property/benefit	Restoration of position as if transaction had not occurred; may include return of property received and/or requirement to pay compensation to the company.
Dishonestly assisting or knowingly receiving property or assets in breach of duty	Any person with the requisite degree of knowledge who dishonestly assists in a breach of duty owed by a person to a company or knowingly receives property as a result of 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 person may also be required to account for any profits made from the dishonest assistance or knowing receipt.
Disqualification	Any person occupying the position of director, by whatever name called (including shadow director for the purposes of sections 6-9 of CDDA 1986) ¹³⁶	Same as for director

¹³⁶ Sections 6(3C) and 22(4) CDDA 1986; *Re Mea Corporation Ltd* supra.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

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.¹³⁷ This reflects the weakened state of a company which is in financial difficulty and the inequality of bargaining power that consequently may have arisen. The rules will also usually be more severe on connected persons – insiders – who may have taken advantage of an information imbalance, for example, to get repaid ahead of other creditors.
- 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 in the twilight zone 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 heads of challenge which may lead to transactions being set aside relate to transactions:¹³⁸
 - (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) entered into in breach of the directors' fiduciary duties;or which involve any of the following elements:
 - (g) onerous property;
 - (h) dispositions of the company's property made after the commencement of winding-up; and
 - (i) unregistered charges.

We look briefly at each head in turn.

¹³⁷ Some may apply whether or not a formal insolvency actually occurs – e.g. transactions defrauding creditors, (section 423); see *B v IB* [2013] EWHC 3755 (Fam), para 50: “it is not the existence of insolvency but the existence of debt which triggers the remedy” and transactions in breach of a director's duties. But most often the catalyst for challenge is the commencement of a formal insolvency procedure. Some provisions 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.

¹³⁸ The heads of challenge in 4.2.1(g) and (h) do not apply in respect of market contracts or margin contracts effected by an exchange or clearing house – Companies Act 1989, s164.

4.3 Transactions at an undervalue¹³⁹

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 or becomes insolvent as a result of the transaction 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 challenge may be made by an administrator or liquidator¹⁴⁰ 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.¹⁴¹

Conditions for setting aside a transaction at undervalue

4.3.2 The Court can only make an order for restoration of the status quo by way of relief under this provision if the following conditions are satisfied.

- (1) The company is in liquidation or administration and an application is made by the liquidator or administrator (S 238(1) and (2) but see footnote 140).
- (2) The company entered into a transaction at an undervalue either:
 - (a) within the two years ending with the “onset of insolvency”; or
 - (b) between the time of presentation of an administration application and the making of an administration order on that application; or
 - (c) between the filing with the Court of a copy of a notice of intention to appoint an administrator and the appointment of an administrator (Ss 238(2), 240(1)(a), (c), (d)).

The “onset of insolvency” is not a reference to the company’s financial state. It is defined, depending upon the circumstances, as:

- (a) the date on which an administration application is filed in Court; or
 - (b) the date of the filing in Court of a copy of a notice of intention to appoint an administrator; or
 - (c) where no such notice of intention to appoint is filed at Court, the date on which the appointment takes effect; or
 - (d) the passing of a voluntary winding-up resolution or the presentation of a winding-up petition on which a winding-up order is subsequently made (except where the company has previously been in administration that has ceased to have effect or where the administration proceedings were opened as territorial proceedings under the EC Regulation on Insolvency Proceedings and are now being converted into secondary winding-up proceedings pursuant to Article 37 of the EC Regulation, in which case, (a), (b) or (c), as appropriate, will be treated as the onset of insolvency) (S 240(3)).
- (3) The company was *unable to pay its debts* within the meaning of S 123¹⁴² 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 footnote 10 above), there is a rebuttable presumption that the company is unable 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

¹³⁹ Section 238.

¹⁴⁰ From 1 October 2015, administrators and liquidators have the power to assign to third parties causes of action arising out of the heads of challenge referred to in 4.2.1 (a), (b) and (d) above.

¹⁴¹ In *Bilta (UK) v Nazir* and others supra, para 110, it was held that section 238 has extra-territorial effect.

¹⁴² See paragraph 1.1.2 in the answer to Question 1 for the meaning of this phrase. In summary it means inability to pay debts in the short term or, in light of the company’s balance sheet, in the longer term.

- (2) otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration; or
- (3) enters into a transaction with that person for a consideration the value of which is significantly less than the value, in money or money's worth, of the consideration provided by the company (S 238(4)).

4.3.4 A transaction is defined as including a gift, agreement or arrangement, and references to entering into a transaction are to be construed accordingly (S 436). In *Phillips v Brewin Dolphin*¹⁴³ the Court accepted that as between the company and the counterparty or counterparties it will look beyond the form to the substance in ascertaining what constitutes the transaction and the consideration being provided. Thus two contracts between the company and the counterparty may, if sufficiently intertwined, be viewed as a whole.

4.3.5 The value of the consideration must be assessed as at the date the transaction was entered into. If, at that date, value was dependent on the occurrence or non-occurrence of some event and that event occurred before the assessment of value, then regard might be had to it but regard should also be had to all other matters relevant to the determination of value. Subsequent events should not be taken into account unless and to the extent that they were both relevant and foreseeable at the time the transaction was entered into.¹⁴⁴

4.3.6 In valuing the consideration, the incidental value to the transferee must also be considered. For example, a lease at full market rent may nevertheless be a transaction at an undervalue if the lease has a ransom or surrender value (for example, because it is a protected tenancy under the Agricultural Holdings Act 1986).¹⁴⁵ In other words, the real value of any incidental benefits to the transferee (and hence the real value of what the company is providing) have to be considered. In *Phillips v Brewin Dolphin*¹⁴⁶ it was held that identification of the consideration is a question of fact and that the consideration for a transaction can include the benefit of a covenant given by a third party, where a company agrees to sell an asset to A on terms that B agrees to enter into some collateral agreement with the company. However, the value of B's covenant in money or money's worth must be determined by discounting the present value of future payments by the possibility of non-payment.

Defences

4.3.7 The Court may not make an order under this provision if it is satisfied:

- (1) that the company which entered into the transaction did so in good faith and for the purpose of carrying on 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 (S 241(2) and (2A)).

It has also been suggested that a defence of good faith change of position (eg where a recipient of a gift of money has, in good faith, spent the money received) may in exceptional circumstances be available, although the legislation does not provide for this.¹⁴⁷

Examples of financial transactions that may fall within the section

4.3.8 In *Re M C Bacon (No.1)*¹⁴⁸ the Court held that the creation of security over a company's assets *as security for the company's own liabilities* was not a transaction at an undervalue but merely attaches payment of a particular liability to a particular asset. The provision required, it was held, a comparison to be made between the value of the consideration obtained by the company and the

¹⁴³ [2001] 1 All ER 673.

¹⁴⁴ *Phillips v Brewin Dolphin* supra and *Re Thoars (deceased), Reid v Ramlort Ltd* [2004] EWCA Civ 800.

¹⁴⁵ *Agricultural Mortgage Corp plc v Woodward* [1994] BCC 688.

¹⁴⁶ Supra.

¹⁴⁷ Applied (subject to academic criticism in the context of a section 423 (transactions defrauding creditors) application but the principle could in theory apply to a transaction at an undervalue application): by *Sales J in 4 Eng Ltd v Harper* [2009] EWHC 2633 (Ch) and again, following his own 4 Eng judgment, in the personal bankruptcy field in *Trustee in Bankruptcy of Gordon Claridge v Claridge* [2011] EWHC 2047.

¹⁴⁸ [1990] BCC 78; followed and applied by the Court of Appeal in *Menzies v National Bank of Kuwait* [1994] 2 BCLC 306.

value of the consideration provided by the company. Both values have to be measured in money or money's worth and have to be considered from the company's point of view. Ordinarily, the mere creation of security over the company's assets does not deplete them or diminish their value so no value measurable in money or money's worth is being transferred by the company. The Courts have, however, suggested that there may be circumstances where the creation of security will be regarded as a transaction at an undervalue for example where no consideration is given by the counterparty.¹⁴⁹

- 4.3.9 A guarantee by a company to a bank of the liabilities of a parent or sister company might be a classic example of an undervalue transaction – if, say, the idea is simply to bleed the company in return for bank support or forbearance for a financially troubled parent or sister company. In relation to guarantees there is as yet little authority on the test to apply to ascertain the value provided by the guarantor and that provided by the guaranteed bank. An interest-free loan might also constitute a transaction at an undervalue.

4.4 Preferences¹⁵⁰

- 4.4.1 By way of overview, a preference is something which a company does, at a time when it is unable to pay its debts or becomes unable to pay its debts as a result of the thing done and it later goes into liquidation or administration, to put a creditor in a better position than he would have been if the thing had not been done and the company had instead just gone into liquidation or administration. The challenge is made by an administrator or a liquidator¹⁵¹ and, as for undervalues (above), the Court has a range of options to restore the position.

Conditions for setting aside a preference

- 4.4.2 The Court can only make an order (for restoration of the status quo by way of relief) under this provision if the following conditions are satisfied.

- (1) The company is in liquidation or administration and an application is made by the liquidator or administrator (S 239 (1) and (2)).¹⁵²
- (2) The company gave the preference within a vulnerability period ending with the 'onset of insolvency' (S 239(2)).¹⁵³ 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 person¹⁵⁴ (other than by reason of the person being its employee) the vulnerability period is two years (S 240(1)(a)); and
 - (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 or became as a result of the preference unable to pay its debts (as explained above in connection with transactions at an undervalue, save that preference with there is no presumption of insolvency in the case of a connected person).¹⁵⁵

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

¹⁴⁹ *Hill v. Spread Trustee Company Ltd* [2006] EWCA Civ 542, para 93; in *Re M C Bacon (No.1)* supra there was consideration in the form of forbearance by the counterparty creditor. The Court of Appeal in *Hill v Spread Trustee Company Ltd* supra went so far as to doubt the analysis and reasoning of *Bacon* as upheld in *Menzies* but, as it was not necessary for their decision, left open whether they were distinguishable or wrong. In support of their doubts, the Court of Appeal cited the speech of Lord Millett (who, as a puisne judge, decided the *Bacon* case) in the House of Lords decision in *Buchler v Talbot* [2004] 2 AC 298, a case on whether certain secured assets were available to pay the costs of liquidation. Whether Lord Millett was surprised to learn that his speech in *Buchler* was supposedly undermining his own earlier judgment in the rather different area of clawbacks in *Bacon* is unknown. Certainly if the approach taken in *Hill v Spread* is ultimately preferred to that in *Bacon* and *Menzies*, it will not be helpful in the context of companies trying to persuade their creditors to help them restructure – see *Transaction Avoidance in Insolvencies 2nd Edition* by Parry, Aylife and Shivji, paragraph 4.49.

¹⁵⁰ Section 239.

¹⁵¹ But see footnote 140 above re the potential for assignment of such a claim.

¹⁵² See previous footnote.

¹⁵³ This concept is the same as for transactions at an undervalue – see paragraph 4.3.2(2) above.

¹⁵⁴ See footnote 10 above for an explanation of this concept.

¹⁵⁵ See paragraph 4.3.2(3) above.

(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 (early) payment of a debt or giving of security to a particular creditor in each case where that improves the recovery of that creditor compared to what it would receive in a winding-up or administration.

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 cannot 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 – correspondence exchanged when the relevant transaction was entered into will often be a starting point in this respect.¹⁵⁶

4.4.6 In *Re M C Bacon (No. 1)*,¹⁵⁷ 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).¹⁵⁸

Accordingly it was held that a decision by a company to give its bank a charge to secure existing borrowings (when the only alternative, if the bank withdrew its support, was liquidation) was not voidable as a preference as the directors’ desire was to obtain continued support, not to put the bank in a better position.

4.4.7 Where the beneficiary is connected with the company at the time the preference is given (otherwise than by reason of being its employee), the company, unless the contrary is shown, is presumed to have been influenced in deciding to give a preference by the relevant desire.

4.4.8 There are the same protections for purchasers in good faith and for value as for transactions at an undervalue (see paragraph 4.3.7 above).¹⁵⁹

4.5 Transactions defrauding creditors¹⁶⁰

Conditions

4.5.1 Where a transaction¹⁶¹ at an undervalue is entered into by a company for the purpose¹⁶² 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.

¹⁵⁶ See, for example, *Re Oxford Pharmaceuticals Ltd* [2009] EWHC 1753 (Ch).

¹⁵⁷ *Supra* at 87.

¹⁵⁸ Followed in *Re Cosy Seal Ltd (In administration)* [2016] EWHC 1255.

¹⁵⁹ Section 241 and see *Re Sonatacus Ltd* [2007] EWCA Civ 31.

¹⁶⁰ Section 423. Payment of a dividend to shareholders is a recent example of a type of transaction caught by this provision: *Bti 2014 Llc v Sequana* *supra*.

¹⁶¹ “transaction” is widely defined and could include the transfer of an English company’s operations to a foreign jurisdiction: *Concept Oil Services v EN-GIN Group LLP* [2013] EWHC 1897 paragraph 80.

¹⁶² It is sufficient for the purpose of s.423 that the “substantial purpose” of the transaction was to put assets beyond the reach of creditors or people making claims; it need not be the only purpose: *Re Husky Group Ltd*, [2014] EWHC 3003 (Ch).

4.5.2 It is not necessary that the company is in liquidation or administration, nor is there any statutory time limit. Essentially, this provision uses the same concept of ‘undervalue’ as for S 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 a creditor (or of otherwise prejudicing the interests of such a person in relation to a claim against the company).

Defences

4.5.3 There are protections for good faith purchasers for value without notice of the relevant circumstances (S 425(2)). It has also been suggested that a defence of good faith change of position (eg where a recipient of a gift of money has, in good faith, spent the money received) may be available, although the legislation does not specifically provide for this.¹⁶³

4.6 Extortionate credit transactions¹⁶⁴

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;¹⁶⁵
- (3) the transaction is or was ‘extortionate’; and
- (4) the transaction was entered into within the three years prior to the day on which the company entered administration or (as the case may be) the company went into liquidation.¹⁶⁶

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 bargaining power so as to produce a result that is oppressive.¹⁶⁷ The test for “extortionate” in a commercial transaction is a very stringent one.¹⁶⁸

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 value¹⁶⁹

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

¹⁶³ Sales J in *4 Eng Ltd v Harper* [2009] EWHC 2633 (Ch) and see footnote 147 above.

¹⁶⁴ Section 244.

¹⁶⁵ But note the ability of a liquidator or administrator to assign the claim to a third party – see footnote 140.

¹⁶⁶ That is, a winding-up order is made or a resolution of members is passed for voluntary winding-up.

¹⁶⁷ *Re St. George's Property Services (London) Ltd (in administration)* [2010] EWHC 2748 (Ch), paragraph 44.

¹⁶⁸ *Ibid*, para 50.

¹⁶⁹ Section 245.

Conditions for setting aside

4.7.2 A floating charge is invalid under this provision¹⁷⁰ 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”¹⁷¹ (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 an application for an administration order and the making of an order on that application (S 245(3)(c)); or
 - (d) in the case of a charge created in favour of any person, between the filing with the Court of a copy of a notice of intention to appoint an administrator and the making of that appointment (S 245(3)(d));
- (3) the charge was given otherwise than for new consideration (see below); and
- (4) in the case of a charge given to a person not connected with the company, the company was then unable to pay its debts within the meaning of S 123¹⁷² or became unable to do so in consequence of the charge (S 245(4)).

4.7.3 Under S 245(2), the charge will be invalid except to the extent of the aggregate of:

- (1) the value of so much of the consideration for its creation as consists of money paid, or goods or services supplied, to the company at the same time as, or after, the creation of the charge;
- (2) the value of so much of the consideration as consists of the discharge or reduction, at the same time as, or after, the creation of the charge, of any debt of the company; and
- (3) the amount of interest (if any) payable on those sums which fall within paragraph (1) or (2) above in pursuance of any agreement under which money was paid, the goods or services supplied, or the debt reduced or discharged.

4.7.4 The new consideration must be for the charge and it must go to the company itself or in the reduction of the company’s indebtedness. Where goods or services are provided rather than new money, it is the true value of the goods and services that counts, not the value that the parties may ascribe to them (S 245(6)).

Defences

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

4.7.6 It is worth considering two practical situations.

- (a) Refinancing or rollover – in a two party situation this usually involves the discharge of an old debt and the creation of a new debt. Even where it cannot be said that the arrangement is a sham, a paper transaction such as this may not amount to new consideration.

¹⁷⁰ Section 245 does not apply to any charge created or otherwise arising under a security financial collateral arrangement: regulation 10 (5), Financial Collateral Arrangements (No 2) Regulations 2003.

¹⁷¹ See the explanation of that concept at paragraph 4.3.2(2) above.

¹⁷² See the explanation of that concept at footnote 6 above.

- (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 followed by payments into the account, represent new credit for these purposes – and, over time, the whole balance in the account may be represented by these new withdrawals thereby ‘hardening’ the security (i.e. rendering it invulnerable from attack under this head of challenge).

4.8 Breach by directors of general fiduciary duties

- 4.8.1 If the directors cause the company to contract with another party on terms disadvantageous to the company, they may be in breach of their general fiduciary duties to the company. Where the counterparty has knowledge of this, there may be circumstances where the company has proprietary or restitutionary rights to recover the property or otherwise overturn the transaction. 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 event¹⁷³

4.9 Disclaimer of onerous property¹⁷⁴

- 4.9.1 When the company is being wound up, the liquidator may, by giving the prescribed notice, disclaim any onerous property and may do so notwithstanding that he has taken possession of it, endeavoured to sell it, or otherwise exercised rights of ownership in respect of it.¹⁷⁵
- 4.9.2 Onerous property includes (a) any unprofitable contract; and (b) any other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act.
- 4.9.3 An example of onerous property would be a lease under which the company was the tenant and where the rent was greater than market rent. Where a person has an interest in the disclaimed property, that person may apply to the Court for an order vesting title to the disclaimed property in the applicant, following the disclaimer.¹⁷⁶
- 4.9.4 An executed contract cannot be disclaimed. This is because if the company has performed its obligations it has no prospective liabilities – accordingly the contract is not “onerous”.¹⁷⁷ It has been held that a liquidator has no right to disclaim a contract entered into by the company to sell land (where contracts have been exchanged and the buyer tendered the purchase price) as this would deprive the buyer of his equitable ownership,¹⁷⁸ nor can the liquidator disclaim a lease whose term has expired as this is no longer the property of the company.¹⁷⁹
- 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.¹⁸⁰ 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 in the liquidation.

4.10 Dispositions of the company’s property made after the commencement of winding-up¹⁸¹

- 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, unless expressly sanctioned by the Court, void.¹⁸² For example, a payment out of a company’s bank account, whether in credit or debit, after the commencement of the winding-

¹⁷³ See also paragraph 2.12 above.

¹⁷⁴ Section 178. This is not a twilight zone-specific provision. But it may affect transactions entered into in that period and so is included for completeness in the context of transactions potentially capable of being undone or terminated.

¹⁷⁵ A liquidator cannot disclaim, as onerous property, any financial collateral arrangement where the company was collateral-provider or collateral-taker: regulation 10 (4) Financial Collateral Arrangements (No 2) Regulations 2003.

¹⁷⁶ *St. Paul Travelers Insurance Co. Ltd v Dargan* [2006] EWHC 3189 (Ch).

¹⁷⁷ *Squires and others (Liquidators of SSSL Realisations (2002) Ltd) v AIG Europe (UK) Ltd* [2006] 2 W.L.R. 1369 and *Capital Prime plc v Worthgate Ltd* [2000] 1 B.C.L.C. 647.

¹⁷⁸ *Capital Prime plc v Worthgate Ltd* supra.

¹⁷⁹ *Re No.1 London Ltd* [1991] B.C.C. 118.

¹⁸⁰ *Shaw v Doleman* [2009] EWCA Civ 279; *Hindcastle v Barbara Attenborough Associates Ltd* [1997] AC 70 HL.

¹⁸¹ Section 127.

¹⁸² This provision does not apply to any property or security interest subject to a disposition or created or otherwise arising under a financial collateral arrangement or to prevent a close-out netting provision taking effect in accordance with its terms: regulation 10 (1) Financial Collateral Arrangements (No 2) Regulations 2003.

up will constitute a void disposition in favour of the payee. A payment into a company's overdrawn bank account will also constitute a void disposition in favour of the bank.¹⁸³ The provision does not, however, give rise to any cause of action against the directors for any loss which the company may have sustained as a result.

- 4.10.2 Commencement of the winding-up backdates to the date on which the presentation of any petition for compulsory winding-up if an order is ultimately made.¹⁸⁴ 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 and avoid being wound up.

4.11 Failure to register a charge¹⁸⁵

- 4.11.1 The applicable law in the United Kingdom operates a system of registration of security created by UK-registered companies.¹⁸⁶ 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).¹⁸⁷ Whilst the obligation to register is not expressly given to the company or the chargee, any party interested in the charge is able to and, indeed, is well advised to effect the registration itself.
- 4.11.2 The registration requirements are set out in Part 25 Chapter A1 to CA 2006 (Ss 859A to 859Q) and apply with effect from 6 April 2013.¹⁸⁸ These requirements simplify the registration process so that, subject to a few limited exceptions, all security must be registered (and not just security over certain categories of property, as was the case previously). The exemption from registration in respect of “financial collateral” continues to apply.¹⁸⁹

4.12 Twilight zone duties of directors and potential liability; incurring new credit

- 4.12.1 Directors, when their company is insolvent or may become insolvent, must think primarily of the interests of the creditors of their company rather than the shareholders – as it is the creditors' money that is now at risk. So, for example, while a transfer of assets at less than full market value may, when a company is solvent, be ratified by the shareholders (they can in a sense do what they like with ‘their’ money),¹⁹⁰ 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 S 238 in connection with transactions at undervalue. Similarly, generally speaking, some creditors should not be paid ahead of others (the law of preferences – the ultimate successor to the Roman Paulian action).
- 4.12.2 Usually the most difficult decision in practice for directors in the twilight zone is whether or not 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 which arises in the *wrongful trading* context whether it can be said there is a *reasonable* (objectively considered) prospect of the company avoiding an insolvent liquidation or administration.¹⁹¹ If that is not a reasonable prospect then the directors will be liable unless they do everything to minimise losses to creditors.¹⁹² 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 an unwitting creditor who comes into the picture for the first time by supplying goods during this period to know that the creditors who were already

¹⁸³ *Re Tain Construction Ltd (Rose v AIB Group (UK) plc)* [2003] All ER (D) 91.

¹⁸⁴ Section 129.

¹⁸⁵ Part 25 CA 2006.

¹⁸⁶ Section 859A(7) CA 2006; an overseas company with a registered place of business in England which grants security over assets situate in England used to be required to register the security under the Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2009. This requirement was removed with effect from 1 October 2011 by The Overseas Companies (Execution of Documents and Registration of Charges) Regulations 2011, but registration is still required in respect of security created prior to 1 October 2011.

¹⁸⁷ Section 859H CA 2006.

¹⁸⁸ The former registration process under Part 25 CA 2006 (repealed) will continue to apply to charges created prior to 6 April 2013.

¹⁸⁹ Security over “financial collateral” (very broadly, cash, shares, tradeable bonds and credit claims) is exempt from registration if the security is taken within the context of a “security financial collateral arrangement” within the meaning given to that expression in the Financial Collateral Arrangements (No.2) Regulations 2003 (SI 2003/3226), which implement in the UK the Financial Collateral Directive (Directive 2002/47/EC).

¹⁹⁰ Although they cannot sanction something that amounts to an illegal return of capital: see *Avelling Barford v Perion* (1989) 5 B.C.C. 677).

¹⁹¹ In *Re Hawkes Hill Publishing Co. Limited* supra the court cautioned against relying too heavily on hindsight in determining whether the prospect was reasonable.

¹⁹² Section 214(3) and see *Re Robin Hood Centre Plc* supra paragraph 259, where the court while noting that taking “every step” to minimise loss to creditors would depend on the facts of the case in question nonetheless gave the following general guidance on good practice (assuming the business remained stable): (a) ensuring accounting records are kept up to date with a budget and cash flow forecast; (b) preparing a business review and a plan dealing with future trading including steps (for example cost cutting) to minimise loss; (c) keeping creditors informed and reaching agreements to deal with debtors and suppliers where possible; (d) regularly monitoring the trading and financial position against the business plan both informally and at board meetings; (e) asking if loss is being minimised; (f) ensuring adequate capitalisation; (g) obtaining professional advice (legal and financial); and (h) considering alternative insolvency solutions.

owed money at the critical point are going to get a better dividend on their debts as a result of the continued trading and sale as a going concern. Where it can be said that the director is dishonest in incurring the credit – knowingly going beyond what a reasonable man of business would regard as honest – then he will be *fraudulently trading* even though doing his best for the general body of creditors. It should be noted that directors of large, sophisticated companies are likely to be held to a higher “objective” standard than directors of small closely-held companies.

- 4.12.3 A recent case suggests that the risk for directors of being liable for wrongful trading is materially diminished or eliminated if the company does not suffer trading losses in the relevant period.¹⁹³ However, should they seek to have the benefit of the defence in S 214(3), the directors need to show not only that continued trading was intended to reduce the net deficiency, but that it was designed appropriately to minimise the risk of loss to individual creditors. So if losses are made during the twilight period the directors should be mindful of taking “every step” to minimise the losses of each individual creditor, and not just the creditors as a general body. Improving the position of one creditor at the expense of another during this period – ‘robbing Peter to pay Paul’ – damages the chances of relying on the statutory defence.
- 4.12.4 English law seeks to strike a balance between the need to stop directors running their companies at the expense of creditors and thereby exploiting them and, on the other hand, the need not to put undue pressure on directors at what is a very difficult time for them and when they will be trying to achieve business survival. 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.
- 4.12.5 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.¹⁹⁴ They will get on top of the financial position of the company, perhaps for the first time: just how often is a significant part of a company’s problem its failure to understand its own financial position? They will develop a plan of recovery with their financial advisers 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 the analysis and conclusions in the minutes of the meetings.
- 4.13 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?**
- 4.13.1 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 transaction 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, S 423 – 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 needs to be aware. However, in practice first it is usually a formal insolvency that brings these matters to creditors’ attention and, secondly, the further away in time from an insolvency that a transaction was entered into the less likely that the transaction will be vulnerable. We look at some practical considerations in the context of the two main statutory clawback provisions.¹⁹⁵
- 4.14 Preferences**
- 4.14.1 The law here is concerned with the clawback of payments and the over-turning of security. 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 survival of the company. This may encourage creditors to put pressure on a company in trouble.¹⁹⁶

¹⁹³ *Re Ralls Builders* supra.

¹⁹⁴ Although of course it will not be enough to claim reliance on advice if that advice is predicated on the directors’ stated belief that the company will be able to avoid insolvent liquidation if, in the light of the directors’ actual knowledge, there is no reasonable basis for that belief: *Re The Rod Gunner Organisation Ltd (Rubin v Gunner)* [2004] EWHC 316 (Ch).

¹⁹⁵ Considered in detail at paragraphs 4.3 and 4.4 above.

¹⁹⁶ In other jurisdictions, such as the United States, ordinary course transactions and payments are, generally speaking, less vulnerable than bespoke arrangements entered into by pressurised directors which is a different emphasis.

4.14.2 What is the practical reality for a creditor considering entering into a twilight zone transaction bearing in mind the preference law? The pragmatic answer almost always will be: 'take the money/security' and argue about validity later. It may well be hard for a liquidator to show what the subjective desire 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 (No. 1)*¹⁹⁷ holds few terrors for arms length counterparties.

4.15 Transactions at an undervalue

4.15.1 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 significantly less than market value then unless the transaction is for other reasons in the interests of, or of benefit to, the company and for the purposes of carrying on its business, it is vulnerable to attack. The main remedy is to restore the status quo ante. This suggests a retransfer of property and disgorgement of the price. The alternative which may on many fact patterns be neater or simply more capable of being implemented is for the counterparty to be ordered to pay the quantum of the undervalue.¹⁹⁸

4.15.2 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 negotiated a very keen price which is insupportable then they have to expect they might have to disgorge the benefit. Difficulties arise where they buy a business in urgent need of substantial investment and they are concerned that the Court may in fact reverse the entire transaction after they have made the further investment. A partial, 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 best 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 may not be forthcoming. The temptation may well be to say that the deal can only be done securely 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 solvent sale or assignment to a purchaser.

QUESTION 5

5. Enforcement

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

5.1 Introduction

5.1.1 In the event of a company going into liquidation, administration or administrative receivership, the authority and powers of the directors are suspended following such an appointment in the face of the powers of 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

¹⁹⁷ Supra.

¹⁹⁸ As Jonathan Parker LJ said in *Re Thoars (deceased), Reid v Ramlort Ltd* supra at paragraph 105: "Each case will turn on its particular facts, and the task of the court in every case is to fashion the most appropriate remedy with a view to restoring, so far as it is practicable and just to do so, the position as it 'would have been if [the debtor] had not entered into the transaction.'" In some cases that remedy may take the form of reversing the transaction; in others it may not."

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 activity, such proceedings must be brought by the Director of Public Prosecutions (DPP) on behalf of the relevant government department or authority.¹⁹⁹ Secondly, only the Secretary of State for Business Energy and Industrial Strategy (SSBEIS), or the Official Receiver²⁰⁰ (appointed where the company is being wound-up by the Court) acting at his direction, may bring proceedings for disqualification under Ss 6 (“unfitness” to be a director) and 8 (disqualification after investigation by the SSBEIS into a company’s affairs) of the CDDA 1986.

5.2 Criminal proceedings

- 5.2.1 The following acts are criminal offences in respect of which the DPP may bring an action against the directors and others involved. A liquidator of a company is under a duty to bring any such offences to the attention of the DPP;²⁰¹ and it is recommended best-practice for an administrator to similarly bring any such offences to the attention of the DPP.²⁰² Those who may be liable in respect of the following offences in addition to the directors are listed in Question 3 above.

Offences

- (a) Fraud in anticipation of winding-up – S 206
- (b) Transactions in fraud of creditors – S 207
- (c) Misconduct in course of winding-up – S 208
- (d) Falsification of company’s books – S 209
- (e) Material omissions from statement relating to company affairs – S 210
- (f) False representations to creditors – S 211
- (g) Restriction on re-use of company name – S 216
- (h) Fraudulent trading – S 993 CA 2006

5.3 Civil proceedings

- 5.3.1 Some rights to bring civil proceedings against directors and others reside in the company itself. In those cases the administrator, liquidator (or administrative receiver) may cause the company to bring the proceedings. Other statutory provisions may specifically envisage the administrator or liquidator being the plaintiff in proceedings. Other provisions may permit a wider range of potential plaintiffs to bring proceedings for loss caused to the company. Generally, monies recovered (after any necessary deductions for the expenses of the recovery process) go into the pot for the benefit of all creditors rateably and according to the statutory priority waterfall. In some instances the recoveries are viewed as simply company assets and secured creditors with security over such assets will have a priority claim to those recoveries.
- 5.3.2 In addition, where an administrator or liquidator has assigned a claim for wrongful trading, fraudulent trading, preference, transaction at an undervalue or in respect of an extortionate credit transaction, the assignee (Assignee) may bring the relevant proceedings.
- 5.3.3 The table below sets out those people who may bring an action against the directors and/or others in connection with certain transactions which the company has entered into, or for disqualification proceedings.

¹⁹⁹ Section 218.

²⁰⁰ The Official Receiver is a civil servant from The Insolvency Service, an agency operating under the aegis of the Department of Business, Energy and Industrial Strategy (created on 14 July 2016 to merge the Department for Business, Innovation and Skills and the Department of Energy and Climate Change). He is often appointed liquidator initially on a winding-up order being made, although where there are assets in the liquidation a creditors’ meeting will likely be called to appoint a private liquidator.

²⁰¹ Section 218(4).

²⁰² The Insolvency Service, ‘Dear Insolvency Practitioner – Millennium Edition’ Chapter 20

²⁰³ Section 212(5)

²⁰⁴ Criminal proceedings are brought under section 993 CA 2006 and may be brought whether or not the company is in administration or liquidation.

Activity / transaction	Person able to bring proceedings	Destination of recoveries or fines (if any)
Misfeasance	Liquidator, Official Receiver, a creditor or, with leave of the court, a contributory ²⁰³	(1) Creditor with security of sufficient width to cover the claim of the company (2) Otherwise in pot for distribution among creditors generally (Creditor Pot)
Fraudulent trading	Criminal sanction: DPP ²⁰⁴ Civil sanction: liquidator, administrator or Assignee only	UK Treasury Creditor Pot or Assignee
Wrongful trading	Liquidator, administrator or Assignee only	Creditor Pot or Assignee
Unlawful use of prohibited name (criminal sanction)	DPP	UK Treasury
Personal liability for unlawful use of prohibited name	Creditor of new company/business using prohibited name ²⁰⁵	Creditor
Transaction at undervalue	Liquidator, administrator or Assignee only	Court has wide range of powers to restore the position
Preference	Liquidator, administrator or Assignee only	Court has wide range of powers to restore the position
Extortionate credit transactions	Liquidator, administrator or Assignee only	Usually Creditor Pot or Assignee although court has a range of powers
Transactions defrauding creditors	(1) If the company is in administration or liquidation: the administrator, the liquidator (or the Official Receiver) or, with the leave of the court, the “victim”. (2) If the victim is subject to a voluntary arrangement (VA): the supervisor of the VA. (3) Otherwise, by a victim of the transaction. ²⁰⁶	Court has wide range of powers to restore the previous position and to protect the interests of victims
Disqualification as a director (1)	Pursuant to sections 2, 3 or 4 CDDA 1986: ²⁰⁷ (SSBEIS), Official Receiver, liquidator, any past or present member or creditor of the company	Not applicable
Disqualification as a director (2)	Pursuant to section 6 CDDA 1986, ²⁰⁸ SSBEIS and (if SSBEIS so directs) the Official Receiver only	Not applicable
Disqualification as a director (3)	Pursuant to section 8 CDDA 1986: SSBEIS only ²⁰⁹	Not applicable

²⁰⁵ Liability is automatic if the offence is proved in the sense that there is no scope for court discretion or leniency.

²⁰⁶ All these proceedings are to be “treated as made on behalf of every victim of the transaction” – section 424(2).

²⁰⁷ Where the basis for disqualification is conviction for an indictable offence, persistent breaches of companies legislation and for fraud in the winding-up respectively.

²⁰⁸ The basis for disqualification under section 6 CDDA is unfitness arising from conduct in connection with an insolvent company – as discussed above at paragraph 2.15.

²⁰⁹ The basis for disqualification under section 8 CDDA is a general finding of unfitness while acting as director or shadow director of a company, an application to court for which the Secretary of State brings in the public interest. It may in practice be brought as a result of information received by the Secretary of State as a consequence of investigations into a company that he may have ordered. While under section 6 CDDA the court *must* disqualify when it finds unfitness, under section 8 the court has a discretion whether or not to disqualify even if it finds the person unfit.

Activity / transaction	Person able to bring proceedings	Destination of recoveries or fines (if any)
Disqualification as a director (4)	When the court make a disqualification order against a person or that person gives a disqualification undertaking, SSBEIS may apply for a compensation order to be made against the person.	The court may order payment (1) to a specific creditor or creditors, (2) to a class or classes of creditor and/or (3) to the Creditor Pot
Disqualification as a director (5)	Where a person has exerted influence over a director who has been disqualified (or given a disqualification undertaking) SSBEIS may apply to the court for a disqualification order against the person who exerted influence.	Not applicable

QUESTION 6

6. Remedies: orders available to the domestic Court

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available in the domestic Court?

Activity / transaction	Remedy available
Wrongful trading	<p>The director/shadow director may be ordered to make such contribution to the company's assets as the court thinks fit. However jurisdiction under section 214 is compensatory.</p> <p>Where the court makes a contribution declaration, it may make further directions to give effect to it such as, for example, imposing a charge on any debt or obligation due from the company to the director or the deferral of debts due from the company to him.</p> <p>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 between 2 and 15 years.</p>
Fraudulent trading (criminal sanction)²¹⁰	If prosecution proceeds on indictment and there is a trial by jury, the penalty is up to ten years imprisonment and/or a fine and, on summary conviction (non-jury trial), a term of imprisonment of up to 12 months and/or an unlimited fine.
Fraudulent trading (civil sanction)²¹¹	<p>The director may be ordered to make such contribution to the company's assets as the court thinks fit. The court may not include a punitive element in its order.</p> <p>Where the court makes a contribution declaration, it may make further directions to give effect to the declaration as for wrongful trading (see above).</p>

²¹⁰ Section 993 CA 2006.

²¹¹ Section 213.

Activity / transaction	Remedy available
	Where the court makes a declaration under section 213 that an individual is liable to make contribution to a company's assets, then it may also make a disqualification order as is the case with wrongful trading (see above).
Misfeasance	Section 212 provides a mechanism for summary trial, a remedy, 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.
Fraud in anticipation of a winding-up	If proceeds by the indictment/jury trial route 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 an unlimited fine.
Transactions defrauding creditors	If proceeds by the indictment/jury trial route 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 an unlimited fine.
Misconduct in winding-up	If proceeds by the indictment/jury trial route 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 an unlimited fine.
Falsification of company Books	If proceeds by the indictment/jury trial route 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 an unlimited fine.
Material omissions from statement relating to the company's affairs	If proceeds by the indictment/jury trial route 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 an unlimited fine.
False representations to creditors	If proceeds by the indictment/jury trial route 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 an unlimited fine.
Unlawful use of a prohibited name	Criminal sanction: on indictment/jury trial the court can order imprisonment for up to 2 years and/or a fine. On a summary conviction the court can order imprisonment for up to six months and/or an unlimited fine. Civil sanction: the director may be held personally liable for the debts of the company incurred whilst trading under the prohibited name.
Destroying, mutilating etc company documents including making an omission in a document²¹²	This offence can lead to imprisonment for six months and/or an unlimited fine on a summary conviction and imprisonment for seven years and/or a fine for a conviction on indictment.

²¹² Section 450 Companies Act 1985, as amended by section 1124 CA 2006

Activity / transaction	Remedy available
Breach of fiduciary duty	The director may be ordered to compensate for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit obtained in breach of fiduciary duty.
Breach of duty of care and skill	The director may be ordered to compensate the company for all loss and damage caused by breach of this duty.
Conduct rendering a director unfit to be a director²¹³	The court may order disqualification for a period of between 2 and 15 years. It may also make a compensation order for the payment of a monetary sum by the disqualified person.
Transactions at an undervalue and preferences	<p>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:</p> <ul style="list-style-type: none"> (a) order that any property transferred as part of the impugned transaction be re-vested in the company; (b) order 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) order the release or discharge of any security given by the company; (d) require any person to pay to the office-holder such sums as the court may direct in respect of any benefits received by him from the company in breach of sections 238 or 239; (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) order that security be provided for the discharge of any obligation imposed by or arising under the order; and (g) provide that to the extent to which any person's property is vested in the company by a court order (above), or on whom obligations are imposed by a court order (above), such person shall 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.²¹⁴ <p>An order under these provisions cannot prejudice any interest acquired from a person other than the company which was acquired in good faith²¹⁵ 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.²¹⁶</p>

²¹³ Section 6 CDDA 1986.

²¹⁴ Section 241(1).

²¹⁵ There are rebuttable presumptions of a lack of good faith where the acquirer is either connected with the company or has knowledge of the surrounding circumstances and the insolvency proceedings affecting the company – sections 241(2), 241(2A), 241(3), and 241(3A)-(3C).

²¹⁶ Section 241(2)(a) and (b).

Activity / transaction	Remedy available
<p>Transactions defrauding creditors²¹⁷</p>	<p>The court may:</p> <ul style="list-style-type: none"> (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.²¹⁸ <p>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.²¹⁹</p>
<p>Extortionate credit transactions²²⁰</p>	<p>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:</p> <ul style="list-style-type: none"> (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.²²¹
<p>Avoidance of a floating charge²²²</p>	<p>The court can declare that the floating charge is invalid in whole or in part.</p>

²¹⁷ Section 423. The requirements for liability to arise under this provision are explained at paragraph 4.5 above. Liability under section 423 is civil.

²¹⁸ Section 425(1).

²¹⁹ Section 425(2).

²²⁰ Section 244. See explanation of this provision in the answer to Question 4, paragraph 4.6. Liability is civil.

²²¹ Section 244(4).

²²² Section 245. See explanation of this provision in the answer to Question 4, paragraph 4.7. Liability is civil.

QUESTION 7

7. Duty to co-operate

- (a) **To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

7.1 Obligation to co-operate with investigation into company’s affairs

General duty to co-operate

7.1.1 S 235 applies in the case of a company where:

- (a) the company enters into administration; or
- (b) an administrative receiver is appointed; or
- (c) the company goes into liquidation; or
- (d) a provisional liquidator is appointed.²²³

7.1.2 Under S 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.²²⁴ 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 office-holder may reasonably require.

7.1.3 The “effective date” is whichever is applicable of the following dates:

- (a) the date on which the company entered administration; 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 (i.e. the date it passed a resolution for voluntary winding-up or the Court made an order for its winding-up).

7.1.4 The duty is imposed on the following people:

- (a) those who are or have at any time been officers of the company – this will include a director, manager or secretary of a company;²²⁵
- (b) those who have taken part in the formation of the company at any time within one year before the effective date;

²²³ Such a person may be 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.

²²⁴ See footnote 199 above regarding the Official Receiver.

²²⁵ Section 251.

- (c) those who are in the employment of the company, or have been in its employment (including employment under a contract for services – which includes those who have provided professional services to the company, for example, accountants) within that year, and are in the office-holder’s opinion capable of giving information which he requires;
- (d) those who are, or have within that year been, officers of, or in the employment (including employment under a contract for services) of, another company which is, or within that year was, an officer of the company in question; and
- (e) in the case of a company being wound up by the Court, any person who has acted as administrator, administrative receiver or liquidator of the company.

Sanction

7.1.5 Under S 235(5), if a person without reasonable excuse fails to comply with any obligation imposed by S 235, 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 property²²⁶

7.2.1 S 234 applies in the case of a company where:

- (a) the company enters into administration; or
- (b) an administrative receiver is appointed; or
- (c) the company goes into liquidation; or
- (d) a provisional liquidator is appointed.

7.2.2 Where any person has in his possession or control any property, books, papers or records to which the company appears to be entitled, the Court may require that person forthwith (or within such period as the Court may direct) to pay, deliver, convey, surrender or transfer the property, books, papers or records to the office-holder.²²⁷

Sanction

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

7.3 Obligation to provide information²²⁸

7.3.1 S 236 applies in the same circumstances as does S 234 and “office-holder” has the same meaning as in that section. Under S 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.²²⁹

7.3.2 Such person may be required (a) to submit a witness statement 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,

²²⁶ Section 234.

²²⁷ That is the administrator, administrative receiver, liquidator or provisional liquidator as the case may be (see section 234(1)).

²²⁸ Section 236.

²²⁹ But an applicant under s.236 has to satisfy the court that there is a proper case for an order to be made. In *Green v Chubb* [2015] EWCH 221 (Ch) the liquidator had to establish that he reasonably required the documents to carry out his functions, that he was not using s.236 abusively and that production did not impose an unnecessary and unreasonable burden on the respondent.

dealings, affairs or property. If a strong prima facie case is established that a legally privileged document was used in fraudulent conduct the privilege (which might otherwise justify a refusal to hand over documentation) could be displaced.²³⁰

Sanctions

- 7.3.3 If a person (without reasonable excuse) 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 S 236 also include powers (under S 237) to:
- (a) order any person who, as it appears to the Court, on consideration of any evidence obtained under Ss 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.²³¹

- 7.3.4 It is worth noting that, in practice, S 236 operates as a backdrop to any request by an office-holder to a director to provide information or documentation. That is, the parties will usually reach an agreement out of Court on the provision of information/documentation without requiring an application to Court and a Court order unless some point of importance divides them.

7.4 Company's statement of affairs²³²

- 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 Failure without reasonable excuse to comply leads to a daily default fine.²³³

7.5 Public examination of officers²³⁴

- 7.5.1 Where a company is being wound up by the Court, the Official Receiver may at any time before the dissolution of the company apply to the Court for the public examination of any person who (a) is or has been an officer of the company or (b) has acted as a liquidator or administrator of the company or as receiver or manager of its property or (c) not being such a person, is or has been concerned, or has taken part in the promotion, formation or management of the company.

²³⁰ *Jackson v Cannons Law Practice LLP* [2013] B.P.I.R. 1020.

²³¹ In *Re Omni Trustees Ltd* [2015] EWHC 2697 (Ch) it was held that section 236 has extra-territorial effect.

²³² Section 131. Equivalent obligations are imposed by section 2(3)(b) where a company is subject to a voluntary arrangement, section 47 if it is in administrative receivership, para 47 of Schedule B1 to the IA 1986 if in administration and sections 99 and 95(3)(a) if in voluntary liquidation.

²³³ Section 131(7).

²³⁴ Section 133.

Sanction

7.5.2 Under S 134, 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.²³⁵ 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 accounts²³⁶

7.6.1 In a creditors' voluntary liquidation²³⁷ 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 S 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 Requirement to discover to the liquidator the company's property and papers when it is being wound up²³⁸ and sanction for failing to do so

7.7.1 S 208 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 in the UK. The HRA incorporates into UK 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) as well as the 1st and 6th Protocols (together: 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 IA 1986).

²³⁵ This may include imprisonment.

²³⁶ Rules 4.39 and 4.40, IR 1986.

²³⁷ This (a 'CVL') is a winding-up effected by a resolution of the shareholders of the company and an appointment of a liquidator by the creditors; control is primarily in the hands of the liquidator and creditors rather than the court.

²³⁸ Section 208

(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 also may fall within the definition.

7.8.4 However, it should be recognised that the Convention Rights are not absolute and may 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.²³⁹ Accordingly, S 433 provides that any statement of affairs or other statement made in pursuance of a requirement imposed by the IA 1986 shall be inadmissible in criminal proceedings.²⁴⁰ In civil proceedings, however, the use of compelled evidence does not per se mean that a hearing is unfair.²⁴¹ It would be a matter for the defendant to raise, as he thought fit, at the civil proceedings.

7.9.3 There is some debate whether directors’ disqualification proceedings (under CDDA 1986) are criminal or civil in nature. The case-law suggests that such proceedings are regulatory and not criminal, although they are capable of being described as penal.²⁴² Thus, the Court of Appeal has held that the use of statements obtained by an insolvency practitioner under S 235 in disqualification proceedings does not necessarily involve a breach of Article 6(1). However, statements taken under S 236 may be treated differently.²⁴³ The public examination of officers of a company being wound up by the Court (under S 133 – see paragraph 7.5 above) is not contrary to Article 6.²⁴⁴

²³⁹ *Saunders v UK* (1997) 23 EHRR 313 [1998] 1 BCLC 362; *ex parte McCormick* [1998] BCC 379. Followed in *I.J.L., G.M.R. and A.K.P v United Kingdom* (Application Nos 29522/95, 30056/96 and 3057/96) [2000] BCC 380 and *Kansal v The United Kingdom* (2004) 39 E.H.R.R. 31. However, it is for the English court only to control the use made of compelled statements in criminal proceedings before the English court (and not their use in foreign criminal proceedings): *Rottmann v Britain* [2009] EWCA Civ 473.

²⁴⁰ Amended by the Youth Justice and Criminal Evidence Act 1999 with effect from 14 April 2000.

²⁴¹ *Re Westminster Pty Management Ltd, Official Receiver v Stern* (Court of Appeal, 2nd February, 2000). In *Shierson v Rastogi* [2002] All ER (D) 124, Gibson L.J. commented in relation to impending civil proceedings against the directors that “what use may be made at the trial of answers given in [a s 236] examination will be subject to the control of the trial judge. It is not inconceivable that a challenge on Article 6 grounds to the use of particular answers may be mounted then.”

²⁴² See *Re Westminster Pty Management Ltd, Official Receiver v Stern* supra and *D.C., H.S. & A.D. v UK*, (ECHR, 14th September, 1999). There is, however, much debate over this issue and a strong argument that proceedings under CDDA 1986 should be treated as being criminal for the purposes of Article 6.

²⁴³ *Re Westminster Pty Management Ltd, Official Receiver v Stern* supra.

²⁴⁴ *Slinn v UK*, 26th June, 1996.

7.9.4 It has been suggested that, whilst the original application for an examination under S 236 will be governed by Article 6, the examination itself will not because this is not a hearing for the determination of substantive rights.²⁴⁵

7.10 Article 4 – prohibition of slavery and forced labour

7.10.1 Under Article 4(2), no one shall be required to perform forced or compulsory labour. There is an argument that work that a director (or other person) may be required to do in complying with the obligations to co-operate with an investigation into the company's affairs following its insolvency may be forced labour contrary to Article 4. However, forced or compulsory labour does not include any work or service which forms part of normal civic obligations (Article 4(3)(d)). Therefore, any such argument is, in most cases, likely to fail, as the duties of co-operation are almost certainly part of a director's normal civic obligations.

7.11 Article 8 – right to respect for private and family life, home and correspondence

7.11.1 Article 8 provides as follows:

- (a) everyone has the right to respect for his private and family life, his home and his correspondence;
- (b) 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.²⁴⁶ In *WGS and MSLs v United Kingdom (Application No.38172/97)*²⁴⁷ it was held that director disqualification proceedings, which are publicly reported in the news with a potential negative effect on the applicants' reputations, do not infringe Article 8. The exception in Article 8(2) (above) means that the interests of the creditors are likely to prevail over most arguments that any examination or investigation is in breach of Article 8.²⁴⁸

7.12 First Protocol, Article 1 – protection of property

7.12.1 This provision provides that:

“Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.”

“The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.”

7.12.2 It is quite likely that any challenge under Article 1 of Protocol 1 to the directors' or others' liability to contribute to the assets of the company (for example under one of the heads listed in Question 2) is likely to fail because there is a general interest in such contribution (for example to protect creditors and to ensure the good management of companies). There is still the requirement of proportionality.

7.13 Human rights law in practice

7.13.1 Undoubtedly the HRA does have practical relevance in the insolvency arena. Cases based on alleged breach of the HRA have cropped up regularly since the HRA came into force²⁴⁹ and nor are

²⁴⁵ See *Fayed v UK* (1994) 18 EHRR 393.

²⁴⁶ Cf *Haig v Aitken* [2000] 2 All ER 80, where, in the context of bankruptcy, the Article 8 right confirmed the judge's view that private correspondence was not property within the bankrupt estate.

²⁴⁷ [2000] B.C.C. 719.

²⁴⁸ 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).

²⁴⁹ And the European Court of Human Rights has held that the HRA can apply retrospectively to cases which predate the HRA and the amended section 433: *Kansal v The United Kingdom*, 27 April 2004.

these cases restricted to those matters dealt with in this question. There have, for example, been a number of claims based on an infringement of the right to a fair trial within a reasonable time (Article 6) in the context of director disqualification proceedings which have taken an inordinate amount of time to reach Court.²⁵⁰ Its ambit is therefore wide reaching and full consideration of its implications is beyond the scope of this work.

- 7.13.2 Each case has been dealt with on its facts. But the general sense is that the Courts have been robust in resisting spurious human rights arguments following the introduction of the HRA²⁵¹ and have sensibly adopted the “proportionate” response necessary in the context of insolvency legislation designed to administer the affairs of the insolvent and to protect creditors and the public generally.²⁵²

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decision of the lower Courts?

8.1 Limitation periods

Limitation period for criminal proceedings

- 8.1.1 No limitation periods apply to the offences attracting criminal liability which have been identified in the answers to Questions 2 and 6.

Limitation period for civil actions

- 8.1.2 In relation to any liabilities created by Ss of IA 1986 the limitation period is 6 years from the date on which the cause of action accrued.²⁵³
- 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.²⁵⁴ 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.²⁵⁵ Case law has interpreted this widely so as to include the use of trust proceeds by a director for the benefit of a company he indirectly controls.²⁵⁶ If the action is based on fraud or concealment by the defendant or seeks relief from the consequences of a mistake the limitation period will only begin when the fraud, concealment or mistake were discovered.²⁵⁷
- 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.²⁵⁸

²⁵⁰ *Davies v UK* [2005] B.C.C. 401.

²⁵¹ *Walker v Daniels* [2000] 1 WLR 1382.

²⁵² *R v Kearns* [2002] All ER (D) 363.

²⁵³ Section 9 of the Limitation Act, 1980. *Re Overnight Ltd* [2009] EWHC 601 (Ch) held that a cause of action under section 213 (fraudulent trading) does not arise until the liquidator is appointed as (at that time) only a liquidator could bring an action for fraudulent trading. Now it will be from the appointment of an administrator or a liquidator. The same should apply in respect of wrongful trading. See also *Re Farmizer (Products) Ltd* [1997] BCC 655.

²⁵⁴ Section 21(3) of the Limitation Act 1980.

²⁵⁵ Section 21(1) of the Limitation Act 1980. *Belmont Finance v Williams (No. 2)* [1980] 1 All E R 393.

²⁵⁶ *Re Pantone 485 Ltd* [2002] 1 BCLC 266.

²⁵⁷ Section 32 of the Limitation Act 1980. See *IT Human Resources plc v David Land* [2014] EWHC 3812 (Ch) in which the court found a deliberate commission of a breach of duty by a director which he subsequently concealed. The court held that the limitation period did not begin to run until the company had learned of the director’s conduct.

²⁵⁸ Section 2 of the Limitation Act 1980 in the case of liability founded in tort. This time limit may be extended under section 14A of the 1980 Act in the event that the facts relevant to the cause of action were not known at the date on which it accrued. The extension allowed under this section is a further 3 year period from the date on which the claimant had both the knowledge required to bring the claim and the right to do so. This is subject to a long stop under section 14B of the 1980 Act which provides that no action shall be brought in respect of a negligence claim more than 15 years after the date on which the act of negligence relied upon occurred.

8.1.5 The limitation period applying to disqualification applications pursued under S 6 of the CDDA 1986 is 3 years²⁵⁹ from the date on which the company became insolvent.²⁶⁰ 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,²⁶¹ the charges laid against the director are particularly serious and there is a public interest in ensuring that they are pursued²⁶² and where it is still possible for the director to receive a fair trial.²⁶³

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.²⁶⁴

8.2.2 Hearings take place at first instance before either a County Court Judge, a Registrar of the High Court or a Judge of the High Court depending upon the complexity of the case and the value of the amount in issue. An appeal from a decision of a County Court (whether made by a District Judge, a Recorder or a Circuit Judge) or of a Registrar in insolvency proceedings lies to a Judge of the High Court. An appeal from a decision of a Judge of the High Court, whether at first instance or on appeal, lies to the Court of Appeal. A first appeal, in each case, is subject to the permission requirements of the Civil Procedure Rules (the CPR) Part 52, rule 3. An appeal from a decision of a Judge of the High Court which was made on a first appeal requires the permission of the Court of Appeal.²⁶⁵

8.2.3 These provisions apply to civil proceedings brought under the Court's insolvency jurisdiction. Where criminal offences are concerned, the procedure of the criminal Courts applies. Instead of the County Court and the High Court, the process involves:

- (1) the Magistrates' Court dealing with less serious offences; and
- (2) the Crown Court dealing with more serious offences and appeals from the Magistrates' Courts.

The Criminal Division of the Court of Appeal hears appeals from the Crown Court.

8.2.4 The Supreme Court is the final Court of appeal for civil and criminal proceedings.

8.2.5 It may also be possible to appeal civil proceedings based on breach of a director's duties (which are not insolvency proceedings).²⁶⁶

²⁵⁹ Section 7(2) CDDA 1986.

²⁶⁰ Under section 6(2) CDDA 1986 a company becomes insolvent when it goes into insolvent liquidation, administration or administrative receivership.

²⁶¹ *Secretary of State for Trade & Industry v McTighe* [1997] B.C.C. 224.

²⁶² *Secretary of State for Trade & Industry v Davies* [1996] 4 All E.R. 289.

²⁶³ *Secretary of State for Trade & Industry v Martin* [1998] B.C.C. 184.

²⁶⁴ Rule 7.47(1) of the IR 1986.

²⁶⁵ Paragraph 20 of the Insolvency Proceedings Practice Direction (October 2014) and rule 7.47(2) of the IR 1986.

²⁶⁶ CPR Part 52.3 sets out the standard permission requirements.

QUESTION 9

9. Foreign Corporations

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

9.1 Introduction

9.1.1 As noted in Question 5 above, apart from criminal proceedings the ability to enforce the rights and duties of directors will usually be undertaken by an administrator or liquidator. In particular, the tables set out in Question 5 above specify who may bring actions against a director. Consequently, the ability to bring English insolvency law actions against directors of foreign companies will, first and foremost, depend on the jurisdiction of the English Courts to wind-up a foreign company or alternatively to place a foreign company in administration although, in appropriate cases, a foreign office-holder might be able to bring certain English insolvency law actions against foreign company directors pursuant to either S 426 or the Cross Border Insolvency Regulations 2006 (CBIR 2006) without English insolvency proceedings having been commenced against the foreign company.

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

- (a) the foreign company is a company to which the EC Regulation on Insolvency Proceedings²⁶⁷ (the Regulation) applies and has its “centre of main interests” or an “establishment” in England;
- (b) the foreign company may be wound up under S 221 as an “unregistered company”;
- (c) the foreign company is one in respect of which a winding-up or administration proceedings could be opened pursuant to an application under S 426;
- (d) the foreign company is incorporated in Norway, Iceland or Liechtenstein;²⁶⁸
- (e) the foreign company’s representative may apply to commence “a proceeding under British insolvency law” pursuant to CBIR 2006 (Article 11).

9.2 Foreign companies to which the EC Regulation on Insolvency Proceedings applies

9.2.1 On 31 May 2002, the Regulation came into force across the European Union (with the exception of Denmark).²⁶⁹ The Regulation applies only to companies with their “centre of main interests” (see below) in the European Union; in respect of such companies, it determines in which Member State(s) insolvency proceedings for a company can be commenced and hence whether there is jurisdiction in England to wind-up a foreign company or place it into administration.

9.2.2 The Regulation provides for two types of insolvency proceedings:

- (a) “main insolvency proceedings” which can only be opened in the Member State where the company has its “centre of main interests” (CoMI). The Regulation provides that there is a rebuttable presumption that CoMI is in the place of the company’s registered office. Recital (13) to the Regulation also states that CoMI “should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.” Main insolvency proceedings have universal scope, encompassing all the debtor’s assets on a Community-wide basis and affecting all creditors, wherever located. Both liquidation and administration proceedings may be opened as main proceedings in England; and

²⁶⁷ Council Regulation (EC) No 1346/2000 of 29 May 2000.

²⁶⁸ See paragraph 111(1A)(b) of Schedule B1 to IA 1986.

²⁶⁹ The Regulation now also applies to the countries that acceded to the European Union on 1 May 2004 and on 1 July 2013.

(b) “secondary proceedings” which may be opened in any Member State where the company possesses an “establishment”. “Establishment” is defined in the Regulation as “any place of operations where the debtor carries out a non-transitory economic activity with human means or goods”.²⁷⁰ This is likely to include a branch office of a foreign company or an established place of business, but the mere presence of assets such as a bank account will not constitute an establishment. Secondary proceedings are limited in scope to assets located in the Member State where they are opened and are also limited to ‘winding up proceedings’. Liquidation and administration proceedings are listed in Annex B to the Regulation as being possible secondary proceedings to be opened in England. That English administration may or may not lead to winding up and that this will likely not be known at the outset does raise the question whether an administration can properly be commenced as a secondary proceeding. The answer proposed by a leading text on the Regulation is that, as all administrations *may* end as windings up, then any administration can qualify as a secondary proceeding.²⁷¹

- 9.2.3 Accordingly, if a company has its CoMI or an establishment in England, it may (notwithstanding that the company is incorporated elsewhere) become subject to liquidation or administration proceedings in England.
- 9.2.4 Article 4 of the Regulation provides that where English insolvency proceedings are opened as main proceedings, English insolvency law will apply to the insolvency proceedings and their effects and will, amongst other matters, determine the powers of the liquidator²⁷² and the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all the creditors. As noted in paragraph 5.1.1 above, it is primarily the office-holders (that is, the liquidator and administrator) who review the actions of directors (and others) taken in the twilight period and bring proceedings, as appropriate. Hence, the powers of a liquidator or administrator outlined above in Question 5 will apply equally in respect of directors of a foreign company which is subject to English insolvency law pursuant to the Regulation.²⁷³
- 9.2.5 Moreover, Article 18(1) of the Regulation further provides that the liquidator or administrator appointed in main proceedings may exercise all the powers conferred on him by English law in any other Member State (so long as no other insolvency proceedings have been opened in that Member State nor any preservation measure to the contrary has been taken there further to a request for the opening of insolvency proceedings in that State) and may, in particular, remove assets from other Member States in which they are situate. In exercising his powers, the office-holder must comply with the local laws of the Member State.
- 9.2.6 In relation to the matters considered in Question 4 above, the vulnerability of any transaction at an undervalue or preference entered into during the twilight period will be subject to the application of Article 13 of the Regulation (where the act in question is subject to the law of a Member State of the EU other than the State where the proceedings have been opened, the act is not vulnerable if the party who benefitted can show that the act could not be successfully attacked under the laws of the governing law state).
- 9.2.7 Where a foreign company has an establishment but no CoMI in England, secondary proceedings can be opened in England but “the effects of those proceedings” will be restricted to “the assets of the debtor situated in [England]”.²⁷⁴ English law will apply in the secondary proceedings.
- 9.2.8 In this context a point which has not yet been considered by the English Courts is whether proceedings for wrongful or fraudulent trading may be brought by a liquidator appointed in secondary proceedings in England against the directors of a foreign corporation or, indeed, of an English company. Technically, as a matter of English law a wrongful trading claim is not an asset of the company in the conventional sense. It is not an asset of the company at the date of administration or liquidation – the administrator or liquidator once appointed has a right to bring

²⁷⁰ See Article 2 (h) of the Regulation.

²⁷¹ See *The EU Regulation on Insolvency Proceedings 3rd Edition* by Moss, Fletcher and Isaacs, paragraph 8.170 and footnote 262. This issue falls away when the Regulation is recast as no distinction will then be drawn between procedures that can be opened as main proceedings and those that can be opened as secondary (or territorial) proceedings – see generally paragraph 9.3 below.

²⁷² “Liquidator” under the Regulation means any person or body whose function is to administer or liquidate assets of the debtor or to supervise the administration of the debtor’s affairs and therefore includes both a liquidator and an administrator of a company.

²⁷³ If English insolvency proceedings are opened as main proceedings in respect of a foreign corporation, the Regulation provides that English law will apply to the conduct of the insolvency proceedings. An action for wrongful or fraudulent trading, which is an insolvency-related action and which can only be brought in the context of insolvency proceedings, should therefore be caught by the terms of the Regulation and English law would apply. But English law will not determine, for example, whether there has been a breach of the directors’ fiduciary duties since this is not a matter of insolvency law but, rather, local corporate law (although section 212 could be invoked by an English liquidator to enforce those local fiduciary duties). And note the position in secondary proceedings discussed at paragraph 9.2.8.

²⁷⁴ Article 3(2) and (3) of the Regulation.

a claim but not before – and the Courts have said that the proceeds of such a claim are also not assets of the company as they are received by the office-holder impressed with a statutory trust for the creditors of the company.²⁷⁵ So arguably a secondary proceeding covering only the assets of the company in England would not extend to empowering a liquidator (or administrator) to bring a wrongful trading claim. However, there are several points which can be made to support the contrary point of view. First it is not clear that the meaning of assets of the company in the Regulation is the same as that in the English authorities which were addressing a separate issue.²⁷⁶ The reason for keeping secondary proceedings narrow in ambit would be to prevent them interfering with the main proceeding under the Regulation. But here the ‘asset’ would not be available in the main proceeding as a wrongful trading claim is a creature of English law alone and only capable of being brought in the context of an English liquidation or administration. A broad purposive interpretation of ‘asset’ in Regulation 3(2) should cover a wrongful trading claim of a liquidator or administrator. Finally, clawback claims (preferences, transactions at undervalue) are similarly treated in English law as not assets of the company yet the Regulation clearly envisages that office-holders in secondary proceedings may pursue them.²⁷⁷ Alternative approaches to effect a territorial limitation to a wrongful trading claim – say, limited to losses generated in the English ‘Establishment’ – do not appear practically feasible.²⁷⁸

9.2.9 As regards the regime for disqualification of directors of insolvent companies for unfitness²⁷⁹ and how it impacts directors of foreign companies, the main principles are as follows:

- (a) the company concerned (a Relevant Company) must be one which is either registered in England and Wales²⁸⁰ or one which “... may be wound up under Part 5 of the Insolvency Act 1986 (unregistered companies)...”;²⁸¹
- (b) the director under consideration must have been a director of a Relevant Company which has become insolvent;²⁸²
- (c) a line of cases dealing with schemes of arrangement under S Part 25, CA 2006 has held that similar words – ‘liable to be wound up under Part 5...’ - in the description of companies amenable to schemes of arrangement requires neither that the company in question could on the particular facts be wound up by the Court²⁸³ nor that on those facts the Court would exercise its discretion to wind up the company.²⁸⁴ The Courts have said that in this context the words simply mean that the company is the *type of company* which could be wound up as an unregistered company under IA, 1986;
- (d) the English Court, will not, however, exercise an exorbitant jurisdiction as regards foreign companies. In the scheme context, the Court will as a matter of its discretion only sanction a scheme of arrangement in relation to a foreign company (all other legal requirements such as class composition having been satisfied) provided three core requirements are satisfied including that there is a sufficient connection with the jurisdiction;²⁸⁵

²⁷⁵ See *Re Oasis Merchandising Services Ltd* [1997] BCC 282 which applied this analysis to a wrongful trading claim by a liquidator. Although there is no similar decision in the case of an administrator, it would seem unlikely that such a claim of a liquidator is not an asset of the company but the same claim of an administrator is such a claim. The point that there is no claim until the office-holder is appointed applies to administration in the same way as it does to liquidation as does the ‘statutory trust for creditors’ analysis - see *Harms Offshore AHT “Taurus” GmbH & Co KG v Bloom* [2009] EWCA Civ 632.

²⁷⁶ This was whether the wrongful trading claim was an asset of the company that a liquidator could assign to a third party. Statute has since intervened in England to permit such assignments by liquidators and administrators.

²⁷⁷ Regulation 4.2(m). And the *Virgo-Schmit Report* dealing with the type of information office-holders in main and secondary proceedings should share with each other includes any actions planned to set aside transactions (paragraph 230).

²⁷⁸ If proceedings both for wrongful trading and for an equivalent procedure in another jurisdiction were brought against directors in main and secondary proceedings, there is the risk that directors have to contribute twice for the same actions and even perhaps more than the total loss caused by their actions or suffered by the creditors. A judgment handed down by a court with jurisdiction in the main or the secondary proceedings and which concerns the course of those insolvency proceedings must be recognised in all other Member States without further formality. It remains to be seen whether any amount which the directors are ordered to pay under the first set of proceedings will be taken into account when quantifying any contribution they are required to make under any order made in another jurisdiction. The office-holder in the main proceedings and the office-holder in any secondary proceedings are required under the Regulation to co-operate with each other and one would therefore expect a coordinated approach to such matters to be adopted. Until guidance comes from the courts up to and including the European Court, considerable uncertainty surrounds this whole question.

²⁷⁹ Section 6 CDDA 1986; see also paragraph 2.15 above.

²⁸⁰ Under CA 2006.

²⁸¹ Section 22(2), CDDA 1986.

²⁸² Which means it has gone into a liquidation where creditors are not paid in full, gone into administration or had an administrative receiver appointed by a secured creditor. The relevant directors’ unfitness can be assessed by reference to his conduct as director both of the Relevant Company and also other companies and ‘overseas companies’ which in each case became insolvent.

²⁸³ See section 221(5) of IA 1986 which gives three circumstances in each which an unregistered company may be wound up. These can be summarised as: (a) the company has ceased business (or is dissolved), (b) it is unable to pay its debts and (c) that the court thinks it is ‘just and equitable’ to wind it up.

²⁸⁴ *Re Drax Holdings* [2003] EWHC 2743 (Ch) and subsequent cases; and see paragraph 9.4 below.

²⁸⁵ See generally paragraph 9.4 below.

- (e) the Regulation is relevant in that the Relevant Company can only go into administration or liquidation if its CoMI is in England or, if CoMI is elsewhere in the EU, it has an Establishment in England. If the CoMI is elsewhere in the EU then the proceedings (administration or liquidation) can only be secondary proceedings²⁸⁶ (and then only if there is an Establishment in England);
- (f) in S 6 of CDDA 1986 (unfitness in connection with an insolvent company), the defined term company is used in two different contexts. First, it is used to identify the type of insolvent company the stewardship of which by a director may lead to a finding of unfitness (see paragraph 9.2.9(a) above). As explained above (see paragraph 9.2.9(c) and (d)), in the context of whether a company not registered in England and Wales can be made subject to a scheme of arrangement, the English Court avoids assuming an exorbitant jurisdiction by requiring that core requirements are satisfied before it will exercise its discretion including that there is a sufficient connection with the English jurisdiction.²⁸⁷ There is, however, no discretion in the Court under S 6 as, once it has concluded that a director is unfit as a result of his conduct in connection with, say, a foreign company, the Court ‘shall make a disqualification order’ (emphasis supplied).²⁸⁸ Accordingly, if, as in the scheme of arrangement context, ‘may be wound up under Part 5[IA 1986]’²⁸⁹ simply identifies the type of company which falls within the definition not whether on its particular facts it *would* be wound up by the Court or whether it satisfies the three core requirements, that would suggest the Court might find itself exercising an exorbitant jurisdiction by disqualifying directors of a foreign corporate with no connection to the English jurisdiction.²⁹⁰ Or it might be forced to conclude that the statute could not have intended to flout the rules of international comity in this way and view the three core requirements as going to jurisdiction (not discretion) in this context;
- (g) secondly, the term is used to describe the entities to which the disqualification order is to apply: the companies in respect of which the disqualified person cannot be a director or involved in management. It would be remarkable if the same defined term bore different meanings in the same statute.²⁹¹ If the wide meaning of unregistered company applies this could lead to an English Court applying English law to disqualify a director from being a director of a foreign company with nothing to do with England. But if the three core requirements needed to be satisfied (that is, a narrow interpretation is taken) that gives rise to the problem that whether the director is disqualified from acting as a director of that company may change depending on whether the three core requirements are satisfied at any point in time and from time to time.²⁹² It seems that in one case, *Secretary of State for Trade and Industry v Lee*,²⁹³ the Court accepted that a British Virgin Islands company which satisfied the three key considerations was a ‘company’ for the purposes of S 22(2)(b) CDDA 1986 and hence a disqualification order could be made against one of its directors under S 8, CDDA 1986. S 8 does, however, give the Court discretion as to whether or not to make a disqualification order despite a finding of unfitness. As mentioned above, there is no such discretion in S 6.

9.2.10 There are other open questions regarding disqualification and foreign companies.

- (a) Does the Regulation cover disqualification orders such that (i) they are automatically enforceable across the EU and/or (ii) their prosecution is subject to the regime of the Regulation?
- (b) If not, are disqualification proceedings ‘civil and commercial’ matters such that they fall within, and are subject to the regime of the recast Brussels I Regulation²⁹⁴ on judgment enforcement?

²⁸⁶ Or ‘territorial proceedings’ where the proceedings are opened *before* main proceedings in the CoMI.

²⁸⁷ See paragraph 9.4.2 below.

²⁸⁸ Section 6(1) CDDA 1986.

²⁸⁹ Section 22(2)(b) CDDA 1986.

²⁹⁰ A potential practical answer to this difficulty might be that in practice it will not arise as SSBEIS will not have information on directors of companies lacking a material connection with England nor would he be likely to bring a disqualification action in the exercise of *his* discretion.

²⁹¹ Notwithstanding the fact that the definition of company in CDDA 1986 does say that it applies ‘unless the context otherwise requires’ (sections 22(1) and 22(2) CDDA 1986).

²⁹² See the discussion in *Mithani: Directors Disqualification* at III [68C].

²⁹³ 31 January, 2005 an unreported decision of Mr Registrar Jacques mentioned in *Mithani* supra at III [67].

²⁹⁴ The European Parliament and Council Regulation No 1215/2012.

9.2.11 Taking each question in turn:

- (a) Disqualification orders would appear not to be ‘judgments deriving directly from the insolvency proceedings and which are closely linked with them...’.²⁹⁵ And so they are not caught by or automatically recognised EU-wide pursuant to, the Regulation.
- (b) The better view is that disqualification matters are not ‘civil and commercial’ but regulatory and administrative and so not within Brussels I.²⁹⁶

9.3 Recast EC Regulation on Insolvency Proceedings and Brexit

9.3.1 Regulation (EU) 2015/848²⁹⁷ (the Recast Regulation) came into force on 26 June 2015. The Recast Regulation was the result of a public consultation exercise undertaken by the Commission on the application of the Regulation. The Recast Regulation will apply from 26 June 2017, two years after coming into force. The Regulation will continue to apply to insolvency proceedings started before that date. The main aim of the Recast Regulation is to shift the focus from liquidation to a company rescue culture. Changes introduced by the Recast Regulation will be to include more pre-insolvency rescue proceedings for recognition; measures to discourage bankruptcy forum shopping; a framework for co-operation between Courts and officeholders involved in group insolvencies; establishment of interconnected insolvency registers; procedures for stopping multiple secondary proceedings.

9.3.2 On 23 June 2016 a majority of the voting electorate of the United Kingdom voted in a referendum to the effect that they wished to see the UK leave the European Union. Unless the United Kingdom negotiates an agreement that allows the Recast Regulation to apply to insolvency proceedings following its formal exit from the European Union, the Recast Regulation will not thenceforth have effect in the United Kingdom.

9.4 Winding-up of a foreign company as an “unregistered company” under S 221

9.4.1 Subject to paragraph 9.2 above in circumstances where the Regulation applies, a foreign company may be wound up in England and Wales, in certain circumstances, as an “unregistered” company.²⁹⁸ In general, all the provisions of the IA 1986 will apply equally on the winding-up of an “unregistered” company.²⁹⁹

9.4.2 The IA 1986 provides no specific criteria for determining when it is appropriate for the English Courts to exercise its jurisdiction (which exercise is a matter of the Court’s discretion) and wind-up an unregistered company. Filling this vacuum, the Courts have developed a general test consisting of three “core” requirements. These can be summarised as follows:³⁰⁰

- (a) there must be a sufficient connection with England and Wales which may, but does not necessarily have to, consist of assets situated within the jurisdiction of the English Court;
- (b) there must be a reasonable possibility, if a winding-up order is made, of benefit to those applying for the winding-up order; and
- (c) one or more persons interested in the distribution of the assets of the company must be persons over whom the Court can exercise jurisdiction.

9.4.3 In practice, it would normally be considered a sufficient connection (under (a) above) 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.³⁰¹ 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;³⁰² making a winding-up order which would

²⁹⁵ Article 25(i) of the Regulation.

²⁹⁶ See *Re Senator Hanseatische Verwaltungsgesellschaft mbH* [1996] 2 BCLC 262; see also *Mithani* supra at IXB [6] – [8].

²⁹⁷ The Recast Regulation can be found at the following website: <http://eur-lex.europa.eu/eli/reg/2015/848/oj>

²⁹⁸ Section 220.

²⁹⁹ Section 221(1).

³⁰⁰ As summarised by Knox J in *Re Real Estate Development Co.* [1991] BCLC 210.

³⁰¹ *Banque des Marchands de Moscou (Koupetschesky) v Kindersley* [1951] Ch. 112.

³⁰² *Re Compania Merabello San Nicholas SA* [1973] Ch. 75.

entitle former employees of the foreign company to claim statutory redundancy payments;³⁰³ where the debt upon which the winding-up petition is founded was incurred within the English jurisdiction;³⁰⁴ where the liquidator would be entitled to launch a claim against the former directors of the foreign company for wrongful trading which may subsequently produce a realisation to be distributed to creditors and (in the context of cases on schemes of arrangement of foreign companies) where the company's finance documents are governed by English law. It will usually be fairly clear whether or not the making of a winding-up order will potentially benefit creditors of the foreign company if the potential return will be more than *de minimis*. The Court will also need to be satisfied that among those who may benefit is at least one person who is either subject to the jurisdiction or has submitted to the jurisdiction of the English Court.

9.5 Application under S 426

- 9.5.1 Under S 426(4), the English Court is under a duty to assist with a request for assistance in matters of insolvency received from a Court in any other part of the United Kingdom or from any “relevant country or territory”.³⁰⁵ This could possibly include a request to wind up or make an administration order in respect of a foreign company.³⁰⁶ In particular, where the English Court receives such a request, the Court may apply, in relation to the issues specified in the request, either the insolvency law applicable in the jurisdiction of the Court making the request (in relation to comparable matters falling within the English Court's jurisdiction) or the normal insolvency law of England. This apparently wide authority is limited by the normal rules of private international law and consequently, the English Court retains a discretion to refuse to provide assistance in certain circumstances (for example, where providing such assistance would prejudice local creditors).
- 9.5.2 Where it is appropriate to respond to a request to wind up or, more likely, to appoint an administrator over a foreign company, the administrator (or liquidator) so appointed will enjoy the normal powers afforded to an administrator (or liquidator, as appropriate) of an English company including the ability to review transactions and if necessary to apply to the Court to have any transactions at undervalue or preferences set aside.
- 9.5.3 Of the relevant provisions concerning the enforcement of directors' duties, the English Courts have confirmed that directors (whether resident in the UK or not) of a foreign company which is being wound-up by the English Court will be subject to the Court's jurisdiction in connection with an application by the liquidator or administrator against those directors for either wrongful or fraudulent trading.³⁰⁷ This will be the case even if the country of incorporation of the relevant company does not contain an equivalent provision within its insolvency laws. However, the English Court might be expected to 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 an undervalue and preferences will apply.³⁰⁸ It should also be noted that the provisions of S 236 placing directors under an obligation to provide information will apply equally to directors domiciled abroad. The same would, *prima facie*, apply to a foreign company subject to English administration proceedings.
- 9.5.4 In addition, various provisions of the CDDA 1986 relating to the disqualification of a director may be applied by the English Courts to a foreign company subject to English insolvency proceedings by virtue of S 426. This will be the case irrespective of whether the director was resident within the jurisdiction, whether the conduct of that director took place within the jurisdiction or whether or not the director is a British citizen. This will be important for directors of foreign companies as a disqualification order may be made on the basis of “unfitness” to be a director not only as a result of wrongful or fraudulent trading but also as a result of being a director of a company which has entered into a transaction at undervalue or given a preference. A director may also be found “unfit” to be a director as a result of a breach of the various other requirements imposed on directors under the Companies Act 2006 or the IA 1986 and which are detailed in the responses to Questions 2 and 3 above.

³⁰³ *Re Eloc Electro-Optieck and Communicatie BV* [1982] Ch. 43.

³⁰⁴ *Re a Company (No.00359 of 1987)* [1988] Ch. 210.

³⁰⁵ See section 426(11). At the present time, the list of relevant countries or territories are: Anguilla, Australia, The Bahamas, Bermuda, Botswana, Brunei, Canada, Cayman Islands, Falkland Islands, Gibraltar, Hong Kong, Tuvalu, the Virgin Islands, Malaysia, Montserrat, New Zealand, South Africa, St Helena, Turks & Caicos Islands, and the Republic of Ireland (SI1986/2123; SI1989/2409; SI1996/253 and SI1998/2766).

³⁰⁶ *Re Dallhold Estates (UK) Pty Ltd* [1992] BCC 394.

³⁰⁷ *Re Howard Holdings Inc* [1998] BCC 549; *Bilta (UK) Ltd v Nazir and others* [2012] EWHC 2163.

³⁰⁸ *Re Paramount Airways Ltd.* [1993] Ch. 223.

9.5.5 S 426 may also be used to request the English Court’s assistance in bringing clawback proceedings against a director of a foreign company, in which event the laws of either the foreign jurisdiction or England can be applied.³⁰⁹

9.6 Norwegian, Icelandic and Liechtenstein companies

9.6.1 By virtue of the definition of “company” in paragraph 111(1A)(b) of Schedule B1 to the IA 1986, a company incorporated in Norway, Iceland or Liechtenstein may become subject to English administration proceedings.³¹⁰

9.6.2 “Company” is defined to mean:

- (a) a company registered under the Companies Act 2006 in England and Wales or in Scotland,
- (b) a company incorporated in an EEA State other than the United Kingdom, or
- (c) a company not incorporated in an EEA State but having its centre of main interests in a member State other than Denmark.

9.6.3 Norway, Iceland and Liechtenstein are EEA States but not members of the European Union. Hence, a company incorporated in any of these countries may become subject to administration proceedings even though its centre of main interests is not in England (as is required under the Regulation).

9.6.4 The author is not aware of any cases in which this definition has been relied upon to appoint an administrator to a Norwegian, Icelandic or Liechtenstein company. However, in the event of any such appointment, the administrator would have, prima facie, all the powers referred in S 5 above to enforce the rights and duties of a director (subject to the comments above in 9.5.3 and 9.5.4 in relation to the powers of a liquidator or administrator in respect of a foreign company).

9.7 Foreign company able to avail itself of the provisions of The Cross-Border Insolvency Regulations 2006

9.7.1 On 4 April 2006, the UNCITRAL Model Law on Cross-Border Insolvency was implemented in Great Britain by The Cross-Border Insolvency Regulations 2006, SI 2006/1030 (the Cross-Border Regulations). The Cross-Border Regulations enable office-holders in a foreign insolvency (known as the foreign office-holder) to seek recognition of their insolvency in England (and the rest of the United Kingdom) and, in appropriate circumstances, to commence English insolvency proceedings in respect of the foreign company. Under English law, there is no restriction on the countries (and therefore the foreign office-holder) that may take advantage of the Cross-Border Regulations although, as a general matter, an English Court will only have jurisdiction to consider a recognition application if the debtor company has a place of business or assets in Great Britain or the Court considers for any other reason that England (or Great Britain) is the appropriate forum to consider the question or provide the assistance requested.

9.7.2 Recognition may be sought in respect of two types of foreign insolvency proceedings:

- (a) “foreign main proceedings” which are proceedings taking place in the State in which the debtor has its “centre of main interests” which is not defined but is subject to a rebuttable registered office presumption substantially similar to the presumption in the Regulation; and
- (b) “foreign non-main proceedings” which are proceedings taking place in a State where the debtor has an “establishment” which is defined to have a meaning similar to the definition in the Regulation.

The effect of obtaining recognition will depend upon whether the proceedings in respect of which recognition is sought are foreign main or foreign non-main proceedings; relief will apply on either an automatic or discretionary basis.

³⁰⁹ *Rubin and New Cap Reinsurance* [2012] UKSC 46.

³¹⁰ For further commentary on paragraph 111(1A)(b) of Schedule B1 to IA 1986, see *Cross Border Insolvency* by Richard Sheldon QC at page 228.

- 9.7.3 Upon obtaining recognition, the foreign office-holder is granted a right to bring proceedings under English law (known as an Article 23 application) to challenge transactions at an undervalue, preferences, extortionate credit transactions and transactions in fraud of creditors (even if English administration or liquidation proceedings have not been commenced).³¹¹ So, for example, where in a foreign insolvency a transaction at an undervalue or a preference has been made in favour of an English creditor (but it is not appropriate to open English insolvency proceedings) a foreign officeholder can still enforce the anti-avoidance provisions referred to in S 4 above by obtaining recognition of the foreign insolvency proceedings under the Cross-Border Regulations and making an Article 23 application. Note, however, that the Supreme Court in *Rubin*³¹² has held that the Cross-Border Regulations cannot be used by a foreign officeholder to enforce in England an anti-avoidance judgment obtained in foreign insolvency proceedings where the defendant had not submitted to the jurisdiction of the foreign Court or taken part in the foreign insolvency proceedings.
- 9.7.4 Additionally, a foreign officeholder is granted the right under the Cross-Border Regulations to apply directly to the English Courts to commence English insolvency proceedings.³¹³ This right is not conditional upon the foreign officeholder having first obtained recognition of the foreign proceedings in England. However, it is subject to the conditions for commencing such a proceeding being met as a matter of English insolvency law.

QUESTION 10

10. Insurance

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

- 10.1 It is permissible (and common) for a director to take out insurance against liability for negligence, default, breach of duty or breach of trust and the company may lawfully pay the premiums.³¹⁴ Directors may not exclude their liability for these matters.³¹⁵ Further, as a general rule, the company cannot indemnify a director against liability for his negligence, default, breach of duty or breach of trust in relation to the company.³¹⁶ However, as an exception to this general rule, the company may provide a director with third party indemnity cover (an indemnity against liability incurred to a person other than the company or an associated company) subject to the indemnity meeting certain qualifying terms (namely, amongst other requirements, that it does not indemnify the director against liability incurred in defending criminal proceedings in which he is convicted, in defending civil proceedings brought by the company in which judgment is given against him or in respect of a fine imposed in criminal proceedings or a sum payable to a regulatory authority in respect of non-compliance with any regulatory requirement).³¹⁷
- 10.2 The insurance policy cannot enable the director to insure against his own wilful or fraudulent wrongdoing as it will be struck down on grounds of public policy. However, it is felt that it is possible to insure against wrongful trading. It would not, however, be possible to insure against fraudulent trading given the public policy considerations.

³¹¹ If English insolvency proceedings are afoot, the permission of the court will be required first and, if the foreign proceedings are non-main proceedings, the court will need to be satisfied that the Article 23 application relates to assets that, under the law of England, should be administered in the foreign non-main proceeding.

³¹² *Rubin and New Cap Reinsurance* supra. This decision has since been applied in a number of cases, most recently in *Erste Group AG (London) v JSC (VMZ Red October)* [2015] EWCA Civ 379.

³¹³ Article 11 of Schedule 1 to the Cross-Border Regulations.

³¹⁴ Section 233 CA 2006.

³¹⁵ See section 232(1) CA 2006.

³¹⁶ Section 232(2) CA 2006 renders void any such indemnity provided by the company (directly or indirectly).

³¹⁷ Section 234 CA 2006.

- 10.3** The main insurance policy available to directors and recommended by the Institute of Directors is director's personal liability cover.³¹⁸ However, this will usually specifically exclude any claims based on or arising out of any insolvency proceedings and insolvency is defined in similar terms to that laid out in Question 1.³¹⁹ A policy is, however, believed to be available by which directors can insure against actions arising out of insolvency, but obtainable only from specialist brokers through Lloyds.

The information provided in this country chapter is correct as at 30/03/2017

³¹⁸ For further information visit <http://www.iod.com/your-venues-and-benefits/specially-negotiated-products-and-services/dli>

³¹⁹ Information obtained from Chubb Insurance Limited, the official insurers recommended by the Institute of Directors.

ESTONIA

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Introduction

The general legal environment of the “twilight” period in Estonia is characterised by a rather high degree of uncertainty. This is partly due to a relatively small number of decisions regarding this topic by the Supreme Court of Estonia. A balance between the creditors’ interests and the directors’ liability is yet to be found. In summary, the inability to enforce tortious claims against a director in Court especially by “old” creditors and the resulting poor business culture of the directors of distressed companies constitute a significant problem for the Estonian economy.

1.2 Directors

Liability during the “twilight” period in Estonia is relevant for directors of private limited companies (*osühing, OU*) and public limited companies (*aktiaselts, AS*). Pursuant to § 180(1) of the Commercial Code 1995 (CC) respectively § 306 (1) CC, the board of directors is the directing body of the company which represents and manages the company. The names and personal identification codes of the members of the management board are to be entered in the commercial register. However, there is also the possibility of a *de facto* director instead of or in addition to the *de iure* director(s) who in fact performs the duties of a *de iure* director in legal transactions. While it is obvious that a *de iure* director may also be held liable for inactivity on tortious grounds, in Estonian law this is generally not true for *de facto* directors, as they do not hold a legal duty to perform certain measures. Therefore, a *de facto* director cannot be held liable for omission.¹

1.3 The “twilight” period

The notion of “twilight” period is generally not known in Estonia, but it can be given a meaning from two perspectives: whether this period has legal consequences to transactions made on behalf of the distressed company or to director’s personal liability.

1.3.1 Recovery

If the parties to a transaction are connected and the interests of the creditors have been knowingly damaged, such a transaction may be revoked by the Court if the transaction has been entered into within the five years before the appointment of an interim trustee. However, due to a high burden of proof, in practice usually only transactions that have been concluded within six months before the appointment of an interim trustee are contested (because for this period the other party’s awareness of the detriment to the creditors’ interests is presumed).²

In recovery, a wide range of transactions may be revoked, including gratuitous contracts, security contracts, and payments. Recovery is possible also in respect of legal successors.

¹ On *de facto* director see 3.1 below.

² On recovery see section 4.1.1 below.

1.3.2 Thin capitalisation

When the net assets of the limited company fall below one half of the share capital or below the statutory minimum, directors are obliged to call a general meeting of the shareholders. This provision is seen as protection for creditors by some lower Estonian Courts and therefore a source of potential liability for directors. However, this view may be erroneous, because the duty to convene a general meeting is to protect shareholders and the company rather than the creditors' interests. The German Federal Court of Justice, however, has held with view to the equivalent German provision that it is meant to protect creditors and the company.³ This is relevant because substantive Estonian insolvency law is generally based on German insolvency law.

1.3.3 Reorganization

If the insolvency of the company is likely or imminent, the company may file with the Court an application for reorganization (*saneerimine*).⁴ Reorganization is not considered as an insolvency proceeding, but as a rescue or pre-insolvency option. Hence reorganization of the company is optional and there are no legal consequences if the director fails to apply for reorganization. On the contrary, the director may face personal liability if he/she assesses the economic situation wrongly and applies for reorganization, when the company was already insolvent and the directors should have filed a bankruptcy petition instead.

1.3.4 Permanent insolvency

A company is deemed to be permanently insolvent if it fails the cash flow test (inability to pay debts as they become due and payable) and/or the balance sheet test (liabilities exceeding assets) and there is no evidence that the insolvency is only temporary (permanent nature of the insolvency). Evidence of insolvency may only be established applying an *ex ante* view. Only information that was available at the time of the alleged insolvency may be considered. Insolvency is evident when an objective and professional bystander assumes from the company's financial data that the debtor company is permanently insolvent. Once permanent insolvency has become evident, directors are obliged to file a bankruptcy petition without delay, and in no event later than after 20 days.⁵ Failure to comply with this duty may result in personal tort liability of the directors.

1.3.5 End of the twilight period

The twilight period ends with the formal declaration of the bankruptcy of the company. Bankruptcy is defined by the Bankruptcy Act 2003 (BA) as the insolvency of a company declared by a Court ruling.

As a result of the declaration of bankruptcy:

- the debtor's assets become the bankruptcy estate;
- the right to administer the debtor's assets and the right to represent the debtor in Court proceedings relating to the bankruptcy estate or the assets which may be included in the bankruptcy estate is transferred to the trustee;
- the debtor is deprived of the right to enter into any transactions;
- the debtor's other rights are restricted pursuant to the procedure prescribed by BA;
- further calculation of default interest and fines on claims against the debtor are terminated.⁶

³ *Bundesgerichtshof* [German Federal Court of Justice], ruling dated 11 November 1985, case no. II ZR 109/84, published in NJW [*Neue Juristische Wochenschrift*] 1986, pp. 837, 839. The equivalent German provision, § 84 German Limited Liability Company Act, has little practical meaning, especially compared to the duty to file for insolvency under § 15a German Insolvency Code. See *Wißmann*, *Münchener Kommentar GmbHG*, 2nd ed. 2016, § 84 para. 10.

⁴ On reorganization see 4.3.2 below.

⁵ §§ 180 (5¹) for OÜ and 306 (3¹) CC for AS, respectively.

⁶ § 35 BA.

If the debtor's assets are insufficient to cover the costs of the bankruptcy proceedings, the Court will terminate the proceedings by abatement, without a ruling on whether the debtor is actually insolvent or not.⁷ A majority of 58% of insolvency proceedings in Estonia are terminated by abatement and an additional 6% of bankruptcy matters are terminated by abatement after declaration of bankruptcy. Thus, only 36% of insolvency proceedings reach the stage in which distribution proposals are submitted. In about two thirds of these cases, creditors recover less than 20% of their claims. Only in 9% of these cases are the creditors' claims satisfied by more than 50%. Note that these numbers include secured claims.

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 the director?
- (b) In relation to each act identified in (a) above:
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?
 - (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 Civil liability

2.1.1 Claims under the Commercial Code

General provisions on directors' duties and liability derive from §§ 35 and 37 of the General Part of the Civil Code Act 2002 (GPCCA) and §§ 187, 315 CC. The directors shall perform their obligations arising from law or the articles of association with the diligence normally expected of a member of a directing body and shall be loyal to the company. Directors who cause damage to the company by violation of their duties shall be (jointly and severally) liable to the company. When the company is in the twilight zone, the same principles apply and the above provisions are the main legal bases for the award of compensation for the damage caused to the company.

In addition, § 306 (31) CC for public limited companies and § 180 (51) CC for private limited companies specifically deal with insolvency situations. These provisions state that directors are liable for any payments made on behalf of the company after insolvency has become evident and which "do not conform with due diligence requirements". However, there is no case law in Estonia on what payments and other disbursements are appropriate in this period. Parallels may be drawn to German law (§ 64(2) German Limited Liability Company Act). Under German law it is established that in an insolvency, disbursements of the company's means may only be justified if they are compatible with the due diligence of a prudent businessman. This includes only disbursements necessary to avoid a more or less immediate collapse of the business and probably a severe detriment to the insolvency estate, such as payment of utility bills.⁸

⁷ § 29 BA.

⁸ German Federal Court of Justice, decision dated 5 November 2007, II ZR 262/06.

In the case of multiple directors, joint liability is applicable. Recently, the Estonian Supreme Court made a decision explaining the principles of joint liability for damage caused by the directors of a company.⁹ Where the management board has multiple directors, the plaintiffs need to prove the obligations of each director, how they personally breached these obligations and how this breach caused damage to the company. In that particular case, the alleged breach was granting a loan without obtaining collateral. Only one director had signed the contract on behalf of the company, yet the lower Courts held all three directors liable for financial loss incurred to the company due to inability to retrieve the loan. The Supreme Court held that the actions of one director cannot be simply transferred to other directors without proving their involvement in causing the financial loss. It is upon the plaintiff to prove which obligation was breached by the director(s) who did not actively participate in concluding the contract. According to the Supreme Court, mere awareness of other directors is insufficient for their liability. Therefore, even though the liability is essentially shared by the directors, this only applies in cases where the personal liability of each director can be proven.

If the breach of director's duty, the damage and causal link have been proven by the plaintiff (for instance, the trustee), the director may rely on the defence that he has performed his obligations with due diligence.

2.1.2 Tort claims

The tort liability of directors under Estonian law arises from the Law of Obligations Act of 2001 (LOA) § 1045(1)(7), which provides for a liability for tort if a person violates a legal duty. The provisions establishing such legal duties are therefore called protection provisions. A protection provision must establish the interest that is being protected and the manner in which it is being protected; also, it must be possible to derive a specific addressee of protection from the protection provision itself or from its purpose. In addition, there is the possibility of holding a director liable for intentional behaviour contrary to good morals according to § 1045(1)(8)LOA.

2.1.2.1 Duty to convene a shareholder meeting in the event of thin capitalisation

As mentioned above, according to § 171(2)(1)CC and § 292(1)(1)CC, directors have a duty to convene a shareholders meeting in the event that the net assets of the limited company fall below one half of the share capital or below the statutory minimum. No statutory provisions have been established yet on the directors' duty to act in any particular way, for instance to initiate the dissolution of the company, if such a meeting has not taken place in due time or has not adopted adequate measures. The protection provided by the duty to call a meeting is therefore rather limited, raising doubts whether it may be viewed as a basis for a tort claim at all.

2.1.2.2 Duty to file for bankruptcy

If a company is permanently insolvent, pursuant to § 180(51)CC or § 306(31)CC, respectively, the directors of limited companies are obliged to promptly file a bankruptcy petition, in no event later than 20 days after the insolvency has become evident. "Promptly" in this context means that only a reasonable amount of time may be taken for the preparation of the filing. More importantly, the 20 days may be used for rescue measures, but only if such measures are realistically likely to eliminate insolvency.¹⁰ Where rescue measures (for instance, obtaining commitments to provide new equity to fix the balance sheet or obtaining fresh liquidity) are not sufficiently promising, "promptly" effectively means without delay. Therefore, upon establishing that the company is insolvent, the directors may continue rescue attempts, but have to constantly carefully assess the likelihood of recovery, and if within the 20 day period the situation substantially worsens, they may have to file without fully using up the 20 days.

⁹ Supreme Court Civil Chamber case No 3-2-1-129-15, 24 November 2015.

¹⁰ Whether the rescue measures taken by the director are promising or not, is to be determined by the Court considering all circumstances on a case-by-case basis. If the likelihood to rescue the company reasonably appeared higher than the likelihood of failure, the measures taken by the director should be deemed promising.

These provisions are recognised by the Estonian Supreme Court as protection provisions and therefore a violation will lead to tort liability of the directors in accordance with § 1045(1)(7)LOA. The provisions serve as protection provisions irrespective of the nature of the claim. The Estonian Supreme Court has identified two purposes of the duty to file for bankruptcy in time: firstly, avoiding deterioration of the company's assets to the maximum possible extent to ensure the largest possible satisfaction of the creditors' claims; secondly, taking companies out of the economic landscape if they are unable to perform obligations arising from their business activities. These purposes are theoretically reflected by the nature of the tort claims.

Where an insolvent company has more than one director, each director is under the obligation to make the filing with the Court, without regard to the particular responsibilities of the single directors. In other words, every single director is responsible for the timely filing, not just the director/s responsible for the financial control of the company. Thus, all directors are jointly and severally liable *vis-à-vis* the creditors for a violation of this duty.

- (a) *Vis-à-vis* the creditors who had claims against the company before permanent insolvency became evident (the "old creditors"), directors are liable for the damage caused by allowing the company's assets to decrease in value after permanent insolvency was evident. This damage is called the quota loss. It is calculated by the amount the old creditors would have received if directors had filed in due time, compared to the amount the old creditors actually recover.
- (b) Creditors who obtain their claims after permanent insolvency (the "new creditors") typically suffer a reliance loss. New creditors can claim for the compensation of the negative interest incurred by them due to the conclusion of the agreement with an insolvent company. In comparison with the old creditors, new creditors do not have to prove any quota loss; basically it has only to be proven that insolvency was not filed in a timely manner. Therefore, the procedural position of new creditors is much more favourable. However, for creditors lacking access to the company's accounting even this might be problematical due to deficiencies in keeping adequate accounts.

The Estonian Supreme Court recognizes the directors' tort liability for the failure to pay tax as a result of the delayed or omitted filing for bankruptcy.

Other than under the circumstances described above, the directors' duty to conduct business affairs orderly are owed to the company, not to the creditors. Given the statutory duty to file for bankruptcy, there is no such concept as "vicinity of insolvency" with respect to creditors' protection. General duties of directors are only owed to the company in question, so that third parties cannot refer to a director's breach of the duty to act diligently with respect to creditors.

2.1.2.3 Book keeping

According to §§ 183 and 306CC, the director has a general duty to organize the accounting of the company. The Estonian Supreme Court has held in several decisions that the purpose of the general accountancy duty is to protect the creditors' interests.¹¹ Hence it may be considered as a protection provision within the meaning of § 1045(1)(7)LOA and may give grounds for a tort claim by a creditor if the latter has been substantially misled by false information, for example, if the creditor has entered an agreement relying on the annual report of the company which was misleading with regard to its solvency.

2.2 Criminal liability

Several criminal offences relating to companies have been repealed during the last revision of Estonian criminal law (for instance, failure to call meetings of shareholders in the event of thin capitalization, failure to perform an obligation to submit a bankruptcy petition). However, new or modified articles have been introduced to the Penal Code 2001 (PC) with effect from 01 January 2015, such as causing insolvency (§ 384PC), unequal treatment of creditors (§ 3841PC) and concealment of property in bankruptcy and execution proceedings (§ 385PC).

¹¹ Supreme Court Civil Chamber case no 3-2-1-191-12, 8.05.2013; 3-2-1-69-15, 17.06.2015; 3-2-1-82-15, 30.09.2015.

It can be said that directors' criminal liability has become even stricter now. The abolition of some offences was not guided by the endeavour to relieve the directors' liability but it was simply a result of realization that some articles of PC were not workable. There is little Court practice based on the new regulation and it is hard to predict possible interpretations. However, the wide wording of the new regulation is an issue of concern. For instance, according to § 3841 PC, preferring one creditor over another, in a manner knowingly prejudicial to such creditor, by a director upon performance of the obligations of the company, if the ability of the company to satisfy the claims of injured creditors decreased thereby by an amount corresponding to or exceeding major damage (€40,000), is punishable by a pecuniary punishment or up to two years' imprisonment. According to a wide interpretation, every single payout to a particular creditor may harm other creditors and in a case of bankruptcy one can always trace backwards to particular payments that were decisive for the occurrence of the insolvency. Mainly, only the need to prove major damage limits directors' liability.

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period
- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
 - (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
 - (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 *De facto* and shadow directors

The notion of the *de facto* director is alien to Estonian statutory law but well explained in recent case law. A person who is not legally appointed to the management board but is performing managing tasks, cannot be held liable on the same legal basis as a *de iure* director. If there is an agreement between the company and the *de facto* director,¹² the person may be held liable for the breach of this agreement. If there is no agreement but the *de facto* director still performs managing tasks, his/her actions may be qualified as *negotiorum gestio* according to §§ 1018-1026 LOA (non-contractual obligation). In *negotiorum gestio*, the *de facto* director shall bear the interests of the company in mind and be guided by the actual or presumed wishes of the company.¹³ The standard of the duty of care should be by analogy the same as applicable according to § 187 CC to a *de iure* director. However, a *de facto* director cannot perform all director's duties due to lack of legal powers, hence such a person cannot be held liable for instance for the failure to file a bankruptcy petition.¹⁴

According to § 167¹(1)CC, a person who, by misusing his or her influence, influences a director to act contrary to the interests of the company, is liable to compensate for any damage to the company. Referred provision can apply to shadow directors and other persons who have substantial influence on the activities of the company (such as a bank as a major creditor). § 167¹(1)CC is considered by the Court practice as a protection provision in the sense of § 1045(1)(7)LOA and the breach of the prohibition stipulated in § 167¹(1)CC may give ground for tort liability of the tortfeasor.

¹² Authorisation agreement, §§ 619-634 LOA.

¹³ § 1022 (1) LOA.

¹⁴ Supreme Court Civil Chamber Case No 3-2-1-181-15, 13.04.2016.

Any person may act as a shadow director (including legal entities), and his liability may arise if following conditions are met:

- the shadow director has substantial influence on the company. It may be such a factual or legal position which is sufficient to induce the *de iure* director to breach his/her duties;
- the shadow director is misusing his/her influence deliberately to the prejudice of the company;
- as a result of the misuse of the influence, the *de iure* director breaches his duties; and as a result of the misuse of the influence and the breach of director's duties, the company suffers loss.

The plaintiff has to prove all elements mentioned above, including the intent of the defendant, which makes it very difficult to succeed in Court with such a case.¹⁵

3.2 Liquidators

Liquidators have the rights and obligations of the directors that are not contrary to the nature of liquidation. Among other things, the liquidators have a duty to submit a bankruptcy petition if the assets of the company are insufficient for satisfaction of the creditors' claims.¹⁶ Although for a liquidator, there is no specific period established for the submission of the bankruptcy petition, a liquidator should by analogy comply with the provisions set forth in § 180(5¹)CC and fulfil his/her duty without any undue delay and in no event later than within 20 days after the date on which the insolvency became evident. Hence the liability of the liquidators is essentially similar to that of the directors.¹⁷

3.3 Members of supervisory board

Public limited companies and in some cases also private limited companies may have a supervisory board which has to plan the activities of the company, organize the management and supervise the activities of the directors.¹⁸

Neither the supervisory board as a body nor its members are under the obligation to file the bankruptcy petition. The supervisory board does not have any direct obligations in the case of thin capitalization of the company either. However, members of the supervisory board may be held liable on tortious grounds for damage caused intentionally contrary to good morals,¹⁹ for example, if the supervisory board suspends a director to prevent the submission of the bankruptcy petition.

3.4 Shareholders

Shareholders liability is generally limited by their capital investment in the company. According to § 140¹ CC, a private limited company (OÜ) may be founded without the shareholders making contributions if the planned share capital is not larger than €25,000. Until the shareholder has paid their contribution, he shall be liable to the company for the obligations of the company in the amount of the outstanding contribution. In a case of bankruptcy, the trustee in bankruptcy may enforce such a claim on behalf of the company.

Should the shareholders make any decision detrimental to the company, they may be liable for the damage according to § 188 or § 289 CC (respectively for private and public limited companies). Examples include if the shareholders make a decision which is within the directors' competence (for instance, a decision to enter a detrimental transaction) or if a majority shareholder releases the director from his liability and the release is detrimental to the minority shareholders.

¹⁵ Supreme Court Civil Chamber Case No 3-2-1-181-15, 13.04.2016.

¹⁶ §§ 209 (1), 210 and 372 (1), 373 CC.

¹⁷ §§ 220 and 383 CC.

¹⁸ § 316 CC.

¹⁹ § 1045 (1) (8) LOA.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1. Revocation of transactions

4.1.1 Recovery

The Court may, on the basis provided in §§ 110–114 of BA, revoke transactions which were concluded or other acts which were performed by the debtor before the declaration of bankruptcy if they damage the interests of the creditors. If a transaction is concluded between the appointment of an interim trustee and the declaration of bankruptcy, the transaction or act is deemed to damage the creditors' interests.

If the transaction is concluded within one year prior to the appointment of an interim trustee, the transaction may be revoked if the other party was aware that the transaction damaged the creditors' interests. Where the other party is connected with the debtor, the awareness of damaging the creditors' interests will be presumed. Regardless of the relationship between the parties, the awareness of the other party is also presumed if the transaction was concluded within six months prior to the appointment of an interim trustee.

A transaction may be revoked if it is concluded within up to five years before the appointment of an interim trustee if the creditors' interests were damaged intentionally and the other party was aware of that. However, in this case, the claimant's burden of proof is rather high and usually such claims will only succeed against a party closely connected to the debtor.

The trustee in bankruptcy is authorized to file a claim of recovery against the other party to the transaction. In all cases, the damaging of creditors' interests has to be established. Hence the defendant may rely on lack of damaging of creditors' interests. It is usually the case if the transaction has been concluded at arm's length or if the creditors' interests would have been damaged in the same way and amount anyway (for instance, while set-off of claims is allowed in the bankruptcy of a company, it is deemed not to be damaging the creditors' interests if the set-off is done before the commencement of the bankruptcy).

The defendant may have a procedural advantage if he is not a connected party and the transaction was concluded more than half year before the appointment of the interim trustee. Even if the parties are connected but the connection is not obvious, the other party may contest it, which will turn the burden of proof to the prejudice of the claimant. It is practically difficult for the claimant to prove the awareness of the defendant of the damaging of creditors' interests.²⁰

²⁰ Beginning in 2003, the German Federal Court of Justice has established a vast body of case law on circumstantial evidence allowing bankruptcy trustees to relatively easily prove debtors' intent and the opposing parties' respective knowledge. Incongruent coverage, payment delays, request for repayment of debt in installments and alike may constitute more or less strong signs of evidence that Courts have to take into account. Since the hardening period for willfully disadvantaging transactions under German law is 10 years, the German Government has taken the view that the Federal Court of Justice has gone too far and is about to both shorten the hardening period and remove certain transactions from the scope of the willful disadvantage provision. The amendment is expected to come into force at the end of 2016 or in early 2017. It will remain to be seen whether Estonian Courts will follow German precedent given the cutting back by the German lawmakers.

4.1.2 Nullity of the transaction

Under special circumstances, a transaction may be revoked by the Court for damaging the creditors' interests. However, in some cases the trustee may rely on the nullity of a transaction concluded with the director himself. According to § 181(3)CC, a transaction concluded between a private limited company and a director is void if the shareholders or the supervisory board did not approve the transaction. This does not apply to transactions concluded in the ordinary course of business of the company or at arm's length, especially at the market price. It is uncertain whether this provision applies if the other party to the transaction is not the director himself but another company connected to the director.

The fact that the transaction is concluded during the twilight period is not in itself a basis for nullity.

4.2 Restriction of payments

After a company has become insolvent, the directors may no longer make payments on behalf of the company, except in the case where making the payments in the situation of insolvency conforms to the due diligence requirements. The directors shall jointly and severally compensate the company for any payments made by the company after the insolvency of the company became evident that were not made with due diligence.²¹

This provision is not a basis for the avoidance or nullity of the payments but for the personal liability of the directors. The provision is misleadingly included in the same clause as the duty to file the bankruptcy petition (§ 180(5¹)CC). As described in S 2.1.2.2 above, if the director fails to timely submit the bankruptcy petition, it may give ground for his personal tort liability. However, the breach of the restriction of the payments according to the § 180(5¹)CC may constitute only internal liability to the company and is not a basis for tort liability towards the creditors.²²

4.3 Fresh money

4.3.1 Overview

There are few options for a company in financial difficulty to obtain additional funding other than from the shareholders or a creditor, even if there is a viable option for reorganization. The distinction between old and new creditors is insufficient reason for granting new credit to a struggling company. It is not possible for a new creditor to obtain a security interest priming an existing lien without consent from the affected secured creditor. Neither is it possible for a new creditor to get "super-priority" for a new loan without the consent of each relevant existing creditor.

4.3.2 Reorganization of the company

If a company is likely to become insolvent and there are realistic options for its reorganization, a company may apply for reorganization proceedings, which are supervised by a reorganization advisor and subject to a Court ruling. If the reorganization plan is accepted by the creditors and approved by the Court, the creditors' claims may be extended and/or reduced in accordance with the plan and new credit may be incurred.

Under the Estonian Reorganization Act 2008, it is only possible to commence the reorganization of the company prior to the insolvency of the company. If the company is already insolvent, the Court shall not instigate the reorganization procedure or approve the reorganization plan. If the insolvency of the company becomes evident later, the Court shall terminate reorganization proceedings and revoke the reorganization plan which means that the consequences of commencement of reorganization proceedings will retroactively cease to exist and new creditors will lose any priority under the reorganization plan: all old claims will be restored in the previous amount and old and new creditors will be treated equally.²³

²¹ § 180 (5¹) CC.

²² For comparison, in Germany referred duties are stipulated in different provisions, which makes the legal nature of the liability in both cases clear. The duty to file a bankruptcy petition is stipulated in § 15a German Insolvency Code, while the restriction of payments is stipulated in § 64 German Limited Liability Company Act.

²³ §§ 49 (6), 51 (1) (7) and 51 (2) Reorganization Act.

The cancellation of the reorganization plan will not annul any agreements between the company and new creditors, but these may be avoided or set aside in the bankruptcy proceeding with one exception: the exception is the grant of security for a loan or any other credit agreement under which the debtor received the value of the security.²⁴ In practice, it is unusual for a struggling company to have uncharged collateral to offer.

4.3.3 Compromise in the bankruptcy

New creditors may get better treatment if the agreement for new credit is part of a compromise accepted by the creditors and approved by the Court in the bankruptcy proceeding. According to § 186BA, a compromise may prescribe that the claims of the persons who granted credit to enable the debtor to continue the business activities shall have priority over other creditors in the bankruptcy proceedings if the compromise is annulled.

At first glance, it may seem more favourable to reorganize a company via compromise in the bankruptcy rather than under the Reorganization Act, since it grants better protection to new creditors. However, a compromise in the bankruptcy can be approved only after the meeting in which creditors' claims are determined, with such a meeting usually being held three to five months after the declaration of bankruptcy. By this time, the rescue of a company is usually hopeless and most compromises are, in practice, aimed at the write-off of claims and liquidation of the company.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Trustee in bankruptcy

The company is entitled to claim compensation for the damage caused by the director to the company. In some cases, creditors may also bring claims, but the beneficiary of such a claim is the company and not the creditor.²⁵

Upon the declaration of bankruptcy, the right to represent the estate in Court is transferred to the trustee by operation of law.²⁶ Hence, after the declaration of bankruptcy, all damage claims based on the internal relationship between the director and the company are brought by the trustee. This includes claims arising from the breach of a director's general duty of care, the breach of the restriction of payments²⁷ or the breach of other duties towards the company. The trustee cannot claim compensation for damage to creditors or other third parties.

The same principles in this section apply to the other persons referred to in the answer to Question 3.

5.2 Creditors

Claims based on the breach of director's internal duties may be brought only by the trustee (or until the declaration of bankruptcy by the company itself). However, in some cases the director may face claims for tortious liability as described in S 2.1.2. In such cases, the creditors may claim directly for compensation for damage caused by the unlawful behaviour of the director.

²⁴ § 114 (2) BA.

²⁵ § 187 (4) and § 315 (4) CC

²⁶ § 35 (1) (2) BA.

²⁷ See clause 4.2 above.

5.3 Tax authorities

According to § 40(1) of the Estonian Taxation Act, the director shall be jointly and severally liable for the tax arrears incurred as a result of his intentional or grossly negligent breach of his duty to ensure that taxes are paid and non-monetary tax obligations of the company are met. The formal basis for directors' liability for tax arrears is a decision of the tax authority. If the director fails to contest such a claim in the administrative Court, the liability decision will come into effect and can be directly executed.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

6.1 Monetary claims

The most common and effective legal remedy against a director who has breached his/her duties is a monetary claim. Regardless of whether the claim is based on the internal relationship between the director and the company or whether it is a tort claim, the plaintiff has to prove the breach of the director's duty, the damage and the causal link between the director's act or omission and the damage.

If the claim is based on the breach of director's duty of care towards the company, the director may in turn prove that his actions have been diligent and economically justified, which may release him from liability.

If the claim is based on tort, the plaintiff has to prove the unlawfulness of the deed. If the fault is also an element of the unlawfulness, the plaintiff has to prove fault (such as intent) of the director as well. In other cases, fault is presumed and the burden of proof lies on the director.

6.2 Other remedies

6.2.1 Recovery

If the director has entered into transactions damaging the interests of creditors, the trustee may contest such transactions and submit a claim for recovery (see S 4.1.1 above). The objective of recovery is that the state prior to the transaction should be restored and a possible damage claim against the director should be avoided. Estonian civil law does not award punitive damages.

6.2.2 Disqualification and other sanctions

In the event of the bankruptcy of a company, the Court may prohibit the director from acting as member of a management body, the liquidator or procurator until the end of the bankruptcy proceeding.²⁸ It has been a fierce debate in the Estonian legal community whether and when the Court should disqualify a director from the management body in another company. According to the Estonian Penal Code, the disqualification (called occupational ban) may be imposed on the director for a criminal offence as a punishment. Basically, the same punishment (disqualification) may be imposed on the director under § 91 BA as an administrative measure. The director does not have comparable legal safeguards in bankruptcy proceedings as in criminal proceedings, hence, according to the Supreme Court, a director may be disqualified in bankruptcy proceedings only under very special circumstances, if it is established that the director has "very likely" committed a criminal offence and the disqualification is needed to prevent new offences.²⁹ However, according to an opposing viewpoint, based on dismal statistics about bankruptcies ending up in abatement in Estonia, disqualification should be imposed more easily as a preventive tool to improve Estonian business culture.

²⁸ § 91 BA.

²⁹ Supreme Court Civil Chamber case no 3-2-1-124-09, 22 February 2010.

Should the director fail to co-operate with the Court, the trustee or the bankruptcy committee as described in S 7.1 below, the Court may impose on the director a fine, compel attendance, or arrest. The director may be sentenced to detention for up to three months.³⁰

6.2.3 Tax liability

As described in S 5.3 above, the Tax Authority can make a liability decision to collect tax arrears from a third party (director) who is liable for the performance of the obligations of a taxpayer.³¹

According to the Supreme Court, the Tax Authority may alternatively file a claim for the compensation of damage as a creditor based on a director's tort.³² In such a case, the unpaid tax shall be considered as the damage. Depending on whether the Tax Authority may be considered as an old or new creditor in a particular case, respectively quota loss or negative interest will have to be compensated by the director.

6.2.4 Criminal liability

Knowing violation by the director of the requirements for maintaining accounting records or knowing and unlawful destruction, concealing or damaging of accounting documents, or failure to submit information or submission of incorrect information in accounting documents, so that the ability to assess the financial situation of the debtor is significantly reduced, is punishable by a pecuniary punishment or up to one year of imprisonment. The same act, if a Court has announced the bankruptcy of the accounting entity or terminated the bankruptcy proceedings due to abatement, is punishable by a pecuniary punishment or up to three years' imprisonment.³³

Knowingly damaging the financial situation of a company by the director, if insolvency or material decline in the solvency of the debtor is caused thereby, is punishable by a pecuniary punishment or up to three years' imprisonment.³⁴

Preferring one creditor over another in a manner knowingly prejudicial to such creditor by the director of a company, if the ability of the company to satisfy the claims of injured creditors is decreased thereby by an amount corresponding to or exceeding major damage, is punishable by a pecuniary punishment or up to two years' imprisonment.³⁵

Concealment by a director, to a significant extent, of the property of a company in bankruptcy or execution proceedings or from an interim trustee, or submission of incorrect information concerning this or other circumstances important for the creditor, if the property is recorded to a significant extent in the information, is punishable by a pecuniary punishment or up to three years' imprisonment.³⁶

³⁰ § 89 BA.

³¹ § 96(1) Taxation Act.

³² Supreme Court Civil Chamber case no 3-2-1-188-12, 25 February 2013.

³³ § 381¹ PC.

³⁴ § 384 PC.

³⁵ § 384¹ PC.

³⁶ § 385 PC.

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder's investigation into the company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Overview

According to the §§ 85 – 89 BA, a director shall provide the Court, the trustee and the bankruptcy committee with information which they need in connection with the bankruptcy proceedings, particularly concerning the assets, including obligations, and the business or professional activities of the debtor. A director is required to provide the trustee with the balance sheet together with an inventory of the assets, including obligations, of the debtor as at the date of declaration of bankruptcy.

In addition, the director has a duty to provide assistance to the interim trustee and the trustee in the performance of their duties. He is required to be available at the direction of the Court in order to perform his obligation to provide information and participate in the bankruptcy proceedings. The director shall be personally present in the sessions of the Court hearing the bankruptcy matter if the Court so requires.

According to § 86 BA, the Court may require a director to swear in Court that the information submitted to the Court concerning the debtor company's assets, debts and business is correct to the director's knowledge. The director shall not leave Estonia without the permission of the Court when the bankruptcy of the company has been declared and the director has not yet taken the oath. If the director gives knowingly false statements under oath, it is a criminal offence punishable by a pecuniary punishment or up to three years' imprisonment.³⁷

The Court may impose a fine, compel attendance or arrest the director in the event of non-compliance with a direction of the Court or in order to secure performance of an obligation provided by law if the director hinders the bankruptcy proceedings.³⁸

The above obligations and sanctions may apply also to the liquidators, procurators, or persons responsible for accounting, even if they have been released from their duties within one year before appointment of an interim trustee. To some extent, a shareholder with a holding of at least one-tenth of the shares also has a duty to co-operate.³⁹

7.2 Exceptions related to a criminal proceeding

The Estonian Bankruptcy Act does not contain any special regulation enabling refusal from the director's duty of co-operation. However, the Estonian Supreme Court held in a recent ruling that albeit there is a special reliance relationship between the director and the creditors of a bankrupt company, which presumes full exchange of information, no one may be compelled to testify against himself or herself, or against those closest to him or her.⁴⁰ Since there is no clear legal prohibition in the criminal proceeding to use the information obtained in the bankruptcy proceeding, the corresponding duty to give information may be unconstitutional as far as it may restrict the director's defence against self-incrimination.⁴¹

³⁷ § 320 PC.

³⁸ § 89 (1) BA.

³⁹ §§ 19 (1) and 90 BA.

⁴⁰ § 22 (3) of Estonian Constitution.

⁴¹ Supreme Court Civil Chamber case no 3-2-1-103-15, 14 October 2015.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Civil liability

According to the § 187(3)CC, the limitation period for assertion of a claim of the company against a director is five years unless the articles of association or an agreement with the director prescribes another limitation period. Any agreements reducing the limitation period are not valid *vis-à-vis* the trustee in bankruptcy.

The limitation period for director's tort liability is three years from the time that the entitled person became or should have become aware of the damage and of the person obligated to compensate for the damage.⁴²

8.2 Tax liability

The limitation period for making an assessment of tax is three years. In the event of intentional failure to pay or withhold a tax, the limitation period for making an assessment of tax is five years. A limitation period begins to run on the due date for the submission of the tax return which was not submitted or which contained information that caused the amount of tax to be calculated incorrectly.⁴³

If the tax authority has failed to make a liability decision⁴⁴ until the bankruptcy proceeding of the company is terminated by abatement and the company is erased from the register without succession, it is not possible to hold a director liable for unpaid tax arrears even if the general limitation period has not yet lapsed.⁴⁵

8.3 Criminal liability

The limitation period of a criminal offence is five years from the offence until the entry into force of the corresponding Court judgment.

8.4 Right of appeal

Estonia has a three-stage Court system. The first instance consists of county and administrative Courts. The county Courts are competent both for civil and criminal cases. In principle, a judge of the county Court is competent to hear any kind of disputes, while in practice there exists specialization of particular judges to some extent, some judges are specialized in insolvency law more than others.

A party to Court proceeding has a right of appeal which may be executed for a period of 30 days after the Court decision has been delivered to the party. The same deadline is applicable in civil, criminal and administrative cases and in all instances.

A circuit Court shall review all appeals as the second Court instance. The Supreme Court is the highest Court, which has the competence to review the decisions of the circuit Courts, while acting also as a Constitutional Court.

⁴² § 150 (1) GPCCA.

⁴³ § 98 Taxation Act.

⁴⁴ § 96 Taxation Act.

⁴⁵ Supreme Court Administrative Law Chamber case no 3-3-1-75-09, 4 December 2009.

QUESTION 9

9. Foreign corporations

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

9.1 Provisions concerning insolvency law

Should the COMI of a foreign company be in Estonia the insolvency proceeding may be instigated in Estonia and according to Article 4 of the Council regulation (EC) No 1346/2000 of 29 May 2000 (EC Regulation) on insolvency proceedings, Estonian law shall be applicable to insolvency proceedings and their effects. From the perspective of director's liability such issues may come into question including the director's obligation to participate in bankruptcy proceedings, imposition of fine or arrest of the director etc.

9.2 Director's personal civil liability

It is disputable whether the EC Regulation on insolvency proceedings determines the law applicable to the director's personal civil liability in Estonia. The legal basis for director's civil liability (especially tort liability) stands in Estonia quite separately from the insolvency law. It is more likely that the applicable law has to be determined by the Estonian Private International Law Act 2002 (PILA). However, if the COMI of the company is in Estonia, a similar legal result may be achieved as according to the EC Regulation on insolvency proceedings: in other words, Estonian law should apply to the director's personal liability. This would comply with a decision rendered by the European Court of Justice on 10 December 2015, where the Court essentially held that German provisions on the directors' liability for payments made in the twilight zone are applicable to non-German entities with COMI in Germany, although the relevant provision (§ 64(2) German Limited Liability Company Act) is not part of the German Insolvency Code.⁴⁶ According to § 15PILA, if a company is actually managed in Estonia or the main activities of the company are carried out in Estonia, the company shall be governed by Estonian law. According to § 50(1)PILA, tort claims shall be governed by the law of the state where the act or event which forms the basis for causing the damage was performed or occurred.⁴⁷

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 Overview

Local branches of international insurance companies are not offering any D&O insurance. Theoretically, one can get an insurance policy directly from a foreign insurance company, but it is not common for directors especially of smaller companies to buy D&O insurance cover. Moreover, the general conditions of foreign insurance companies do not always take the regulation of the local law into consideration, hence it is not clear how a particular insurance event could be solved by the foreign insurer.

While D&O insurance covering the "twilight zone" is in principle available, it is rarely used by companies and directors, though international investment seems to slowly push for more coverage.

The information provided in this country chapter is correct as at 01/03/2017

⁴⁶ European Court of Justice, 10 December 2015, C-594/14 – *Kornhaas*.

⁴⁷ According to Article 1 (2) (d) of the Regulation (EC) No 864/2007 of the European parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II), from the scope of this regulation are excluded non-contractual obligations arising out of the law of companies regarding personal liability of directors of the company.

FRANCE¹

¹. This Chapter is up to date as of 15 May 2016 and has been specifically adapted for educational or for information purposes only. As such, the answers are limited to the questions raised and do not go into detail on specific subjects of French law. The chapter is not intended to be a substitute for professional advice.

QUESTION 1

1. The directors and the start and duration of the “twilight” period

(a) How are directors identified /defined?

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

1.1 Definition of the directors

1.1.1 For the purposes of insolvency proceedings, two categories of persons can be defined or identified as “directors”: *de jure* directors (*dirigeants de droit*) and *de facto* directors (*dirigeants de fait*) in commercial companies.

1.1.2 *De jure* directors are directors who are officially appointed in accordance with the applicable laws and regulations as well as with the company’s articles of association. They differ for each type of company as set out below:

1.1.3 In a *société anonyme* the directors are:

- In the case of a *société anonyme* with a board of directors: the chairman and members of the board (*président du conseil d’administration* and *membres du conseil d’administration* respectively), the general director (*directeur général*) and, if any, the delegate general director (*directeur général délégué*).²
- In the case of a *société anonyme* with a management board (*directoire*) and supervisory board (*conseil de surveillance*): the president and members of the management board but not the members of the supervisory board.³

1.1.4 In a *société par actions simplifiée* the directors are: the president (*président*) and, if any, the general director(s) and delegate general directors(s)⁴ as well as any formal position created by the company’s articles of association that would involve participating in the company’s day to day management.⁵

1.1.5 In a *société en commandite par actions*,⁶ *société en commandite simple*,⁷ *société à responsabilité limitée*,⁸ *société en nom collectif*⁹ and *société civile*¹⁰ the directors are the manager(s) (*gérant(s)*).

1.1.6 *De facto* directors are individuals who, or legal entities which, have not been appointed as *de jure* directors, but act or have acted in such a way as to be regarded as directors. Please refer to section 3.2 thereafter for a more detailed definition.

1.1.7 In the event a director is a legal entity, the person representing such legal entity in its capacity as director may, in the context of insolvency proceedings, incur liability under the same conditions as the legal entity itself. The aforementioned person might, in some cases, not be a director of said legal entity but rather a specially appointed permanent representative (*représentant permanent*).

². Articles L. 225-17 et seq. of the French Commercial Code.

³. Articles L. 225-57 et seq. of the French Commercial Code.

⁴. Article L. 227-6 of the French Commercial Code.

⁵. Where the law is silent, the articles of association may provide the conditions that allow the appointment of other directors and their functions (see Le Lamy des sociétés commerciales 2016, §4231)

⁶. Article L. 226-7 of the French Commercial Code.

⁷. Article L. 222-2 of the French Commercial Code by reference to article L. 221-4.

⁸. Article L. 223-18 of the French Commercial Code.

⁹. Article L. 221-4 of the French Commercial Code.

¹⁰. Article 1846 of the French Civil Code.

1.2 Start and duration of the “twilight” period

1.2.1 Overview

1.2.1.1 For the purposes of assessing which transactions are vulnerable to attack (as opposed to possibly giving rise to the directors incurring personal liability), the “twilight” period is known in France as the “suspect period”.¹¹ Under French law, this is different to the observation period during which the directors undergo supervision and/or direct involvement of a Court-appointed administrator, liquidator or receiver, as appropriate. (See further the Appendix below).

1.2.1.2 The date on which the suspect period is deemed to begin is the date on which the company first became unable to pay its debts as they fell due or, to use the French terminology, the date on which it entered in a state of *cessation des paiements* – a cash-flow insolvency test.¹² The suspect period ends on the date on which the Court opens formal insolvency proceedings, being either judicial reorganisation or liquidation. In principle, there is no suspect period prior to the safeguard proceedings (*procédure de sauvegarde*) as only debtors that are not yet in cessation of payments are permitted to enter safeguard proceedings.¹³

1.2.1.3 The suspect period ends with the opening of judicial reorganisation or liquidation since on this date the Court appoints either an administrator or a liquidator who will be involved in and control the management of the insolvent company.

1.2.1.4 The date on which the company first became unable to pay its debts (and therefore, the date on which the suspect period commences) is determined in one of three ways (in each case by the Court with jurisdiction over the insolvency proceedings concerned). The Court may:

- (a) find that the date is the same as the date of the judgment opening the proceedings. In such a case, there is no suspect period;
- (b) find, as a question of fact, that the date occurred prior to the date of its order to open formal insolvency proceedings (i.e. often the date when the filing was made in Court);
- (c) subsequent to the opening of judicial reorganisation or liquidation, decide (after a prior summons and hearing of the debtor and eventually after appointing an expert for the purpose of gathering any useful information)¹⁴ to revisit its original decision on the basis of new facts and modify the date of cessation of payments. An application for such a judicial deferral of the date of cessation of payments may be made by one or more of the following: the Court-appointed administrator, the *mandataire judiciaire*, the public prosecutor¹⁵ or the Court-appointed liquidator as appropriate.¹⁶ The application must be made within one year of the judgment opening the proceedings.

1.2.1.5 The maximum duration of the suspect period is 18 months.¹⁷ This means that acts passed by the company 18 months before the opening of the proceedings can be cancelled. This 18 month period may be extended to 24 months only in the case of transactions for no consideration (see section 1.2.1.7). If the parties have concluded a settlement (a *conciliation* agreement) approved (*homologué*) by the Court (see the Appendix), the date of the cessation of payments cannot be set to a date prior to the date of the Court’s approval, except in the event of fraud.¹⁸

1.2.1.6 In the case of conversion into formal insolvency proceedings (i.e. conversion of a safeguard into a judicial reorganisation), any judicial deferral of the date of cessation of payments will need to be brought within one year of the conversion judgment. The Court may not set the date of cessation of payments earlier than 18 months prior to the judgment opening the safeguard.¹⁹

¹¹ Articles L. 632-1 et seq. and L. 641-14 of the French Commercial Code.

¹² Pursuant to Article L. 631-1 of the French Commercial Code, the company is in cessation of payments whenever it is unable to meet its current liabilities with its available funds.

¹³ Noting in the event the Court determines the debtor is in cessation of payments, regular safeguard proceedings must be converted into formal insolvency proceedings. Indeed, as for the new Rapid Safeguard Proceedings (*Sauvegarde accélérée*) and the Rapid Financial Safeguard Proceedings (*Sauvegarde Financière accélérée - SFA*), there is no such suspect period.

¹⁴ Commercial chamber of the Cour de cassation, 15 February 2000 n°97-16770 & 97-14415.

¹⁵ Article L. 631-8, paragraph 3 of the French Commercial Code.

¹⁶ Article L. 641-5 of the French Commercial Code.

¹⁷ Article L. 631-8, paragraph 2 of the French Commercial Code.

¹⁸ Article L. 631-8 of French Commercial Code.

¹⁹ Article L. 631-8, paragraph 5 of the French Commercial Code.

- 1.2.1.7 With respect to transactions made for no consideration, the Court may treat these as null and void if concluded in the six months prior to the date of cessation of payments.²⁰ Each type of transaction which may be subject to attack and the conditions which would render such a transaction void are considered in Question 4.
- 1.2.1.8 The duration of the period during which transactions entered into by the company are liable to give rise to personal liability on the part of directors and/or others involved in the management of the company is not specifically determined by law. Each case of liability is considered in more detail in response to Question 2. In certain circumstances, the risk of liability arises only after the date of cessation of payments. In other circumstances, liability may arise if there is a causal link between the relevant act of the director and the company's difficulties.
- 1.2.2 Summary
- 1.2.2.1 If a company is cash-flow insolvent and thereafter goes into judicial reorganisation or liquidation, certain specifically defined transactions may or must be declared null and void.
- 1.2.2.2 Furthermore, directors and/or others involved in the management of the company may be personally liable for certain types of actions during the suspect period or at any other time even after the opening of insolvency proceedings.

QUESTION 2

2. Actions potentially giving rise to liability for directors

- (a) In respect of which acts during the twilight period may a director be held personally liable or which may otherwise have adverse consequences for the director?
- (b) In relation to each act identified in (a) above:
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or 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

French law does not address the potential liability of directors and/or others involved in the management of a company in formal insolvency proceedings on the basis of the type of act performed. Rather French law starts from the causes of action available against such persons based on their behaviour. The responses to this question are therefore explained below on the bases of the main types of causes of action available.

²⁰ Article L. 632-1, II of the French Commercial Code.

2.2 Action “en responsabilité pour insuffisance d’actif” (based on the shortfall of assets on the date the Court rules on the sanction)

2.2.1 *De jure* and *de facto* directors²¹ of the debtor may be subject to personal liability in the case of judicial liquidation proceedings in the event of a shortfall of assets arising as a result of an act of “mismanagement” of the directors. Claiming against the directors for the shortfall of assets is commonly used by liquidators as a means of augmenting the assets available to cover the debts of the insolvent company.

For a director to be held personally liable for the shortfall of assets, the following criteria must be met:²²

- (i) There must have been an act of “mismanagement”. However, under French law, “mismanagement” is not defined. Instead, it has been left to the relatively broad interpretation of the Courts. Each case is determined on its own facts. The most common examples of mismanaging a business are failing to put adequate measures in place whilst operating the business at a loss and the management granting excessive remuneration to itself during financially turbulent times for the company. Other examples of mismanagement include: corporate asset misappropriation (*abus de biens sociaux*),²³ the distribution of fictitious dividends (*distribution de dividendes fictifs*) and management making decisions which *prima facie* are badly prepared and destined to fail (for example burdensome investment decisions taken in an uncertain and difficult economic climate or acquisitions made as a result of poor negotiations); failure to comply with fiscal legislation (for example failing to comply with compulsory taxation requirements, as a result of a failure to declare tax obligations²⁴ including the failure of a director to notify the non-compliance with tax legislation by other directors, including, previous directors, even if the failure to comply with fiscal legislation occurred prior to the director's nomination)²⁵; failure to comply with social legislation (for example, failing to comply with compulsory taxation requirements, as a result of a failure to declare social taxes)²⁶; or favouring one creditor over another (for example, paying a specific creditor who was aware that the debtor was in cessation of payments).²⁷ Such acts (and many others) that result in a shortfall of assets may be considered as acts of mismanagement and may consequently result in sanctions against individual directors of the company.
- (ii) The liabilities of the company must exceed the value of its assets (*une insuffisance d’actifs*), to be assessed at the time the Court determines liability. Debts that arise after the opening of judicial liquidation are not included in the company’s liabilities for the purposes of this analysis.
- (iii) The claimant must demonstrate that the act or acts of mismanagement contributed to the shortfall of assets. However, the act(s) need not have been the sole and exclusive, unique or principal cause of the shortfall. It is enough that the act or acts of mismanagement were one of a number of causes that contributed to the shortfall. The question as to how much an act or acts contributed to the shortfall is for the Courts to decide. The Court’s decision is based on the facts of each case and this can sometimes lead to varied and unpredictable results. Furthermore, the acts and omissions of one director do not automatically exonerate the other directors because, as stated above, an act of mismanagement is not required to be the sole and exclusive cause of the asset shortfall.
- (iv) at least a partial²⁸ causal link must exist between the act of mismanagement and the shortfall of assets.²⁹

²¹ *De jure* directors who are appointed in accordance with the company’s articles of association and with the law. Please refer to Question 3, below for an explanation of *de facto* directors.

²² Article L. 651-2 of the French Commercial Code. A reform bill known as *Loi Sapin II* (Article 48), may amend this article and complete it with a new paragraph which provides “However, in the case of a *de jure* or *de facto* director’s slight negligence in the management of the company, he/she will not be held liable in case of a shortfall of assets”.

²³ Commercial chamber of the Cour de cassation. 21 February 2012 n°11-13.513.

²⁴ Commercial chamber of the Cour de cassation 13 November 2007, n°06-13.212.

²⁵ Paris, 3° ch.A, 16 mai 2006, RG°2005/15820.

²⁶ Commercial chamber of the Cour de cassation 13 Novembre 2007, n°06-13.212

²⁷ Commercial chamber of the Cour de cassation 11 June 1996, n°94-16.067.

²⁸ Commercial chamber of the Cour de cassation, 17 February 1998, n°95-18.510.

²⁹ Commercial chamber of the Cour de cassation, 14 May 1991, n°89-19.081.

Pursuant to Article L 651-3 of the French Commercial Code, only the liquidator or the public prosecutor has the right to bring a claim for the shortfall of assets and within three years from the date of the Court decision opening the judicial liquidation of the company. Should the liquidator decide not to bring such a claim, the majority of the Court-appointed *contrôleurs* (creditors representing the interests of all creditors, usually large creditors) will have the right to bring this claim.³⁰

2.2.2 If (i) to (iv) of 2.2.1 above are satisfied:

- (i) It is for the Court to decide, on the facts presented before it, whether the directors are to be held personally liable for the shortfall of assets.
- (ii) Directors found liable will be required to pay damages, which will form part of the assets of the debtor available for distribution to creditors. It is up to the Court to decide, on the basis of the seriousness of the act(s) of mismanagement and the strength of the causal link, whether the director in question should pay damages or not. That is, even if (i) to (iv) of 2.2.1 above are satisfied, the Court is not required to impose a sanction.
- (iii) It is up to the Court to decide the amount of damages that the director must pay. The amount is not necessarily proportionate to the level of contribution caused to the debts of the company. Indeed, Courts often materially reduce the amount of damages imposed on a director if the latter has endeavoured to solve the financial distress of the company, including by requesting the appointment of a *mandataire ad hoc* or a *conciliateur* (see hereafter under Appendix – Pre-insolvency proceedings). However, the appointment of a *mandataire ad hoc* or a *conciliateur* is not *per se* sufficient to avoid or mitigate any liability relating to a shortfall of assets. The maximum amount of damages that a director can be ordered to pay is the total liabilities of the company less the available assets. If more than one director is liable, they may be held severally liable if the Court considers this reasonable and justifiable.
- (iv) There is no specific time period prior to the commencement of formal insolvency proceedings during which an act of mismanagement must have occurred. In practice, the period is limited by the need for there to be a causal link between the act of mismanagement and the insolvency of the company. In the vast majority of cases, the last possible act is the failure to file the declaration of cessation of payments within the requisite (45) days after the date of cessation of payments.³¹
- (v) Other than the general defence of absence of act of mismanagement (including, in the case of an alleged *de facto* director, absence of the person's implication in the management of the company) or absence of causal link or a shortfall of assets, there are no specific defences to this allegation.³²
- (vi) The claim must be brought within three years from the date of the Court decision opening the judicial liquidation of the company.³³

2.3 Liability for the debts of the company

Since the entry into force of law n°2008-1345 dated 18 December 2008, claims against directors having committed faults pursuant to Article L.624-5 of the French Commercial Code may only be brought in judicial reorganisations or judicial liquidations which were opened prior to 15 February 2009. This permitted the Court to hold an individual *de jure* or *de facto* director liable for the debts of the insolvent company if there was a fault pursuant to the old Article L.624-5 of the French Commercial Code and if the fault had a causal link with the cessation of payments.

³⁰ Commercial chamber of the Cour de cassation, 11 May 1993 : Bull. civ. IV, n°187; D. 1993. IR 195.

³¹ Pursuant to Article L. 631-1 of the French Commercial Code, the company is in cessation of payments whenever it is unable to meet its current liabilities with its available funds.

³² Subject however to: i) the amendment which may be implemented by the *Projet de Loi Sapin II* - see footnote 22 above, and ii) the provisions of Article L. 653-8 of the French Commercial Code – see footnote 36 hereafter.

³³ Commercial chamber of the Cour de cassation, 19 May 2004, n°02-11.199.

2.4 Personal bankruptcy – prohibition on management

2.4.1 Personal bankruptcy is a professional sanction, which, in essence, prevents a director from being involved in the management, administration or control of any commercial or business entity or any company engaged in economic activity. In some ways, it is similar to director disqualification in the UK but in addition, French personal bankruptcy may prevent a director from being elected in any public election and holding any public function (see below). An individual *de jure* or *de facto* director may be subject to personal bankruptcy during the course of judicial reorganisation or judicial liquidation against the company;³⁴ personal bankruptcy may not therefore be sought during safeguard proceedings nor accelerated financial safeguard proceedings.³⁵ The sanction of personal bankruptcy may be imposed on an individual as a result of that person:

- (i) abusively (wrongfully) carrying out an unprofitable business activity that would necessarily lead to the company's insolvency;
- (ii) misappropriating or concealing all or part of the assets of the company or fraudulently increasing the liabilities of the company;
- (iii) committing any of the violations listed under Article L. 653-4 of the French Commercial Code which are as follows:
 - (a) using property of the company as his or her own. This concept covers a wide range of behaviours including, most typically, excessive remuneration, withdrawals from the company's bank account for personal ends, performance of renovation or other works by the company for personal ends, payment of personal expenses;
 - (b) undertaking commercial transactions for his or her own interests in the name of the company. This typically applies to directors who abuse of their majority position in the company and manage the company for their own personal interests;
 - (c) using property or assets of the company in a manner contrary to the company's own interests for personal ends or the ends of another company in which the director has a direct or indirect interest. This type of behaviour is in practice very similar to that covered by (b);
 - (d) pursuing abusively and for personal ends a loss-making activity which would inevitably lead to the company falling into a state of cessation of payments. This concept typically covers directors who, using artificial financial methods, maintain a company afloat for the purpose of continuing to receive remuneration, to reduce the amount of a personal shareholder loan or to pay off company debts that he or she has guaranteed; or
 - (e) misappropriating or concealing all or part of the assets of the company or fraudulently increasing the liabilities of the company. This is the most serious type of behaviour, where the director may seek to organise the insolvency of the company or to deal with the assets of the company to the detriment of the company's creditors.
- (iv) carrying out a management role in the company when prohibited from doing so;
- (v) with the intention of avoiding or delaying the opening of formal insolvency proceedings, entering into purchases with a view to resale at below market price or using other inappropriate means to obtain funds;
- (vi) entering into, for the account of a third party, and without consideration, undertakings judged to be too significant or important at the time given the situation of the company;
- (vii) paying or causing to be paid, after the date of cessation of payments, one creditor in preference to others;

³⁴. Article L. 653-1 of the French Commercial Code.

³⁵. Article L. 628-1 of the French Commercial Code.

- (viii) intentionally failing to co-operate with the good progress of the insolvency proceedings; and/or
- (ix) keeping accounts that are fictitious, manifestly incomplete or irregular according to applicable law, not keeping accounts when required by applicable law, or causing accounting books and records to disappear.

Although the provisions of the law do not specifically require, typically there must be a link (if not the cause) between the wrongful act in question and the insolvency of the company – apart from those cases where, by definition, no link is necessary, for example, in respect of (vii) and (viii) above.

2.4.2 If any of (i) to (ix) are satisfied:

- (i) the Court is not required to impose sanctions on the director liable. If it does, liability is civil, whether the sanction imposed is personal bankruptcy or prohibition on management (see further below);
- (ii) although liability is civil, certain characteristics of personal bankruptcy are penal in nature.
 - (a) The sanction of personal bankruptcy carries with it a prohibition on directly or indirectly managing, administering and/or controlling a commercial business or any form of company which has an economic business activity. Furthermore, the Court may also prohibit a director from carrying out certain professions or functions which have a public nature (for example, the judiciary, the legal profession, and activities as a financial intermediary, insurance agent, etc.), meaning that a director sanctioned by personal bankruptcy may not take part in public elections.
 - (b) Alternatively, the Court may impose a prohibition on management, which is a diluted form of personal insolvency. The most severe form of this sanction is the prohibition on managing, administering and controlling a commercial business or any form of company which has an economic business activity where the director knowingly failed to file for insolvency in a timely manner.³⁶
 - (c) It must be noted, however, that a director held liable for personal bankruptcy may request that instead of being subject to the sanctions of personal bankruptcy or prohibition of management, he/she/it will instead incur personal liability for the shortfall of assets of the insolvent company that he/she/it manages.³⁷
- (iii) The Court has discretion over the duration of the personal bankruptcy or the prohibition on management, subject to a maximum of 15 years³⁸ and a maximum of 5 years for any prohibition on public functions, professions and office.³⁹
- (iv) Except in certain limited circumstances, there is no specific time period prior to the commencement of formal insolvency proceedings during which the wrongful action must have occurred. In practice the period is limited by the “informal” requirement that there be a link between the act in question and the insolvency of the company. In respect of (vii) and (viii) above, by definition the wrongful act must have taken place after the date of cessation of payments which, as explained above, depends upon a finding of fact by the Court. This date cannot be more than 18 months prior to the date of the Court order opening formal insolvency proceedings.

Other than the general defence of absence of one or more of the specific requirements for the offence, there are no specific defences to this action. A person may have some or all of the prohibitions lifted if he/she can show that they have made a sufficient contribution to the payment of the insolvent company’s debts.

2.4.3 The following persons may also be subject to personal bankruptcy:

- (i) any director who has been found liable for having contributed to the shortfall of assets;⁴⁰ and

³⁶ Article L. 653-8-3 of the French Commercial Code

³⁷ Article L 653-11 of the French Commercial Code

³⁸ Commercial chamber of the Cour de cassation, 15 February 2000 n°97-16770

³⁹ Article L. 653-10 of the French Commercial Code.

⁴⁰ Article L. 653-6 of the French Commercial Code.

(ii) any director who has been found guilty of criminal bankruptcy.

In both cases, personal bankruptcy or prohibition on management is a complementary penalty decided upon by the criminal Court and, can be either permanent or temporary and, if temporary, must not exceed five years.⁴¹

2.5 Criminal bankruptcy (*Banqueroute*)

2.5.1 An individual *de jure* or *de facto* director may be subject to criminal bankruptcy in any of the following cases during the course of judicial reorganisation or judicial liquidation⁴² opened against the company:⁴³

- (i) where the person, with the intention of avoiding or delaying the opening of formal insolvency proceedings, has made purchases with a view to resale below market price or has used other inappropriate means to obtain funds;
- (ii) where a person has misappropriated or concealed all or part of the company's assets;
- (iii) where a person has fraudulently increased the debts of the company;
- (iv) where a person has kept fictitious accounts or caused accounting books and records to disappear or failed to keep accounts contrary to legal requirements; and
- (v) where a person has kept manifestly incomplete sets of accounts or kept accounts that do not comply with legal requirements.

It should be noted that there is no offence of attempted criminal bankruptcy.

2.5.2 If any of (i) to (v) are satisfied and the company is in a state of cessation of payments:

- (i) it is for the Court to decide if the directors are personally liable and guilty of the offence of criminal bankruptcy;
- (ii) a person guilty of this offence is liable to imprisonment (maximum of five years or seven years for a company providing investment services) or a fine (maximum of 75,000 euro, or 100,000 euro for a company providing investment services) or both.

In addition, the Court can impose any of the following:

- (a) Deprivation of civic, civil and family rights.
- (b) Prohibition (for a maximum period of five years) on having a public function or conducting a professional activity in the same field as that in which the offence was committed.
- (c) Exclusion from being permitted to bid for public tenders for a period of at least five years.
- (d) Prohibition for a maximum period of five years from issuing cheques other than those enabling the drawer to withdraw funds deposited with the drawee or certified cheques.
- (e) Publication of the judgment.
- (f) Personal bankruptcy or prohibition on management.
- (g) Furthermore, if there is a civil party to the criminal proceedings, the Court may award damages to the civil party if it is the victim of the offending behaviour – typically the company – on the basis of the principles of tort (Articles 1382⁴⁴ et seq. of the French Civil Code).

⁴¹ Commercial chamber of the Cour de cassation 22 March 2011 n°10-14889; of the Cour de cassation 22 May 2012 n°11-14366.

⁴² Article L. 654-2 of the French Commercial Code.

⁴³ Ibid.

⁴⁴ This Article will become Article 1240 of the French Civil Code as from 1st October 2016.

- (iii) The gravity of the offence will be reflected in the length of imprisonment or the amount of the fine ordered and in the nature and extent of any of the other sanctions imposed. In exercising its punitive jurisdiction, the Court is not seeking to compensate the company. The amount of damages that may be awarded will depend upon the extent of the loss caused by the offending act.
- (iv) Except in the case of misappropriation or concealment of the company's assets (for which the acts in question must have been committed while the company was in a state of cessation of payments), there is no specific period prior to the commencement of formal insolvency proceedings during which the acts concerned must have been committed.
- (v) Absence of intent to defraud is a defence to a charge under 2.5.1(i) and (iii). Absence of a voluntary and positive act of disposal is a defence to a charge under 2.5.1(ii).

2.6 Fraudulent organisation of insolvency

- 2.6.1 Any director or associated person can be held liable for this offence if:⁴⁵
- (i) that person fraudulently misappropriates or conceals part of their own personal property to avoid paying the debts of the company in insolvency; and
 - (ii) such a person 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) apply.
 - (ii) The offence can only be committed once a company is in a state of cessation of payments.
 - (iii) Absence of intent to defraud is a defence.

QUESTION 3

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

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 Introduction

- 3.1.1 French insolvency law provides expressly that liability that may attach to a formally appointed director of a company, also known as a *de jure* director, extends to *de facto* directors – known in French as *dirigeants de fait*. The definition of *de facto* director is explained below.
- 3.1.2 In certain circumstances, third parties may be found liable to a company subject to formal insolvency proceedings. For example, third parties who commit certain offences: in particular if their behaviour has provoked the insolvency of the company or aggravated its consequences, may be liable for the damage they have caused.

⁴⁵ Criminal chamber of the Cour de cassation, 22 November 2011, n°10-81.562.

3.2 *De facto* directors (*dirigeants de fait*)

3.2.1 Before going into any detail, it is important to note that being qualified as a *de facto* director does not make such individual or legal entity liable *per se*.

3.2.2 French legislation offers no definition of a *de facto* director. In the absence of such a definition, French case law fills the gaps. According to the Court of Appeal of Paris⁴⁶, a *de facto* director is an individual who, or legal entity which, is not a *de jure* director but assumes similar functions and has similar powers in the management of the company that he/she/it exercises independently and has an influence on the decisions made within the company.

Hence, whether an individual or a legal entity is a *de facto* director is a question of fact for the French lower Courts to determine, subject to the control of the *Cour de cassation*.⁴⁷

3.2.3 In establishing the question of fact based on a body of corroborating evidence, the two criteria below are the most significant:

- (i) The management or administrative acts of the *de facto* director have been carried out without restriction and independently, so that the director had autonomous decision-making power. This implies that the *de facto* management situation is inconsistent with a position of subordination; such as results from an employment contract (for example, if the claimed *de facto* director is given orders by another person to whom he is subordinated, such other person is the real *de facto* director).⁴⁸
- (ii) An active and positive decision-making role, implying that the *de facto* director has directly intervened in the management of the company, behaved as the master of the business and “unofficially” ran the company. There is no need to find that the person was treated as a director by the other directors. The key is the active involvement by the person in the determinative management of the company.⁴⁹

3.2.4 Examples of other corroborating evidence that may be taken into account by the French Courts are the nature of the technical functions granted to the alleged *de facto* director (for example, commercial management, supply management), the powers granted to the *de facto* director (for example, placing orders with suppliers, signing cheques, hiring or dismissing employees) and the *de facto* director’s behaviour (for example, the fact that he/she/it considers that the company belongs to him/her/it, that he/she/it behaves as a director of the company).

3.2.5 Based on such evidence, shareholders of the company are often targeted by liquidators as *de facto* directors to compensate for the shortfall of assets.

Shareholders who are regularly involved in the daily management of a company which later files for insolvency, may be considered *de facto* directors. Having a majority shareholding will not in itself be regarded as evidence of intervention in the management of a company. It is for the French lower Courts to determine whether or not a shareholder is a *de facto* director. The following are examples of where shareholders have been held to be *de facto* directors:

- The Paris Court of Appeal concluded that multiple factors such as attending a number of board meetings without being a board member, signing letters as a director without having the appropriate status and authority to do so and granting oneself the benefit of a company car meant that a shareholder with 38% of the share capital was considered a *de facto* director.⁵⁰

⁴⁶ Court of Appeal of Paris, 16 December 1997, JCP E 1998, 718 p 250.

⁴⁷ Commercial chamber of the Cour de cassation, 16 March 1999, n°95-17.420.

⁴⁸ Commercial chamber of the Cour de cassation 12 July 2005, n° 02-19.860.

⁴⁹ Commercial chamber of the Cour de cassation 30 May 2006, n°05-14.958. Commercial chamber of the Cour de cassation, 27 June 2006, n°04-15.831.

⁵⁰ Court of Appeal of Paris, 11 October 1996.

- The Paris Court of Appeal, in a different matter, ruled that a parent company was a *de facto* director of its subsidiary, not on the basis of the two criteria mentioned above, but on the basis that the business unit that the parent company transferred to its subsidiary continued to be operated by the parent company⁵¹ as if it had remained within the parent company's scope of activities. In doing so, the Court took into account the common operating mechanisms which often exist within group companies (such as paying for raw materials and packaging for products, making personnel available to the subsidiary as well as administrative accounting services). One may therefore conclude that the Court held that what the parent company did went beyond just providing administrative and technical support in respect to the transferred business unit to determining the distribution strategy of the trademarked products of the transferred business unit, requesting the sale at a fixed price for each unit sold and invoicing for products in its own name without indicating that the sales were carried out in the name of its subsidiary.

3.2.6 Shareholders holding external roles with a company have also, albeit rarely, been considered *de facto* directors. Two examples are as follows:

- Statutory auditors: the French Courts have held that a founding partner of a company, who also acted as the statutory auditor for that company, was a *de facto* director as he did not act solely as the auditor of the company, but took important decisions, in particular, concerning the company's financing and the attempt to wind-up the company when he acknowledged that the company was in debt by as much as the total of its capital.⁵²
- Lawyers: it has been held by the French Courts that a lawyer who was also the majority shareholder of a company could be considered a *de facto* director where he held a decisive role in the management of the company, especially where he fixed the price for the purchase of the business as a going concern; the registered office was located at his domicile whilst the activity of the company was located elsewhere; he decided on the financial and economical functioning of the company; and the *de jure* director was actually in a position of subordination.⁵³

3.2.7 Other individuals or legal entities that may be considered by the French Courts as *de facto* directors include:

- Banks: the *Cour de cassation* held on 30 October 2007 that the exercise by a banking institution of its obligation to advise its clients (see below) on the use of loaned funds may not be considered in itself as *de facto* management of the borrower company. However, a situation where the bank takes over the control of the company in financial difficulties by artificially maintaining credits in the current account and covering all its expenses where the *de jure* director could not hold the company's cheque books could amount to *de facto* management.⁵⁴
- Franchisers: a franchiser who interfered in the management of its franchisee by giving orders to the franchisee, firing one of its employees and by deciding the working conditions of the franchisee's employees.⁵⁵
- Suppliers / clients: a supplier has been held to be *de facto* director due to its intrusion in the management of its client. In one instance, this interference was characterised by the fact that the supplier sold the client's registered office, put the client's shop in his building and the client was obliged to pay his supplier in priority.⁵⁶
- Family: the brother of the *de jure* director of a company, who negotiated and signed the quote for the company and the commitment it represented, negotiated payment terms with customers depending on the precise progress of the work and the release of funds to customers and who negotiated payment terms with the supplier and had free access to the cheque books of the company which he could sign to pay suppliers.⁵⁷

⁵¹ Commercial chamber of the Cour de cassation 23 November 1999 n°1860 : RJDA 3/00 n°270.

⁵² Criminal chamber of the Cour de cassation June 27, 1983 n°81-94465.

⁵³ Commercial chamber of the Cour de cassation 15 February 2011 n°10-11.781.

⁵⁴ Commercial chamber of the Cour de cassation, 23 September 2010, n°09-83.274.

⁵⁵ CA Rouen 23 May 1978 :JCP 1979 II n°19235 note Notté.

⁵⁶ Commercial chamber of the Cour de cassation 4 April 1962, Rauscher c/ Ferrari : Bull. civ. III n° 215.

⁵⁷ Commercial chamber of the Cour de cassation 17 September 2002 n°1427 : RJDA 12/02 n°1307.

3.3 Third party liability during formal insolvency proceedings

3.3.1 Third parties who are involved with a company that enters into formal insolvency proceedings may be subject to liability in tort if all or part of the loss suffered by the insolvent company's creditors is caused by the wrongful action of those third parties. The existence of a fault (tort), damage and a causal link between the fault and the damage must be established by the claimant (the company or the creditors) seeking recovery.⁵⁸

3.3.2 Financial and banking institutions

3.3.2.1 Duty to inform

Articles 111-2⁵⁹ of the French Consumption Code and 1134⁶⁰ of the French Civil Code impose a duty on financial and banking institutions to provide certain information to their clients. For these purposes, three different types of information exist: (i) advice, (ii) information construed as orders and (iii) information given as a warning. Advice may be given to clients under French law, but information that is interpreted as a request or order may not be given by banks to clients. As for the third type of information, under the duty of "*mise en garde*" (cautionary duty), a banker is required to ensure that the client is aware of all the risks that may be incurred carrying out the operation in question.

The banker must choose the best way to advise the client, bearing in mind the level of knowledge of the client.⁶¹

3.3.2.2 Wrongful termination of credit facility

Article L. 313-12 et seq. of the French Financial and Monetary Code governs the right of banks to terminate their credit facilities.

This Article provides that a bank may only reduce or terminate an open-ended facility on expiry of the written notice period provided in the facility. The notice period may not be less than sixty days.

If the bank wrongfully terminates the credit facility in breach of this Article, the bank may be found liable for breach of contract and liable in tort to third parties, including the creditors of the company in insolvency proceedings. The bank's liability under this head of challenge may be the full amount of damages suffered by the creditors if it is proved that the wrongful termination of the credit facility was the sole cause of the company being in insolvency proceedings.⁶²

That said, the second paragraph of Article L. 313-12 of the French Financial and Monetary Code provides for two exceptions where the bank may immediately and unilaterally terminate or reduce a credit facility granted to a company (in other words without any notice period.) These are as follows:

- Where there has been seriously reprehensible conduct on the part of the company including: where the company is found guilty of an offence; where the company intentionally tried to or did mislead the bank as to its real financial situation; and where there has been a serious breach of contract (such as refusing to give promised guarantees or hand over documents requested by the bank).⁶³
- Where the company's situation has been irreparably compromised. It appears through case law that this does not mean where a company finds itself in a state of cessation of payments but where the company cannot restructure itself (for example where the company can no longer pay the premiums provided for in its restructuring plan, is only receiving a very limited amount of orders and/or is doomed to go into liquidation and be dissolved).⁶⁴

⁵⁸. Criminal chamber of the Cour de cassation, 11 oct. 1993, n°92-81.260.

⁵⁹. This Article has been amended, so as to include further duties to inform, by an order n°2016-301 dated 14 March 2016 and will enter into force on 1 July 2016.

⁶⁰. Which will become Article 1103 and Article 1104 of the French civil code as from 1 October 2016.

⁶¹. Commercial chamber of the Cour de cassation, 4 June 1991 : RD bancaire et bourse 1992, n° 32, p. 151, obs. F.-J. Crédot et Y. Gérard. –1st Civil chamber of the Cour de cassation 18 september 2008, n° 07-17.270.

⁶². Commercial chamber of the Cour de cassation, 23 October 2001, n°98-18.788.

⁶³. Commercial chamber of the Cour de cassation, 2 June 1992, n°90-18.313.

⁶⁴. Commercial chamber of the Cour de cassation. 21 November 2006, n°05-18.979.

3.3.2.3 Wrongful credit transactions (*octroi et soutien abusif de crédit*)⁶⁵

Pursuant to Article L.650-1 of the French Commercial Code, when a company is in insolvency proceedings, including safeguard, reorganisation or liquidation, creditors may not be held liable for credit facilities granted to the company except in the case of:

- Fraud: an event of fraud implies a criminal offence in the granting of the credit facility such as extravagant financial operations (*cavalerie financière*). Fraud can also be characterised if the credit facility is given to the company for a purpose other than to start-up or maintain the business. A credit facility granted with the negligence of the banker, such as when the banker omits to request the provision of the company's accounts or to obtain the opinion of experts before granting the credit facility;⁶⁶ will not be considered a fraudulent credit facility.
- Interference in the company's management: this event relates to the event of *de facto* management; however, the influence of the bank on the management of the company needs to be “characterised”, meaning that if the bank did not interfere, the company would not have made such or such decision. French academics believe that the wrongful (*abusif*) grant of a credit facility may be “characterised” where the bank is party to an oversight board or to a LBO where the bank grants the credit facility on the condition that the ratios are not violated. The *Cour de cassation* does not consider there to be interference in the company's management when, in accordance with a facility agreement, the bank reviews transfers which may not be carried out without being evidenced by invoice.⁶⁷
- If the guarantees given are disproportionate to the credit facility for which they were granted: most French academics believe that this example of a wrongful grant of credit facility is intended to target the practice of unusual requests for guarantees within the banking sector. For example, in order to obtain a facility to finance the purchase of freehold, banks normally require a mortgage over all the freehold even though the facility only finances part of the purchase of the freehold. Some academics believe that this rule against the wrongful granting of credit facilities is actually intended to deter banks from proceeding with what is called a “*coup de râteau*”, meaning obtaining an excessive number of guarantees so as to have an unfair advantageous position relative to other creditors in the event of the borrower company entering into insolvency proceedings. The Courts will determine whether the guarantees were disproportionate or not on the date the guarantee was given by reference to the maximum amount owing by the company to the bank, including interest, fees and accessory amounts.

If the Court holds that one or more of the above events exists, the Court must then determine whether there is a causal link between the wrongful granting of the credit facility and the prejudice caused to the borrowing company, other creditors or even other third parties such as guarantors.

According to the majority of French academics, this Article implements a presumption that creditors that grant credit facilities (that is, mostly banking institutions) are not liable for the facilities granted except where the credit facility is considered *abusif* (wrongful) in one of the three circumstances outlined above. This would mean that even if the bank committed a fault in respect to the credit facility granted, the bank would be immune from tortious liability unless the facility was considered abusive under either fraud, ‘characterised’ interference in the management of the company or disproportionate guarantees. This, however, is not the view of the French Constitutional Council that considers that banking institutions are not immune from liability as this Article of the French Commercial Code specifically provides for the three cases where banking institutions may be held liable.⁶⁸

3.3.3 Auditors

Pursuant to Article L. 822-17 of the French Commercial Code: “*Auditors are responsible, in respect of a person or entity or third parties, for the consequences of errors and omissions committed by them in the exercise of their functions. Responsibility may not be sought for any information or disclosures of fact on which they proceed in the execution of their mission. They are not civilly liable for offences committed by directors and officers unless, having knowledge, the offences are not indicated in their report to the General Assembly or the competent authority referred to in Article L. 823-1*”.

⁶⁵ Law applicable to insolvency proceedings opened after 1st January 2006.

⁶⁶ Commercial Tribunal of Nanterre, 7th chamber, 19 June 2009, RG n°2008F00426.

⁶⁷ Commercial chamber of the Cour de cassation, 30 October 2007, n°06-12.677.

⁶⁸ Constitutional Council 22 July 2005 n°2005-522.

French Courts will hold statutory auditors liable if they have committed a fault which has caused damage. This means that a creditor will have to prove damage and a causal link between the fault and the damage. A claimant has three years in which to commence a claim pursuant to Article L. 225-254 of the French Commercial Code. The three-year period starts on the date of certification of the company's accounts except if the statutory auditors concealed the fault, in which case, the three-year period commences on the date when the damage is suffered.⁶⁹

The three-year limitation period is applicable to insolvency proceedings.⁷⁰ For example, a statutory auditor was held liable when he certified accounts of the company without undertaking any serious inspection.⁷¹ However, he cannot be held liable under Article L. 651-2 of the French Commercial Code for a shortfall of assets resulting from his failure to inform the relevant parties of the problems discovered upon completion of the company's accounts, unless he is deemed to have acted as a *de facto* director.

3.3.4 The end of the insolvency proceedings does not bar a creditor from claiming against third parties if the claim can be formed outside of its rights against the debtor. For example, it was found that the initiation of proceedings against the licensor did not interrupt the proceedings in respect of the patent owner who had conceded the operation.⁷²

3.3.5 Furthermore, creditors have a direct right to claim (*action directe*) against the insurers of the company⁷³ or against third parties even if the proceedings are closed.⁷⁴ Guarantors of the debtor are included within the pool of third parties against whom creditors have a direct right of claim.

However, pursuant to Articles L. 622-28 (safeguard proceedings), L. 631-14 (reorganisation proceedings) and L. 641-3 (liquidation proceedings) of the French Commercial Code, claims against guarantors who guarantee a security (*caution*), are co-debtors, autonomous guarantors or have granted a personal security are suspended from the date of the Court decision opening the insolvency proceedings until the adoption of a business restructuring plan or the judicial winding-up of the company.

3.3.6 The loss may be general – suffered by all of the creditors – in which case only the representative of the creditors can bring the claim. Alternatively, the loss may be specific to one creditor in which case the claim can only be brought by the injured creditor. In order to be allowed to bring such a specific claim, the creditor must be capable of establishing, to the satisfaction of the Court, the existence of a prejudice which is (i) specific and (ii) personal to him/her/it and (iii) separate from the prejudice of the other creditors as a whole ("*distinct de celui de l'ensemble des créanciers*"). These claims are of a civil nature for which damages may be awarded (either to the company in the event of a general claim or to the injured creditor in the event of an individual claim).

⁶⁹ Commercial chamber of the Cour de cassation, 15 September 2009, n°08-18.876, Commercial chamber of the Cour de cassation, 1st July 2008, n°07-17.729.

⁷⁰ Commercial chamber of the Cour de cassation, 13 February 2007, n°03-13.577.

⁷¹ Commercial chamber of the Cour de cassation, 18 May 2010, n°09-14.281.

⁷² Commercial chamber of the Cour de cassation, 11 March 2008, n°06-19.616

⁷³ Mixte Chamber of the Cour de cassation, 15 June 1979 : D. 1979, jurispr. p. 561, note F. Derrida et A. Honorat; JCP G 1979, II, 19197, note A. Besson et J. Bigot.

⁷⁴ Commercial chamber of the Cour de cassation, 17 December 2003, n°02-12.891; Commercial chamber of the Cour de cassation, 4 Oct. 2005: JurisData n° 2005-030100; Act. proc. coll. 2005, comm. 240.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Introduction

- 4.1.1 Like many other legal systems, out of a concern to protect creditors and the company itself, French law recognises the right to bring proceedings to render void certain payments and transactions made during the suspect period (which, as explained in Question 1, begins with the date on which the company finds itself in a state of cessation of payments and ends on the date of the order commencing formal insolvency proceedings). The basis of such concern is the risk that the company facing financial difficulties may, because of the unequal bargaining power that exists on account of its situation or in an attempt to use whatever means it can to face up to its financial difficulties, grant certain favours and enter into certain transactions which are to the detriment of the company and/or unfairly beneficial to a creditor or counterparty and thus are detrimental to the overall body of creditors.
- 4.1.2 Actions to avoid payments or transactions (*actions en nullité*)⁷⁵ are intended to reconstitute the assets of the company by either imposing a sanction on the company or reversing the inequality created as between creditors. A third party contracting with the company may therefore see transactions that it entered into with the company during the suspect period held void.
- 4.1.3 An action to avoid based on Articles L. 632-1 and L. 632-2 of the French Commercial Code may not be brought by a creditor since Article L. 632-4 of the French Commercial Code provides that it may only be brought by the administrator, the *mandataire judiciaire*, the person appointed by the Court to execute the plan or the public prosecutor (acting jointly or individually).
- 4.1.4 In addition to the statutory basis for an action to avoid, French civil law also recognises a claim, known as the “*action paulienne*” (a right of claim, which Article 1167⁷⁶ of the French Civil Code provides to the creditors of a debtor, to challenge transactions or other acts undertaken by the debtor defrauding creditors’ rights). Such a right of claim is not linked to the suspect period and can be used by creditors who do not have the right to bring an action to avoid.

4.2 Summary of heads of challenge

- 4.2.1 The transaction or payment must have occurred during the suspect period (that is, after the date of cessation of payments and prior to the judgment opening formal insolvency proceedings). It must have been undertaken by the company and not by a third party. It must fall within one of the twelve heads of challenge enumerated in Article L.632-1 of the French Commercial Code (applicable during judicial reorganisation and judicial liquidation under Article L. 641-14 of the French Commercial Code). It is not, however, necessary for the person bringing the action to evidence that the act has caused loss to the company. The heads of challenge fall into two different categories:
 - (a) those which must be held automatically void by the Court if the legal requirements are met; and
 - (b) those which, if the legal requirements are met, may be held void by the Court at its discretion.

⁷⁵ Commercial chamber of the Cour de cassation, 21 February 2012, n°11-13.513.

⁷⁶ This Article will become Article 1341-2 of the French Civil Code as from 1st October 2016

4.2.2 The potential heads of challenge are the following:

(a) Transactions which are automatically held null and void:

- (i) any transaction under which the ownership of a fixture, any real estate or a chattel is transferred for no consideration (transactions for no consideration);
- (ii) any “commutative” transaction in which the company’s obligations far exceed those of its counterparty (an unequal transaction);
- (iii) any payment made by any means whatsoever of debts which are not due as at the date of payment (payment of debts not due);
- (iv) any payment of debts which are due, but made in a manner not commonly admitted in business relationships;
- (v) all deposits and “consignments” of sums of money given, pursuant to a Court order, as guarantees during the suspect period, unless given as a result of a final and binding Court decision which was issued prior to the opening of bankruptcy proceedings;
- (vi) security granted over the debtor’s assets for pre-existing debts;
- (vii) all “conservatory measures”, unless the filing or the act of seizure pre-dates the date of cessation of payments;
- (viii) any authorisation, exercise or resale of options defined in Articles L. 225-177 et seq. of the French Commercial Code (that is, “stock-options”);
- (ix) any transfer of assets or rights into a “*fiducie*” (a sort of French statutory quasi-trust) unless the transfer took place as a guarantee of a debt that was entered into at the same time;
- (x) any amendment to a *fiducie* contract affecting rights or assets already transferred into a *fiducie* as a guarantee of debts entered into prior to the amendment;
- (xi) where the debtor is an individual businessman with limited liability (*entrepreneur individuel à responsabilité limitée*), any allocation or modification in the allocation of an asset (save for the payment of revenues mentioned under Article L. 526-18) which results in a decrease in the assets of the estate of the insolvent business for the benefit of the businessman’s personal assets; and
- (xii) the declaration, referred to under Article L. 526-1 of the French Commercial Code, protecting the primary residence of a tradesman from any seizure by his trade creditors.

(b) Transactions which may be avoided at the Court's discretion:

- (i) transactions mentioned in (a)(i) may be avoided where they were entered into during the six-month period prior to the date of cessation of payments.⁷⁷ As stated above, however, such transactions must be avoided if made during the suspect period;
- (ii) any transaction for consideration entered into and any payment made for debts that have fallen due during the suspect period if the counterparty knew that the company was in a state of cessation of payments. In addition, any notice to a third-party holder, seizure or objection may also be avoided where it has been delivered or undertaken by a creditor with knowledge of the state of cessation of payments.⁷⁸

⁷⁷. Article L. 632-1 of the French Commercial Code.

⁷⁸. Article L. 632-2 of the French Commercial Code.

Each head of challenge is considered briefly below.

4.3 Transactions for no consideration

4.3.1 The statutory text defines such transactions as transactions under which ownership to fixtures, or any real estate, or chattels is transferred for no consideration). This type of transaction is automatically void if entered into during the suspect period, but the Court may also decide that such transactions are void if entered into during the period of six months prior to the date of cessation of payments.

4.3.2 Included in this type of transaction are:

- (a) Relief from debt: granting relief from debts will be treated as reducing the assets of the insolvent company. Granting relief from debts, including relief from debts forming part of another transaction, will be voidable if granted for no consideration. If the relief is granted in respect of a debt included in another transaction, it may be hard to demonstrate that it was given without consideration; alternatively, the transaction may be void under a different head of challenge, for example, if its terms strike a poor balance between the parties.
- (b) Gifts: regardless of whether the purchaser acted in good faith, or whether the transaction was notarised, in the case of a gift given in person (or by any other means), the gift (and even the on-sale of the gift) during the suspect period will be held void unless the gift was given for consideration. To determine whether the gift was made during the suspect period, the date that will generally be taken into account is the date the gift was accepted.
- (c) “Disguised gifts”: a number of transactions may be considered as disguised gifts, which will be held as void if concluded during the suspect period. An example of a 'disguised gift' is the transfer of shares in consideration of a loan where the lender has no intention of requesting repayment of the loan.⁷⁹

4.4 Unequal transactions

4.4.1 The statutory text refers to any bilateral “commutative” transaction in which the debtor’s obligations clearly exceed those of the counterparty. A contract is “commutative” if, at the time of signature, the nature of the advantage that each party obtains from the contract can be clearly ascertained. It covers, for example, the sale of personal property, the sale of goods, the creation of a guarantee, and the transfer of a trademark.

4.4.2 The advantages drawn from the contract by each of the parties must be clearly unequal as at the date of the transaction taking into account all assets and debts forming part of the transaction (i.e. not only the price) and to the detriment of the company. The difference must (a) be objectively ascertained and ascertainable and (b) be economically and mathematically clear. There must be no room for the parties to obtain a more or less advantageous position.

4.4.3 An example of an unbalanced/unequal transaction is where the obligations of the purchaser of a business are unbalanced as compared with the obligations of the seller such as where the business is only composed of a few assets and the purchaser is being obliged to proceed with the redundancy of employees dedicated to the business.⁸⁰

4.5 Payment of debts which have not yet fallen due

The statutory text refers to any payment, regardless of the manner in which it is carried out, of debts which are not due at the date of payment. Any payment made which is not due will be void regardless of how the payment was made. A payment made during the suspect period may be held void even if made by transfer, novation or contractual set-off of debts and claims.

⁷⁹. Civil chamber of the Cour de cassation, 2 March 2004, n° 01-13.767.

⁸⁰. Commercial chamber of the Cour de cassation, 27 June 2006, n°04-19.423.

4.6 Payments not normally recognised in business relations

- 4.6.1 The statutory text refers to any payment of debts that have fallen due made in a manner other than in cash, commercial instruments, wire transfer, deposit slip or transfer in accordance with Law 81-1 dated 2 January 1981 facilitating credit to business (codified under Article L. 313-23 et seq. of the French Monetary and Financial Code), or by any other method of payment commonly recognised in business relations.
- 4.6.2 The purpose is to avoid payments that, on account of their unusual nature, grant an advantage to one creditor. The notion of payments commonly recognised in business relations covers any method of payment which is generally and habitually used in the appropriate field of business affairs.
- 4.6.3 The burden is on the defendant to bring sufficient evidence that the payment is commonly recognised in business relations. An example of a payment that was considered uncommon in business affairs, and therefore void, was the payment of the cost of works by the resale of parking spaces in the building.⁸¹

4.7 Deposits and consignments

- 4.7.1 The statutory text refers to any deposit or consignment of monies pursuant to Article 2350 of the French Civil Code unless made pursuant to a final and binding Court ruling). Article 2350 of the French Civil Code relates to any deposit or consignment of money, commercial instruments, or securities which an entity has been ordered to make as a guarantee (or as a conservatory measure). The deposit or the consignment will not be avoided if it was ordered by a final and binding Court decision.
- 4.7.2 The purpose is to avoid the priority right that such deposit or consignment grants to the creditor in question in accordance with Article 2333 of the French Civil Code.

4.8 Creation of security for existing debts

- 4.8.1 The statutory text refers to any mortgage whether contractual, judicially-ordered or pursuant to law as between spouses, and any pledge over assets of the debtor granted for debts previously incurred. The text covers all forms of security over property, whether real or personal. The key is the date on which the security was granted as compared to the date on which the debt was incurred by the company. If the debt was incurred before the grant of security and if the security has been granted during the suspect period, the action to avoid must succeed.

However, it has been held by the French Courts that this text is not applicable to a mortgage granted to a creditor in consideration of a guarantee granted simultaneously by the debtor even if the mortgage was granted in respect of a credit facility which had already been drawdown. The Courts have held that this text is not applicable as the guarantee, granted simultaneously with the grant of the mortgage, is not a debt incurred prior to the granting of the security.⁸²

- 4.8.2 Again, the reasoning behind the existence of this head of challenge is clear given the absence of any justifiable rationale for granting security over a debt that already exists, such security not having been a *sine qua non* condition for the creation of the obligation. The existence of an advantage to the creditor in question, through the grant of additional or new security, is presumed.

4.9 Conservatory measures

- 4.9.1 The statutory text provides for the avoidance of any conservatory measure unless the filing or the act of seizure took place prior to the date of cessation of payments.
- 4.9.2 Where the recovery of a creditor's claim appears threatened, the Court may make an order to seize the debtor's assets or to grant judicial security over the debtor's assets (a 'conservatory measure'). Assets seized or judicial security enforced after the date of cessation of payments are void.

⁸¹. Commercial chamber of the Cour de cassation 13 May 2007, n°06-15.619.

⁸². Commercial chamber of the Cour de cassation 10 December 2002, n° 99-19.300.

As a general rule, judicial security can only be enforced once it has been publicised – a two stage filing process. Judicial securities granted over the assets of a debtor become enforceable on the date all publicity measures have been fulfilled in accordance with Articles L. 532-1 and L. 533-1 of the French Enforcement of Civil Procedures Code. Publication of such judicial measures is undertaken in two steps: (i) a temporary filing and (ii) a definitive (final) filing; publication is not effective until the definitive filing. Once the definitive filing has been carried out, the effective date is backdated to the date of the temporary filing. Therefore, a judicial security will be held void when the temporary filing took place during the suspect period even if the two steps have been carried out.

As an exception to the above, should the Court authorise a pledge over the shares or securities held by the debtor, this pledge is not subject to filing but only to notification to the entity in question. In this case, French academics appear to agree that such conservatory measure is considered void if the notification takes place during the suspect period.

The purpose of this action to avoid is to protect the company against conservatory measures obtained by a creditor which would have the effect of giving that creditor an advantage. The reasoning behind this head of challenge is similar to that for security granted for existing debts.

4.10 Transactions on stock options

- 4.10.1 Stock options granted by the company or exercised by an employee during the suspect period are held void.
- 4.10.2 The purpose of this provision is to prevent directors from using their insider knowledge of the company's financial difficulties to dispose of stock just before the opening of formal insolvency proceedings.

4.11 Transfers to a *fiducie*

- 4.11.1 The French version of a *quasi-trust*, *fiducie*, has only existed since 2007. The statutory text defines the head of challenge as any transfer of assets or rights to a *fiducie* unless the transfer was given as a guarantee of a debt simultaneously incurred.
- 4.11.2 The purpose is to protect creditors against the company transferring assets or rights into a *fiducie*, which would shelter the assets or rights in the event of insolvency.
- 4.11.3 Any amendment to a contract of *fiducie* which would affect rights or goods already transferred to a *fiducie* as guarantee of debts incurred prior to the amendment will also be held void if made during the suspect period.

4.12 Allocations (or modifications to allocations) of rights and assets by an individual entrepreneur⁸³

This head of challenge is fairly recent and renders void the allocation (or modification of an allocation) of assets during the suspect period to the detriment of creditors (i.e. reducing the assets of the insolvent business for the benefit of another business, or the owner of the business).

This avoidance provision may apply, not just to assets, but also to the allocation of liabilities to the insolvent business, although the latter would also be an act of mismanagement for which the individual entrepreneur could be held personally liable (see Question 2).

4.13 Counterparty aware that the company was in a state of cessation of payments

- 4.13.1 Under this head of challenge a Court may, at its discretion, render void certain payments and transactions entered into during the suspect period. In other words, these transactions may be avoided by the Court but are not automatically null and void. The statutory text⁸⁴ refers to payments for debts that have fallen due on or after the date of cessation of payments and transactions for consideration entered into on or after the date of cession of payments may be held void if those dealing with the debtor were aware of the cessation of payments.

⁸³. Article L. 632-1, I, paragraph 11 of the French Commercial Code.

⁸⁴. Articles L. 632-2 and L. 641-14 of the French Commercial Code.

4.13.2 The transaction or payment must have taken place during the suspect period. There is no need to show that the company suffered a loss as a result of the transaction. The key element is the counterparty's knowledge that it was dealing with a company that was in a state of cessation of payments; it is not enough that the counterparty knew that the company was in financial difficulties. In practice, it will be easier to prove that certain creditors (such as a company's bankers, lawyers, accountants, statutory auditors, etc.) had knowledge of the date of cessation of payments as their appointment grants them greater knowledge of the functioning and the financial situation of the insolvent company.

4.14 **Action Paulienne**

Unlike an action to avoid, creditors, the *mandataire judiciaire*, the person appointed by the Court to execute the plan and the *contrôleurs* may all bring a claim, known as the *action paulienne*, pursuant to Article 1167⁸⁵ of the French Civil Code, if any transaction or act was carried out by the debtor with the intention of defrauding creditors. The claim will be available regardless of whether the company is in a state of cessation of payments and therefore can be made in respect of any transaction or act of the debtor, whether entered into during the suspect period or not. Fraudulent intent must be shown to have existed on the part of the debtor – such fraudulent intent aimed at harming the creditor. If such fraudulent intent can be shown to exist and if the creditor can show that it has a valid and existing debt against the company that has been declared, the creditor can request that the transaction be held unenforceable against him.

An *action paulienne* can only lead to the fraudulent act or transaction being held unenforceable against the creditor; it does not render the act or transaction void. Accordingly, the transaction or act carried out by the debtor remains valid and binding between the debtor and third parties (other than the party to the *action paulienne*) including co-contracting parties to the transaction in question.⁸⁶

In the event the *action paulienne* is brought in respect of a transaction between the debtor and co-contracting parties, this will give rise to a conflict between protecting the interest of the creditor against the fraudulent transaction and protecting the co-contracting parties for whom the transaction remains binding.

French Courts have resolved this issue by determining whether the co-contracting parties were the accomplices of the debtor in the fraudulent transaction or whether they entered into the transaction in good faith.

Here, French case law observes a distinction between gratuitous transactions and transactions for consideration. If the fraudulent transaction was a gift, the co-contracting party will be deemed to be an accomplice of the debtor, without the creditor having to satisfy any burden of proof.⁸⁷ But if the fraudulent transaction was for consideration, the creditor will be required to prove bad faith on the part of the co-contracting party.⁸⁸ The Court will not sanction an *action paulienne* if the creditor has not satisfied this burden of proof.

If the Court holds that the co-contracting party was an accomplice to the debtor as regards the fraudulent transaction, the *action paulienne* will deprive the co-contracting party of the benefit of the fraudulent act (so as to protect the defrauded creditor). In this event, the third party co-contractor will be entitled to a warranty claim against the debtor but in practice such claims are rarely used when the debtor is insolvent or in financial difficulties.

⁸⁵. This Article will become Article 1341-2 of the French Civil Code as from 1st October 2016

⁸⁶. Commercial chamber of the Cour de cassation, 14 May 1996, n°94-11.124.

⁸⁷. Commercial chamber of the Cour de cassation, 24 January 2006, n°02-15.295.

⁸⁸. Commercial chamber of the Cour de cassation, 20 February 2007, n°05-18.241.

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

4.15.1 Overview

- 4.15.1.1 The duties of directors and *de facto* directors are considered above in the response to Question 2. As noted in that answer, French law does not focus on the types of transactions but rather on sanctions that may be imposed on directors and persons in similar *de facto* positions for particular types of conduct. In other words, if a director incurs further credit during the twilight period, the risk of such director being exposed to liability lies in the circumstances in and the reasons for which such further credit was incurred, rather than in the type of transaction through which such credit was obtained.
- 4.15.1.2 Consequently, if by incurring further credit, a director commits an act of mismanagement (for example, there was no good reason for the company to incur such credit or to acquire a costly asset financed by credit) or did so for his or her own personal ends and not for the company, that director would be exposed to a civil liability claim for the shortfall of assets or personal bankruptcy respectively.
- 4.15.1.3 A director must therefore be sure of the reasons for entering into any new transaction once the company in question is in a situation where, from a cash flow point of view, the assets of the company are, or risk being, insufficient to cover its due and owing debts.
- 4.15.1.4 Given the technical nature of the definition of cessation of payments and the risk that the date of cessation of payments may be fixed retroactively by the insolvency Court, it is possible (generally only for companies which do not have appropriate financial monitoring processes) for a director to be running a company in a state of cessation of payments without knowing that to be the case. Directors should therefore be particularly careful of their intentions when entering into new transactions whenever the company is facing financial difficulties.
- 4.15.1.5 In practice, in France, well-advised directors will get independent professional help, whether from insolvency practitioners, legal professionals, accountants and/or the Courts in voluntary reorganisation proceedings to assist them in any difficult decisions they may make to avoid insolvency. They will also often seek the support of the company's creditors and in particular, its banks and major suppliers.
- 4.15.2 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?
- 4.15.2.1 As mentioned above under 4.2, Articles L. 632-1 and L. 632-2 of the French Commercial Code provide for a series of different types of acts which will either be null and void or voidable at the discretion of the Court if undertaken during the "twilight" period – a period which can extend to 18 months prior to the date of the commencement of formal insolvency proceedings or 24 months in the case of transactions for no consideration.
- 4.15.2.2 The types of transaction which are automatically null and void if entered into during the twilight period are described under 4.2.2 (a) above. It is thus clear under French law that a party transacting with a company that is or is likely to be in a state of cessation of payments must avoid each of the 12 different types of transaction listed in Article L. 632-1 of the French Commercial Code. Failure to do so will result in the automatic avoidance of the transaction and the concomitant measures of restitution required against the third party. It should be noted that the causation of loss to the company is not a condition for the applicability of Article L. 632-1 of the French Commercial Code, neither is bad faith nor any form of wilful intent or knowledge that the company is in a state of cessation of payments on the part of the third party.

- 4.15.2.3 Again as noted above under 4.2.2 (a), the Courts have a discretionary right to avoid any transaction entered into during the twilight period in circumstances where the other party was aware of the fact that the company was in a state of cessation of payments. The apparently draconian nature of this power is tempered by the need to show that the counterparty was aware not only that the company was in financial difficulties but that it was in the technical and special position of having an amount of available assets less than the amount of its due and payable debts. According to French case law, available assets comprise assets which are available immediately or within a short period of time.⁸⁹ For example, any claims that need to be recovered are in principle excluded from the notion of “available assets”.⁹⁰

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons 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 French Commercial Code.
- 5.1.2 Civil liability claims for the shortfall of assets and personal bankruptcy can only be brought by the liquidator, the public prosecutor or by the majority of the *contrôleurs* in the event the liquidator fails to bring such a claim after formal notice to do so.⁹¹ These civil claims are brought before the commercial Court (*Tribunal de Commerce*) or the civil Court (*Tribunal de grande instance*) depending upon which has jurisdiction over the insolvency proceedings in respect of the company.⁹² Should the debtor be a company which carried on a commercial activity, the commercial Court has jurisdiction and in all other cases, it is that of the civil Court.
- 5.1.3 Criminal claims based on criminal bankruptcy (*banqueroute*) or on the fraudulent 'organisation' of bankruptcy may only be brought by the public prosecutor. However, other persons may initiate the criminal claim if the public prosecutor decides to not bring a criminal claim by forming a civil party which will seize the relevant *Juge d'Instruction* who will then proceed with criminal investigations.⁹⁴ In the case of criminal bankruptcy, only the liquidator, the administrator, the *mandataire judiciaire*, the employees' representative and the person appointed by the Court to execute the plan of reorganisation may form a civil party.⁹⁵ Furthermore, in the event the judicial representative fails to initiate such a claim, the majority of the Court-appointed *contrôleurs* may initiate such a claim after formal notice from the judicial representative to do so. These criminal claims are brought before the criminal Court (*tribunal correctionnel*). Any creditor may also join the criminal proceedings as civil party if the criminal claim has already been brought and if he or she is able to establish an individual specific loss that is different from the amount of the creditor's claim and results directly from the offence.

⁸⁹ Report of MP Xavier de Roux, n°2095, p.339 <http://www.assemblee-nationale.fr/12/rapports/r2095.asp>.

⁹⁰ Paris, 3^e ch. B, 8 November 2007, RG n°07/08101.

⁹¹ Article L. 651-3 of the French Commercial Code.

⁹² Article L. 621-2 of the French Commercial Code.

⁹³ Articles 1 and 2 of the French Criminal Procedure Code: criminal proceedings may be initiated by civil parties, meaning all those who have personally suffered damage directly caused by an offence, it being a felony, misdemeanour or a petty offence, in accordance with the provision of the French Criminal Code. May only form a civil party, those who have filed a prior complaint in front of the public prosecutor or the French police services (Article 85 of the French Criminal Procedure Code).

⁹⁴ Article 85 of the French Criminal Procedure Code.

⁹⁵ Article L. 654-17 of the French Commercial Code.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Heads of challenge	Sanctions available
<p>Liability for shortfall of assets</p>	<p>Liability is civil. <i>de jure</i> and/or <i>de facto</i> directors may be ordered to compensate from their own pockets all or part of the shortfall of assets that their mismanagement contributed to.</p> <p>The Court may also order professional sanctions (see below) for 'personal bankruptcy' in the event a director held liable for the shortfall of assets has not paid the compensation ordered in relation to that liability.⁹⁶</p>
<p>Personal bankruptcy</p>	<p>Liability is civil. If the Court holds <i>de facto</i> and/or <i>de jure</i> directors liable for personal bankruptcy, they will be prohibited from managing, administering and controlling any commercial business and any form of company which carries on an economic activity.⁹⁷</p> <p>The Court may also order that they may not hold any elective public office for the same period as the prohibition but subject to a maximum period of five years.⁹⁸</p> <p>As mentioned in Question 2, as an alternative to a personal bankruptcy ruling, the Court may decide instead to solely order prohibition on a management⁹⁹ and may tailor such prohibition to cover certain types of activity only.</p> <p>The maximum period for which personal bankruptcy or prohibition of management may be ordered is 15 years.¹⁰⁰</p> <p>It must be noted however that a director held liable for personal bankruptcy may request that instead of being subject to the sanctions of personal bankruptcy or prohibition of management, he/she/it will instead incur personal liability for the shortfall of assets of the insolvent company that he/she/it managed.¹⁰¹</p>
<p>Criminal bankruptcy</p>	<p>Liability is criminal. When <i>de jure</i> or <i>de facto</i> directors, who are individuals, are held liable, they may be sentenced up to a maximum term of five years imprisonment and/or a fine up to 75,000 euro (seven years and 100,000 euros for investment service providers).¹⁰² If the <i>de jure</i> or <i>de facto</i> directors are corporate or other such legal entities, then (i) pursuant to Articles 131-38 of the French Criminal Code, they may incur a fine up to five times the</p>

⁹⁶. Article L. 653-6 of the French Commercial Code.

⁹⁷. Article L. 653-2 of the French Commercial Code.

⁹⁸. Article L. 653-10 of the French Commercial Code.

⁹⁹. Article L. 653-8 of the French Commercial Code.

¹⁰⁰. Article L. 653-11 of the French Commercial Code.

¹⁰¹. Article L 653-11 of the French Commercial Code.

¹⁰². Articles L. 654-3 and L. 654-4 of the French Commercial Code.

	<p>maximum fine for an individual which gives a maximum of 375,000 euros, and (ii) pursuant to Article 131-39 of the French Criminal Code, they may, amongst other sanctions, be dissolved, prohibited from carrying on the activity in the course of which the offence was committed for a maximum period of five years and being placed under judicial control.¹⁰³</p> <p>In addition, should the <i>de jure</i> or <i>de facto</i> director held liable for criminal bankruptcy be an individual, his or her sentence may include any of the following orders:¹⁰⁴</p> <ul style="list-style-type: none"> - deprivation of civil rights; - prohibition for a maximum period of five years from having a public function or conducting a professional activity in the same field as that in which the offence was committed; - exclusion from participating in public tender offers for a period of at least five years; - prohibition for a maximum period of five years from issuing certain forms of cheque; - that the judgment be published, <p>and, at the Court's discretion and unless the civil Courts have already made such civil orders, incur civil liability for personal bankruptcy or prohibition of management, for which the possible sanctions are mentioned above.¹⁰⁵</p> <p>If civil proceedings are associated with the criminal proceedings, the <i>de jure</i> or <i>de facto</i> director in question may be ordered to compensate the company for any loss that his offending conduct has caused.</p>
<p>Fraudulent organisation of insolvency</p>	<p>Pursuant to Article L. 654-9 of the French Commercial Code, the same sanctions for personal bankruptcy may be ordered in the event of fraudulent organisation of insolvency. Article 314-7 of the French Criminal Code may also apply, in which case sanctions such as a fine of 45 000 euros and up to three years of imprisonment may be applicable.</p>

¹⁰³ Article L. 654-7 of the French Commercial Code.

¹⁰⁴ Article L. 654-5 of the French Commercial Code.

¹⁰⁵ Article L. 654-6 of the French Commercial Code.

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder's investigation into the company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Obligation to commence insolvency proceedings

7.1.1 Pursuant to Articles L. 631-4 and L. 640-4 of the French Commercial Code, the company, through its director(s), meaning:

- the general director in a traditional *société anonyme* who may also have the role of president of the board (*conseil d'administration*);
- the president of the management board (*directoire*) of a two-tier managed *société anonyme* with a supervisory board and a management board;
- the president, and as the case may be, the general directors of a *société par actions simplifiée*; and / or
- the director (*gérant*) of a *société à responsabilité limitée*,

must request the opening of judicial reorganisation or judicial liquidation proceedings by the Court within 45 days of the date of cessation of payments (except where the company has requested the opening of *conciliation* proceedings). Pursuant to Article L. 653-8 of the French Commercial Code, if the director of the company in cessation of payments knowingly fails to make the request, he/she/it may be prohibited from exercising any management role (see Question 2).

Pursuant to Article L. 2323-48 of the French Employment Code, before filing for judicial reorganisation or judicial liquidation, the company, through its directors, must inform and consult the workers' council and call and hold a meeting of the council. Article L. 2323-4 of the French Employment Code also provides that when consulting the workers' council, the council ought to have precise and written information given by the employer within the time frame provided by Article L. 2323-9 of the same code to be able to form and give an opinion on, in this case, the opening of insolvency proceedings. If the members of the workers' council consider that they do not have sufficient information to form and give their opinion, they may seize the judge in order to obtain, from the employer, the communication of the missing information.

However, in practice the seriousness of the financial situation of the company normally leads to informing, and consulting with, the workers' council in a very short timeframe so that the company does not breach its obligation to open formal insolvency proceedings within 45 days of the cessation of payments. Despite this timeframe to open insolvency proceedings, the company must comply with the legal timeframe to consult the workers' council otherwise the directors in place may be held guilty of a "*délit d'entrave*" which was the case when a director only consulted the workers' council one day before declaring the cessation of payments in its filing for insolvency proceedings.¹⁰⁶ This legal timeframe allows the representatives of the employment bodies of the company to either participate in the process of opening insolvency proceedings or to bring claims against the opening of such proceedings.¹⁰⁷

¹⁰⁶ Criminal chamber of the Cour de cassation. 15 October 1991, n°89-83.950.

¹⁰⁷ Commercial chamber of the Cour de cassation. 3 July 2012, n° 11-18.026.

- 7.1.2 Thereafter, the request to open judicial reorganisation or judicial liquidation is made at the registry of the commercial Court where the company is registered (save where the company has commenced Court-supervised *conciliation* proceedings when the Court supervising the *conciliation* proceedings is the appropriate Court).
- 7.1.3 The request must be accompanied by a number of documents that are listed under Articles R. 631-1 and R. 640-1 of the French Commercial Code. Examples of such documents include a *Kbis* extract (commercial extract) of the company from the relevant Trade and Company Registry and the annual accounts of the company for the last financial year.
- 7.1.4 Insolvency proceedings, being judicial reorganisation or judicial liquidation proceedings, may also be commenced in a number of different ways by persons other than the director of the company (for instance, by one or more creditors of the company or by the public prosecutor), provided that the company is not under *conciliation* proceedings.¹⁰⁸
- 7.1.5 The director of a company which is not yet in a state of cessation of payments may file for the opening of safeguard proceedings (it is not obligatory as is the case when a company is in a state of cessation of payments). Safeguard proceedings may only be commenced by the company's director on a voluntary basis; they cannot be commenced by third parties as for judicial reorganisation and judicial liquidation. For more information on safeguard proceedings, see Appendix.

7.2 Obligation to communicate information in the initial stages of the proceedings

- 7.2.1 Pursuant to Article L. 622-6 of the French Commercial Code (applicable to safeguard proceedings), also applicable to judicial reorganisation based on Article L. 631-14 of the French Commercial Code and to judicial liquidation based on Articles L. 641-4 and L. 641-14 of the French Commercial Code, the company, through its director, must assist the administrator or liquidator in drawing up an inventory of the company's assets, liabilities and encumbrances.

To this effect, a director is under an obligation to cover the following:

- information on assets that the company holds that may be claimed by third parties: pursuant to Article R. 622-4 of the French Commercial Code; this must include encumbered assets as well as assets held on deposit, rented or under a leasing contract, or subject to a retention of title clause or that may otherwise be claimed by third parties;
- a list of creditors: pursuant to Article R. 622-5 of the French Commercial Code, this list must be filed with the administrator and the *mandataire judiciaire* within eight days of the opening of the proceedings and must include the names and addresses of the creditors of the company, the amounts due and owing at the date of the commencement of the insolvency proceedings, the amounts becoming due and their due date, the nature of the debts and any guarantees or charges relating to them, and the object of the main on-going contracts;
- the amount of liabilities;
- the main on-going contracts; and
- information on pending proceedings.

Pursuant to Article L. 653-8 of the French Commercial Code, the director must provide these documents and this information to the administrator or liquidator within one month of the opening of judicial reorganisation or judicial liquidation, or risk a prohibition on management. However, for a director to be liable, he/she must be acting in bad faith and not merely being negligent. In order to evidence such bad faith, it is advisable for the administrator or liquidator to send a formal notice to the directors requiring them to provide such documentation.

- 7.2.2 Article L. 622-5 of the French Commercial Code also provides that as from the opening of the insolvency proceedings, any third party is obliged to provide the administrator, on his/her request, with any document relating to the company's accounts.

¹⁰⁸ Articles L. 631-5 and L. 640-5 of the French Commercial Code.

7.2.3 During safeguard proceedings, it is provided under Article L. 622-6-1 of the French Commercial Code that if no public officer is mandated to draw up an inventory, the company, through its director and employees, is to draw up the inventory which then has to be certified by the statutory auditor. If the company does not proceed with drawing up the inventory within eight days from the opening of the safeguard proceedings or within the period determined by the Court, the *juge-commissaire* will appoint a qualified professional (listed in the Article) to draw up the inventory.

7.3 Right to be heard during the proceedings

7.3.1 Throughout the insolvency proceedings, the company, through its director(s), has a number of specific rights to be informed, intervene and put forward his/her/its observations either to the administrator, the liquidator, the *juge commissaire* or the Court.

7.3.2 An example of being heard is Article L.623-3 of the French Commercial Code which provides that the company, through its directors, must be informed by the administrator of the company's financial situation and the terms of payment of the company's outstanding debt gathered by the *mandataire judiciaire*. At that occasion, the directors are entitled to provide the administrator with their comments.

7.3.3 Likewise, in judicial liquidation proceedings the Court cannot decide to close the liquidation without having summoned the director by bailiff to the hearing two months ahead of the hearing. Similarly, the directors are entitled to ask the Court, at any time, to close the on-going proceedings, in which case the directors will be invited to attend a hearing by registered letter sent by the registry of the Court.

7.4 Obligation to collaborate during the proceedings

7.4.1 Given that the director of the company in question is often the person best placed to know and understand the company and its activities, his or her or its collaboration with the judicial organs/officers conducting the insolvency proceedings will be invaluable. French law thus provides for the involvement of the director of the company at all stages of the proceedings.

7.4.2 Besides the collaboration of the director in the initial stages of the proceedings provided above, pursuant to Article L.623-1 of the French Commercial Code, under safeguard and judicial reorganisation proceedings (Article L.631-18. of the French Commercial Code), the company, through its directors, must assist the administrator appointed by the Court in drawing up a report on the economic and social position of the company. The report must identify the origin, nature and significance of the difficulties affecting the company. The administrator must also propose in the report either a plan for the reorganisation of the company or its judicial liquidation.

7.4.3 Other examples where the company, through its directors, must collaborate with the organs / officers appointed by the Court, during insolvency proceedings are the following:

- At the request of the administrator, the directors of the company must perform all steps and acts necessary to preserve the company's rights against its debtors and to preserve the production capabilities of the company (Article L.622-4 of the French Commercial Code).
- As from the date of opening the proceedings, the company, through its directors, must inform the administrator of all the establishments of the company and assist in accessing such establishments, provide a list of employees as well as any information that may determine salaries and indemnities to be paid (Article R. 622-2 of the French Commercial Code).
- On the order of the *juge-commissaire*, during liquidation proceedings, the liquidator may request the directors or any employee of the company that may have useful information to automatically forward their electronic mail from their professional email service to the email address designated by the liquidator (Article R. 641-40 of the French Commercial Code).

- 7.4.4 Should a director intentionally not fulfil his/her obligations to collaborate with the organs and officers appointed under the insolvency proceedings to which the company is subject and that non-cooperation interferes with or prevents the smooth conduct of the insolvency proceedings, he/she/it may be sanctioned and held liable for personal bankruptcy under Article L. 653-5, paragraph 5, of the French Commercial Code (see Question 2).
- 7.5 Rights granted to directors (applicable in both safeguard and judicial reorganisation proceedings)**
- 7.5.1 The director of the company in question has the right (*locus standi*) to request the *juge-commissaire* to seize the Court to replace the administrator or expert(s) appointed by the Court during the safeguard proceedings (Article L.621-7 of the French Commercial Code). Naturally, any decision to use this right needs when using it, careful consideration since if the Court refuses to change the administrator, co-operation between the director and the administrator may be jeopardised by the conflict.
- 7.5.2 At any time during the observation period, the director has the right (*locus standi*) to file a request with the Court for the total or partial cessation of the company's activities or the judicial reorganisation or judicial liquidation of the company (Articles L. 622-10 and L 631-15 of the French Commercial Code).
- 7.5.3 A director has the power to challenge, on behalf of the company, any decision taken by judicial organs during the procedure that by law is open to challenge (for example, the decision of the *juge-commissaire* to admit, reject or contest debts of the company submitted by creditors in the course of the insolvency proceedings (Articles L. 624-3 and L. 631-18 of the French Commercial Code)).
- 7.5.4 The director has the right to request that the Court extends the observation period (Articles L. 621-3 and L. 631-15 of the French Commercial Code).
- 7.5.5 Throughout the observation period, the director has a right to be informed by the administrator of the progress of the administrator's objectives (see 7.6.4 below).
- 7.5.6 The *mandataire judiciaire* must seek the director's observations on proposals to admit, reject or contest before the competent Court debts owed by the company and duly submitted by the creditors (Articles L. 624-1 and L. 631-18 of the French Commercial Code).
- 7.5.7 The Court must summon to appear before it the director of the company before it takes a decision to: (i) extend the observation period (Articles R.621-9 and Article R. 631-7 of the French Commercial Code), (ii) modify the objectives granted to the administrator (Articles R. 622-1 and R. 631-17 of the French Commercial Code), (iii) order the judicial liquidation of the company following the commencement of an observation period or (iv) order a plan of reorganisation (Articles L. 622-10 and L. 631-15 of the French Commercial Code).
- 7.5.8 Pursuant to Articles L. 627-1 et seq., and L. 631-21 of the French Commercial Code, during either safeguard or judicial reorganisation proceedings where an administrator has not been appointed, the director is to exercise all the powers that are normally granted to the administrator so that, generally speaking, the directors carry on the management of the company during the observation period and proceed with the restructuring of the company.

7.6 Rights retained by directors

- 7.6.1 In the event that the Court orders the immediate judicial liquidation of the company at the commencement of the proceedings, pursuant to Article L. 641-9 of the French Commercial Code, a director of the company is not removed from his/her/its position but is immediately stripped of all rights of action, power and authority with respect to the activities of the company. All such rights of action, powers and authorities are vested in the judicially-appointed liquidator.¹⁰⁹ However, this Article provides certain exceptions. The company, through its directors, may form a civil party to criminal proceedings where the company has been the victim of the offence, and may carry out the acts and exercise the rights that are not included in the powers of the liquidator or the administrator when appointed. As the director remains in his/her/its office, there is no need to appoint an ad hoc representative to exercise these rights.¹¹⁰ In practice, this scope of action is relatively limited, as the liquidator will, among his/her other powers, usually be granted all powers, in respect of the assets of the company.
- 7.6.2 In all other insolvency proceedings (safeguard and judicial reorganisation), the director remains at the head of the company with varying degrees of power and authority over the conduct of the company's activities, depending upon the nature of the objectives granted to the Court-appointed administrator (see 7.6.4 below).
- 7.6.3 Within this scope, the principal powers retained by directors are the power to take conservatory measures and the power to undertake acts in the ordinary course of business:
- (i) The power to take 'conservatory measures': conservatory measures in this context means those measures necessary to protect the rights of the company and to preserve the production capabilities of the company. Measures to protect the rights of the company include acts to stop statutes of limitation from running, sending formal notices to debtors of the company, and the creation or renewal of guarantees, charges and other encumbrances. Measures to preserve the company's production capabilities include the renewal of the company's stocks, replacement of used or worn material, repair of damaged machinery and acts to prevent the theft or other wrongful disappearance of the assets of the company.
 - (ii) The power to undertake acts in the ordinary course of business of the company: Articles L. 622-3 and L. 631-14 of the French Commercial Code (applicable to both safeguard and judicial reorganisation proceedings) provide that subject to the prohibited acts listed below under section 7.7.1 and the acts considered within the scope of the administrator's objectives, acts taken in the ordinary course of business by the company alone, through its directors, "*are deemed valid vis-à-vis third parties acting in good faith*". Acts in the ordinary course of business in the sense of Article L.622-3 of the French Commercial Code are those which fall within the scope of the normal business activities of the company, which are of such a nature as to occur and recur on a regular and frequent basis, which do not have a significant financial impact on the company and which would not be likely to be detrimental to the reorganisation of the company. Examples include the issuing of orders for office supplies of minor financial significance, the issuing of orders for materials necessary for the conduct of the company's business for amounts that are ordinary for the company, and the sale of goods typically sold by the company on normal terms and conditions. The third party must be act good faith which means that it must not be aware of any restrictions on the director of the company undertaking the act in question. It is not however typically necessary for the third party to have undertaken any specific investigation into the powers and restrictions actually affecting the director to prove its good faith.
- 7.6.4 The extent and nature of the other powers of directors with respect to the activities of the company in question depend upon the nature of the objectives granted to the administrator. These objectives will differ depending on whether the company is subject to safeguard or judicial reorganisation proceedings.

¹⁰⁹ Article L. 641-9 of the French Commercial Code.

¹¹⁰ The director is allowed to receive notifications of judgments and certificates for the admission of a claims.

During safeguard proceedings, the Court determines the extent of the objectives of the administrator which will be limited to two powers (Article L. 622-1-II of the French Commercial Code):

- (i) the power to supervise the director in his/her/its management of the company: under this power, the administrator has as objective to prevent damaging decisions being taken by the director of the company; and
- (ii) the power to assist the director in all or some of his/her/its management powers; the Court exercises its discretion in this respect, taking into account the needs of the company: here, the company is truly managed by means of strict collaboration between the administrator and the director. This power may involve areas such as the redundancy or dismissal of employees, the management of bank accounts and the bringing and defending of claims.

During judicial reorganisation proceedings, the Court also determines the extent of the powers of the administrator to either:

- (i) fully manage the business and represent the company: even though Article L. 631-12 of the French Commercial Code does not specifically provide that the administrator will represent the business, the power of full management of the company means that the administrator will be fully and solely managing, and therefore representing, the company. (This means for example that the administrator will be the one bringing claims on behalf of the company, and claims against the company should be addressed to the administrator); or
- (ii) assist in all or part of the management of the business: as with safeguard proceedings (Article L. 631-12 of the French Commercial Code) but will not include the power to supervise as with safeguard proceedings.

7.7 Acts that directors cannot undertake

7.7.1 The acts which the director is prohibited from taking as a general matter are the following:

- (i) The director cannot pay debts incurred prior to the opening of insolvency proceedings except by way of set off of related claims, and any such payment is at risk of being held void (Article L. 622-7 of the French Commercial Code). Except for a very limited number of exceptions specifically provided for by law, the payment of any such debts must receive the prior approval of the *juge-commissaire*.
- (ii) Article L. 622-7 of the French Commercial Code also provides that the director cannot pay debts incurred after the opening of the insolvency proceedings which are not mentioned under Article L. 622-17 of the French Commercial Code which requires that they have to have been incurred in the sole interest of carrying on the business activities of the company.
- (iii) The director cannot pay any debts incurred outside the ordinary course of business of the company in question (Article L. 622-7 of the French Commercial Code). This prohibition is of course the corollary to the right of the director to undertake acts that fall within the ordinary course of business of the company noted above. If such an act, such as the sale of assets (as opposed to stock) of the company or the entering into settlement of a dispute becomes necessary, it must receive the prior approval of the *juge-commissaire*.
- (iv) The director is prohibited from granting any form of security over the assets of the company without the prior approval of the *juge-commissaire* (Article L. 622-7 of the French Commercial Code).
- (v) The director cannot take any decision with respect to the continuation or cessation of existing contracts binding the company to its customers or suppliers, such right of decision being vested in the administrator (Article L. 622-13 of the French Commercial Code).
- (vi) In the context of reorganisation proceedings, lay-offs may be made only after consultation with the *juge-commissaire* (Article L. 631-17 of the French Commercial Code).

- (vii) The administrator, in agreement with the debtor, or the debtor alone with the authorisation of the liquidator, has the power to pay for goods purchased prior to the commencement of the insolvency proceedings but subject to a retention of title clause¹¹¹ because a contract with a retention of title clause is treated as a claim incurred after the opening of the proceedings.

7.8 Human rights

- 7.8.1 France is a contracting party to the European Convention for the Protection of Human Rights and Fundamental Freedoms (signed in Rome on 4 November 1950) (the Convention), the provisions of which are incorporated into French law.
- 7.8.2 The persons identified in response to Question 3 will thus be entitled to rely upon the rights contained in the Convention (the Convention Rights). This is the case whether such persons are individuals or companies. In an insolvency context, a director or other person with Convention Rights under the Convention will be able to:
 - (i) require that a particular provision of insolvency law is construed in accordance with those rights or otherwise declared incompatible; or
 - (ii) claim that the judicial organs are each a public authority and are acting unlawfully in breach of that person's Convention Rights.
- 7.8.3 It should be recognised that the Convention Rights are not absolute and may be limited by authorised interference by the state where such interference is justified by a limited aim and/or is proportionate to the need in hand.
- 7.8.4 In the context of insolvency, and the duties of co-operation discussed above, certain Convention Rights may be particularly relevant. These include:
 - (i) Article 6 – the right to a fair trial;
 - (ii) Article 4 – prohibition of slavery and forced labour;
 - (iii) Article 8 – right to privacy;
 - (iv) Article 10 – right to freedom of expression and information; and
 - (v) Protocol 1, Article 1 – right to protection of property.
- 7.8.5 An example of certain inconsistencies between the Convention Rights and French insolvency proceedings relates to the right to a fair trial provided for under Article 6 of the Convention, where individuals or companies enjoy a range of rights, including in particular: (i) to be heard before a tribunal in order to determine their civil rights and obligations, and (ii) for the judge to be independent and impartial, which are two notions that may be seen as limited in the context of French insolvency proceedings.
 - (i) Right to access the French Court in insolvency proceedings

Under French insolvency law, the right to bring claims and rights of appeal are in some circumstances limited; for example, the absence of the right for creditors to bring individual claims after the opening of insolvency proceedings against the insolvent company (with limited exceptions) (Article L. 622-21 of the French Commercial Code).

¹¹¹ Article L. 624-16 of the French Commercial Code.

France was held liable by the European Court of Human Rights (the ECHR) in its decision *Arma v. France*, dated 8 March 2007, where the French Court held that a director could not appeal against a decision opening judicial liquidation proceedings against the company. The French Court based its decision on the fact that the decision opening judicial liquidation also ordered the dissolution of the company and this constituted the end of the office of directorship and that therefore the director did not have the power or interest to form an appeal against the decision. The ECHR held that this was contrary to Article 6 of the Convention. Reform of French law in 2006 rectified this point; for proceedings opened after 1 January 2006: the director remains in office on the opening of liquidation proceedings unless provided otherwise in the articles of association or by a shareholders' decision.

(ii) Right to an independent and impartial judge

The question of whether a person's right to an independent and impartial judge is respected during French insolvency proceedings involves consideration of the jurisdiction of the *juge-commissaire* and the insolvency Court and also the make-up of the insolvency Court itself.

Under French law, the *juge-commissaire*, an organ in the insolvency proceedings that is also referred to in practice as the “*orchestra conductor*”, has certain powers including, for example, the power to approve creditor claims. This *juge-commissaire*, outside of this role may also be part of the composition of the insolvency Court. The ECHR will review all facts to evaluate whether the presence of the *juge-commissaire* in the composition of the insolvency Court breaches the right to a fair trial. It will be regarded as relevant that the *juge-commissaire* granted orders relating to the management of a group of companies during an observation period and at the same time presided over the insolvency Court in charge of determining whether the business plan (*plan de continuation*) is itself viable.¹¹² The *juge-commissaire* will not always have a dual role. Pursuant to Article L. 651-3 of the French Commercial Code, the *juge-commissaire* may not be a member of the insolvency Court for claims against directors in respect of a shortfall of assets.

In most cases, the insolvency Court is the commercial Court which is composed of practitioners being businessmen and women, who may be competitors or friends of the directors or shareholders of the insolvent company. This danger of being seen to be potentially partial was highlighted in a case where a number of members of the commercial Court actually participated in the operations of the company that was placed in judicial reorganisation.¹¹³ In this case, the Court decided to quash the decision of the Commercial Tribunal of Carcassonne because the judges were not impartial and independent on the basis of the Article 6 of the ECHR.

7.8.6 In December 2015,¹¹⁴ the French *Cour de cassation* set a ground breaking precedent to preserve the confidentiality of preventative measures, in which it ruled that:

- The publication by a media company of confidential information in relation to negotiations between a company under *conciliation* and its creditors, is a breach of Article 10-2 of the ECHR and of Article L. 611-15 of the French Commercial Code, which provides for the confidentiality of pre-insolvency proceedings.
- The publication of confidential information in relation to on-going *conciliation* proceedings falls under the scope of the exceptions to the freedom of expression referred to in the ECHR and a breach of the confidentiality of these proceedings may give rise to preventative measures (mesures conservatoires) and sanctions by interlocutory judges.

¹¹² ECHR, 6 June 2000, *Morel v. France*: Here the ECHR decided that it needed to be determined objectively on the facts whether the *juge-commissaire* was impartial due to the fact he had taken measures during the observation period and he was also seated as president of the insolvency tribunal deciding on the outcome for the company. On this basis, the ECHR held that the impartiality of the *juge-commissaire* depended on the extent of the measures ordered during the observation period and that on the facts the *juge-commissaire* in this case was impartial.

¹¹³ Court of Appeal of Montpellier, 8 July 1992, *Société Le Vicomte v. Rey*.

¹¹⁴ Commercial chamber of the Cour de cassation 15 December 2015, n° 14-11.500, “France: The Cassation Court sets ground breaking precedent to preserve the confidentiality of pre-insolvency preventative proceedings”, *International Corporate Rescue* May 2016, p. 154, Anker Sorensen.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation periods

8.1.1 Limitation period for criminal proceedings

Criminal bankruptcy (*banqueroute*) and fraudulent organisation of insolvency (*organisation de son insolvabilité* – see Question 6) fall within the category of offences known as *délits correctionnels*. The applicable limitation period is three years. Article L. 654-16 of the French Commercial Code provides that the limitation period starts to run only from the date on which formal bankruptcy proceedings have been opened if the incriminating facts occurred prior to that date. This Article of the Commercial Code, however, does not indicate the date from which the limitation period begins to run for such criminal proceedings where the incriminating facts occurred after the commencement of formal insolvency proceedings. For criminal proceedings, the limitation period is of utmost importance and therefore, the majority of French academics believe this omission to be deliberate so that the limitation period for such incriminating facts would be the period provided under general principles of criminal law. This is the period starting on the date on which these incriminating facts were discovered or took place. If the view is taken that it should be the same date as for other similar corporate offences, the limitation period would commence on the date the incriminating facts were discovered.

8.1.2 Limitation period for civil proceedings

Civil liability claims for the shortfall of assets are barred three years after the date on which the Court orders judicial liquidation.¹¹⁵

It should be noted that if a claim is brought against one director, this claim does not bar the possibility of bringing another civil liability claim for the shortfall against another director of the same insolvent company if the directors are not severally liable.¹¹⁶

8.1.3 Civil liability claims for personal bankruptcy are also barred after three years from the date of the Court decision opening the judicial reorganisation or judicial liquidation, as appropriate.¹¹⁷

8.2 Appeals

8.2.1 Appeal in criminal proceedings

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.¹¹⁸ Only the director in question, the civil party, the public prosecutor or the general public prosecutor of the Court of Appeal may bring an appeal. Where the director is present at the hearing at which the judgment is rendered at first instance, the period for appeal is 10 days from the date of the judgment.¹¹⁹ However, the period of appeal runs from the date the judgment was served where the director in question was judged in his or her absence (but after having heard a counsel that was present to ensure the director's defence without having the letter of instruction signed by the director).

¹¹⁵ Article L. 651-2 of the French Commercial Code.

¹¹⁶ Cour de cassation, 7 November 2006, n° 05-16.693.

¹¹⁷ Article L. 653-1 of the French Commercial Code.

¹¹⁸ Article 496 of the French Criminal Procedural Code.

¹¹⁹ Article 498 of the French Criminal Procedural Code.

8.2.2 Appeal in civil proceedings

Pursuant to Article R. 661-6 of the French Commercial Code, judgments holding directors liable for the shortfall of assets or personal bankruptcy may be subject to appeal by the director in question by application of the applicable general civil procedural rules. The director's appeal must be made to the Court of Appeal of the district in which the first instance Court was sitting. The appeal must be filed within ten days of the date on which the judgment at first instance was notified to the director.¹²⁰

Pursuant to Article L. 661-11 of the French Commercial Code, judgments holding directors liable for the shortfall of assets or personal bankruptcy may be subject to appeal by the public prosecutor and the general public prosecutor of the Court of Appeal even if neither of them were the main claimants in the case.¹²¹ The appeal must also be filed within ten days, but ten days from the date the public prosecutor receives notification of the judgment from the Court clerks.¹²²

QUESTION 9

9. Foreign corporations

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

9.1 Introduction

The Court which has jurisdiction over civil claims brought against directors is the Court which has jurisdiction over insolvency proceedings.

The French criminal Court has jurisdiction over criminal claims against directors of a company under formal insolvency proceedings commenced in France.

Given the above it is essential to determine which Court has jurisdiction over insolvency proceedings.

Insolvency proceedings can be commenced in France in respect of a foreign corporation pursuant to the following:

- (i) The EU Regulation on insolvency proceedings (the EU Regulation).
- (ii) International treaties.
- (iii) French laws on insolvency matters¹²³ for international non-European insolvency proceedings (French private international law).

¹²⁰ Article R. 661-3 of the French Commercial Code.

¹²¹ Articles L. 661-11 and L. 661-12 of the French Commercial Code.

¹²² Article R. 661-3 of the French Commercial Code.

¹²³ See (commercial chamber of the Cour de cassation, 15 February 2000 (appeals number: 97-16770 & 97-14415), 22 March 2011 (appeal number : 10-14889), 22 May 2012 (appeal number : 11-14366)).

9.2 European insolvency proceedings

9.2.1 Since 31 May 2002, EU Regulation n° 1346/2000 has replaced the former law, that is, international treaties and national French laws on insolvency matters concerning entities located in the EU. The EU Regulation applies to “European Insolvency Proceedings”¹²⁴ (that is, insolvency proceedings which are included within the scope of the EU Regulation in relation to a company¹²⁵ which has its centre of main interest or COMI in a Member State of the EU, with the exception of Denmark). An insolvent company’s COMI will therefore determine in which country the main insolvency proceedings can be commenced.

On 20 May 2015 the European Parliament approved the new EU Regulation n° 2015/848 which will replace the current EU Regulation as from 26 June 2017.

This new Regulation is aimed at improving the functioning of proceedings and completing the former Regulation.

The current EU Regulation provides for two distinct sets of proceedings: main proceedings and secondary proceedings. Main proceedings concern all of the insolvent company’s assets, whether they are located in the jurisdiction in which the main proceedings have been opened, or are located in another EU Member State. Secondary proceedings concern only the assets of the insolvent company located in the Member State where the secondary proceedings have been commenced. The debtor’s COMI is of critical importance in determining where the main proceedings take place, but COMI is not defined by the EU Regulation.

9.2.2 Despite the lack of a definition of COMI, the EU Regulation provides some guidance in its recitals that a debtor’s COMI “*should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties*”¹²⁶ and that where the debtor is a company, its COMI is to be deemed to be located at the place of the company’s registered office.¹²⁷

One of the questions that previously remained unanswered concerned how strong the registered office presumption was where, in the objective view of third parties, the registered office was not located in the place where the company operates its business. This question was answered by the Court of Justice of the European Union (CJEU) in the *Eurofood* case¹²⁸ where it firstly held that the COMI should be an autonomous and uniform concept, meaning that the COMI should be applied and interpreted in each Member State, independently of any national legislation. Secondly, the CJEU in *Eurofood* to an extent limited the scope of the rebuttal of the registered office presumption by stating that the presumption may only be rebutted “*if factors which are both objective and ascertainable by third parties enable it to be established that an actual situation exists which is different from that which locating it at that registered office is deemed to reflect.*”¹²⁹

The position of the CJEU in the *Eurofood* case was confirmed and expanded upon by the CJEU in the *Interedil* case.¹³⁰ The CJEU held that - debtor’s COMI must be determined by attaching greater importance to the place of the company’s central administration, as may be established by objective factors which are ascertainable by third parties. Where a company’s registered office and place of central administration are in the same jurisdiction, the registered office presumption cannot be rebutted. Where a company’s central administration is not in the same place as its registered office, the presence of assets belonging to the debtor and the existence of contracts for financial exploitation of those assets in a Member State, other than that in which the registered office is situated, are not sufficient factors to rebut the registered office presumption, unless a comprehensive assessment of all the relevant factors makes it possible to establish, in a manner that is ascertainable by third parties, that the company’s central administration is located in that other Member State.

¹²⁴ The EU Regulation only applies to proceedings of insolvency which involve the appointment of an administrator, that is to say, as far as French proceedings are concerned, liquidation and judicial reorganisation, i.e. *redressement judiciaire* (Annex A of the EU Regulation).

¹²⁵ Credit institutions, insurance undertakings, investment undertakings holding funds or securities for third parties and collective investment undertakings are excluded from the scope of the EC Regulation. (Considering (9) of the EC Regulation’s preamble). Credit institutions are subject to EC Regulation 2001/24/CE dated 4 April 2001 (see Articles L. 613-31-1 et seq. of the French Monetary and Financial Code); insurance companies are subject to EC Regulation 2001/17/CE dated 19 March 2001 (see Order n° 2004-504 dated 7 June 2004); investment undertakings holding funds or securities for third parties and collective investment undertakings are subject to EC Regulation 2004/39 dated 21 April 2004 and EC Regulation 2009/65 dated 13 July 2009.

¹²⁶ Recital 13 of the EU Regulation.

¹²⁷ Article 3(1) of the EU Regulation.

¹²⁸ CJEU, *Eurofood*, number C-341/04, dated 2 May 2006.

¹²⁹ *Ibid.*

¹³⁰ CJEU, *Interedil*, number C-396/09.

According to Article 3 of the new Regulation, “the centre of main interests shall be the place where the debtor conducts the administration of its interests on a regular basis and which is ascertainable by third parties. In the case of a company or legal person, the place of the registered office shall be presumed to be the centre of its main interests in the absence of proof to the contrary. That presumption shall only apply if the registered office has not been moved to another Member State within the 3 month period prior to the request for the opening of insolvency proceedings”.

- 9.2.3 One common issue that directors can face, when they are a director of various companies within the same group that are registered in different States, is that different legal regimes are likely to govern their duties as director of each company. The EU Regulation in its current version does not make any reference to group companies and, therefore, it was debatable whether the EU Regulation could be used to place all companies within the same group into insolvency proceedings in the same jurisdiction (thus potentially avoiding the problem highlighted above). However, where each group company has its COMI in the same Member State (normally the State where the parent company is located) the Courts of that Member State have on a number of occasion been able to place each company into insolvency proceedings in the same jurisdiction - rebutting the registered office presumption when doing so. This approach was found to be valid by the CJEU in *Eurofood*.

The French Courts are a good example of Courts that refer to the decisions of the CJEU and will rebut the registered office presumption in appropriate circumstances. A good example of the French Court rebutting the registered office presumption was the *Eurotunnel* case.

The *Eurotunnel* group, comprised of seventeen companies with the parent's registered office located in France, was experiencing financial difficulties where every company of the group was unable to reimburse the loans to which they were subject. This case has been debated extensively by numerous academics on the basis that, arguably, the Commercial Court of Paris, ruling on the facts, overlooked certain facts that could have led to the conclusion that the COMI of a number of the subsidiaries should have been located at their own registered office (i.e. not in France but in another Member State).

Of course, the Court decision ruling that the COMI of all subsidiaries was located at the registered office of the parent company facilitated the efficient and effective restructuring of the group.

Another example of a case in front of the French Courts is the *Coeur Défense* case where the French subsidiary of a Luxembourg parent company found itself in financial difficulty and in breach of its financing agreements. The French subsidiary and the Luxembourg parent company both requested the opening of safeguard proceedings which were opened by the Commercial Court of Paris. This case was concluded by the Court of Appeal of Versailles on 19 January 2012 after being referred back to it from the Cour de cassation. The Court of Appeal referred to the *Eurofood* and the *Interedil* decisions of the CJEU to come to a ruling that, based on “a global appreciation of the pertinent elements”, the Luxembourg-based parent company was actually managed from Paris.

- 9.2.4 In light of the absence of any reference to group companies and the resistance of certain national Courts, including French Courts, to comply strictly with the CJEU's interpretation of the EU Regulation, the EU Regulation has been reformed (see above).

Some of the key changes of the new EU Regulation 2015 / 848 are as follows:

- The extension of scope of the regulation to cover hybrid¹³¹ and pre-insolvency proceedings.¹³²
- The codification of determination of COMI (i.e Article 3 of the EU Regulation).
- The establishment of a system for inter-connecting national registers that may be accessed through the European E-Justice Portal.

¹³¹ Hybrid proceedings may commence where there is a likelihood of insolvency and are aimed at a collective restructuring of debts but where the existing management is left in place.

¹³² Pre-insolvency proceedings are aimed at the restructuring of the debtor in financial difficulties at a pre-insolvency stage.

- Secondary proceedings where a company has an establishment will no longer be limited to liquidation proceedings in order to allow the reorganisation of profitable establishments. But also, the opening of secondary proceedings may be avoided if the insolvency practitioner in the main proceedings gives an undertaking to local creditors that he will comply with the distribution and priority rights under national law that they would have if secondary proceedings were opened (Article 36 of the EU Regulation 2015/848).
- The implementation of the Chapter V of the EU Regulation which is aimed to facilitate the better coordination of cross-border group insolvency.

9.3 International non-European insolvency proceedings

9.3.1 Where the EU Regulation does not apply, the question of whether insolvency proceedings can be commenced in France will depend on whether there is an international treaty governing the matter. If there is no international treaty the matter will be governed by French private international law. The number of treaties that remain in force has considerably decreased since the EU Regulation came into force; as this Regulation has replaced all the bilateral treaties concluded between EU Member States. To our knowledge, the only bilateral treaty that remains applicable is the treaty entered into between France and Monaco dated 13 September 1950 and effective since 12 July 1952. Pursuant to Article 2 of this bilateral treaty, jurisdiction to commence insolvency proceedings lies with the Court with jurisdiction in the location of the registered office of the insolvent company. If the registered office of the insolvent company is, however, not located in France or in Monaco, then the Court having jurisdiction is the Court that has jurisdiction in the location of the insolvent company's principal establishment.

9.3.2 French private international law adopts a mixed approach to cross-border insolvencies, being more favourable to the jurisdiction of the French Courts and therefore to the application of French law. Under French private international law, the French Courts may be able to open insolvency proceedings in respect of a company with its registered office located in France or where the insolvent company has its centre of main interests (as defined in French law "*le centre principal de ses intérêts*") meaning, in most cases, that its main establishment (*établissement principal*) is in France,

Pursuant to Article R. 600-1 of the French Commercial Code, French Courts may have jurisdiction over cross-border insolvency proceedings effective over all assets of the insolvent company, even those located abroad.

Furthermore, even though the minimal condition to commence insolvency proceedings in France is for an establishment to be on French soil, in order to protect rights of French creditors, the French Courts have held in the past that they had jurisdiction resulting from the "presence of commercial relations"¹³³ or even the presence of real estate that may not even be allocated to a business activity of the insolvent company.¹³⁴ Nevertheless, these cases were one-off cases that have not been followed since. In more recent times, the French Courts have been more cautious when applying national law to cases with an international dimension and therefore, it is questionable whether the case law from these two cases would still apply today.

9.3.3 Despite the will of French law and French Courts to have jurisdiction and apply French national law to cross-border insolvency proceedings, French Courts are limited by decisions of foreign Courts ruling on the cross-border insolvency that have been granted exequatur, requiring the acknowledgement and enforcement of the foreign Court decision in France.

¹³³ Cour de cassation 14 April 1934.

¹³⁴ Commercial Chamber of the Cour de cassation 26 October 1999, n°96-12.946.

QUESTION 10

10. Insurance

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

10.1 Insurance coverage

Under French law, a company may take out insurance and pay insurance premiums in respect of the civil liability of its directors. Insurance policies for directors are called RCMS or D&O (Directors and Officers Liability). These types of insurance policies are not considered as contracts which are regulated by Article L. 225-38 of the French Commercial Code and therefore, do not need the prior approval of the board if the company is incorporated in France.

10.2 Insurance and criminal liability

Pursuant to Article L. 113-1 of the French Insurance Code, which provides: “[...] *the insurer shall not be answerable for loss and damage caused by the insured’s deliberate tortious, intent or fraud*”, these insurance policies do not cover intentional fault. French Courts interpret strictly this notion of the insured’s deliberate tortious, intent or fraud. Directors who act with the intention/purpose of causing damage will not be covered by the insurance policy. As the intention relates to the damage, directors who take risks associated with the operation of their duties will still be covered by such insurance policies as long as their intent was not to damage the company.¹³⁵ Insurance policies shall at all times cover *de jure* directors and their heirs (for example, the liability of a deceased director). Insurance policies may also cover *de facto* directors depending on how the insurance policy is drafted. If the policy states the names of the *de jure* directors, only those who are named will be covered. It is recommended that insurance policies expressly provide for which types of directors are covered by the policy, and this should be negotiated at the time of taking out the coverage. Insurance policies can therefore cover (if expressly provided for): *de jure* directors, *de facto* directors, newly appointed directors, as well as retired directors.¹³⁶

These insurance policies do not cover directors who are found guilty of criminal offences or for fines ordered by the criminal Courts. However, insurance policies may cover the following:-

- The legal fees incurred for legal assistance to the director in Court; but if the director in question is found guilty from a criminal perspective, the insurance company may bring a claim against the director to recover the costs it incurred by covering the legal fees paid to the director’s lawyers.
- Compensation granted by the criminal Court to the civil party that attached their civil claim to the criminal proceedings, but only if there is no presence of intentional fault as mentioned above (i.e. Article L. 113 - 1 of the French Insurance Code).

The coverage by insurance policies of civil liability consequences arising out of a criminal claim in front of a criminal Court is further justified by the reform of Article 4 of the French Criminal Procedural Code by law n°2007-291, dated 5 March 2007, making the principle that “*criminal prevails over civil*” more flexible. As a result of this reform, a second paragraph was added to Article 4 of the French Criminal Procedural Code to temper the above principle. This paragraph states “*the public prosecution’s initiative of the proceedings does not enjoin the suspension of judgment of the other actions of any kind exercised before the civil Courts, even if the decision of the criminal Court may directly or indirectly influence the decision to be held in the civil proceedings*”.¹³⁷

¹³⁵ Civil Second Chamber of the Cour de cassation, 1st July 2010, n° 09-10.590

¹³⁶ G.Greff, La responsabilité des dirigeants retirés RTD Com. 1978

¹³⁷ Article 4 of the French Criminal Procedure.

10.3 The insurance policy will usually cover all actions of the directors although some actions may be specifically excluded. These kinds of contracts are referred to as “*assurance tout sauf*” (insurance with full coverage with limited listed exceptions where the policy will not apply). Normally, mismanagement is covered in the General Conditions of such insurance contracts, but it may be more prudent to specifically state that mismanagement is covered by the specific policy, regardless of whether the mismanagement was committed within or outside of the director’s management role.

10.4 Existence of a cap and possible reimbursement

All insurance policies have a cap on liability for damages. Where an insurance policy does not provide comprehensive cover of all risks, it is permissible to enter into several insurance policies to ensure comprehensive coverage. This kind of process is called assurances *multilignes*.

It is important to note that any person who has suffered a loss due to a director's mismanagement has a direct right to claim for damages against the insurance company.¹³⁸ Where such a direct claim is brought by a victim, if the mismanagement of a director is not covered by the policy, the insurance company is subrogated to the rights of the victim, and can seek reimbursement from the director.

Where an insolvency procedure is opened, the risk for the insurance company of having to pay for a mismanagement claim increases. That is why in some policies, a specific termination clause is inserted with regard to the opening of an insolvency procedure. However, despite the fact that this clause is present in many insurance policies, the mechanisms of Article 80 of the Law n°2003-706 on Financial Security, dated 1 August 2003 mean that this type of clause is no longer effective.

¹³⁸. Article L. 124-3 of the French Insurance Code.

Appendix

Overview of French pre-insolvency and insolvency proceedings

– Preventative measures before insolvency proceedings

With the aim of preventing businesses going into insolvency, French law provides for two different but similar proceedings for companies experiencing financial difficulties or anticipating foreseeable financial difficulties: the *mandat ad hoc* and *conciliation* proceedings.

1. *Mandat ad hoc*

The *mandat ad hoc* is a confidential procedure¹³⁹ (a special mediation process) which enables companies experiencing difficulties to avoid insolvency proceedings by instigating confidential negotiations, usually with their main creditors, with the assistance of the *mandataire ad hoc*.

1.1 Filing¹⁴⁰

Any debtor¹⁴¹ facing difficulties, usually of a financial, economic or legal nature but without being in cessation of payments, may file a motion (*requête*) with the president of the local Court to appoint a *mandataire ad hoc*. The motion must be in writing and set out the grounds for the request. Certain other documents must also be filed which are along the same lines as for the *conciliation* proceedings below.

1.2 Appointment and remuneration of the *mandataire ad hoc*

If a debtor company requests the appointment of a *mandataire ad hoc*, it can propose the appointment of a specific person. However, the president of the local Court can refuse the proposal. This will depend on the practice of the local Court. The president of the Court is nevertheless limited in its choice of *mandataire ad hoc*. A person who has received, directly or indirectly, a remuneration or payment from the debtor, or a person who controls or is controlled by the debtor, (or has done so within the last 24 months) may not be appointed as *mandataire ad hoc*.¹⁴²

The president of the Court will also fix the remuneration of the *mandataire ad hoc*, having approved this with the debtor.

1.3 Objectives of the *mandataire ad hoc*¹⁴³

On the appointment of the *mandataire ad hoc*, the president of the Court will determine its objectives and powers. These will normally be to:

- assist the company in its negotiations with creditors, employees and all other relevant commercial partners, including, when required, the main shareholders;
- help the company to evaluate its financial situation;
- try to resolve these difficulties;
- when requested by the company, organise the sale of a part of the business or of the whole business operated by the company, possibly in the frame of subsequent safeguard or insolvency proceedings, and
- report back to the president of the Court.

¹³⁹ Article L. 611-15 of the French Commercial Code.

¹⁴⁰ Article L. 611-3 of the French Commercial Code.

¹⁴¹ For the sake of simplicity, we will consider hereafter that the debtor is a commercial company.

¹⁴² Article L. 611-13 of the French Commercial Code.

¹⁴³ Article R. 611-19 of the French Commercial Code.

1.4 The main advantage of the *mandat ad hoc*

The main advantage of this process is that it remains confidential and is very flexible - the process is not legally limited in time¹⁴⁴ and the *mandataire ad hoc* is appointed to assist the directors who remain in charge of the company's management. In this respect, the French *Cour de cassation* recently ruled¹⁴⁵ that the duty of confidentiality applicable to parties involved in pre-insolvency preventative proceedings also applies to third parties (i.e not involved in these proceedings), including the foreign financial press.¹⁴⁶

1.5 Stay of proceedings

Under a *mandat ad hoc*, the only way a debtor can stay proceedings is by contractual agreement with the creditors concerned.

1.6 Outcome of *mandat ad hoc* proceedings

Even if the company comes to an agreement with some of its creditors, this will not affect the company's other creditors or commercial partners who remain outside the agreement and who will be entitled to take legal action as they see fit to recover sums due to them.

Therefore, it is common for the *mandat ad hoc* to be followed either by *conciliation* proceedings to render these agreements enforceable by Court or by safeguard proceedings under which a restructuring plan may be adopted. (See section 2.4.1 below.)

Since the implementation in French insolvency law of pre-packs¹⁴⁷ prepared during the pre-insolvency proceedings, the sale of major businesses organised during *mandat ad hoc* and/or *conciliation* proceedings have taken place in subsequent insolvency proceedings.

For example, NextiraOne, a subsidiary of Alcatel was the subject of such a pre-pack in June 2015, and FRAM, the tour operator selling packaged holidays in North Africa, was also the subject of a prepack in November 2015.

2. Conciliation proceedings

Conciliation is a confidential procedure¹⁴⁸ available to companies experiencing legal, economic or financial difficulties or likely to experience such difficulties in the future. Unlike the *mandat ad hoc*, conciliation is also available to companies which have been in cessation of payments for less than 45 days.¹⁴⁹

2.1 Filing¹⁵⁰

The director of a company may file a motion with the president of the local Court requesting the appointment of a conciliator. The motion must be made in writing and set out the financial, economic, social situation of the company, its financing needs and proposals to deal with its difficulties.

Certain corporate and financial information must be filed with the motion, as set out in Article R. 611-22 of the French Commercial Code. If the company is in cessation of payments, this will also need to be mentioned in the motion, including the date on which cessation of payments began.

2.2 Appointment and remuneration of the Conciliator¹⁵¹

The appointment of the conciliator is very similar to the appointment of the *mandataire ad hoc* whereby the president of the local Court:

¹⁴⁴ Article R. 611-21 of the French Commercial Code.

¹⁴⁵ Commercial Chamber of the Cour de cassation, 15 December, 2015, n°14-11.500

¹⁴⁶ Please refer to section 7.8.6

¹⁴⁷ Articles L. 611-7 and L. 642-1 of the French Commercial Code.

¹⁴⁸ Article L. 611-15 of the French Commercial Code.

¹⁴⁹ Article L. 611-4 of the French Commercial Code.

¹⁵⁰ Article L. 611-6 of the French Commercial Code.

¹⁵¹ Article L. 611-6 of the French Commercial Code.

- appoints a conciliator of its choice (within the limits provided by the Commercial Code);¹⁵² and,
- determines the remuneration of the conciliator, having agreed this with the director of the company.¹⁵³ Since a reform implemented in 2014¹⁵⁴ (the “2014 Reform”), Article L. 611-14 of the French Commercial Code put an end to the common practice of compensating the *mandataire ad hoc* or conciliator in proportion to the amount of debts waived by creditors, thus removing gratification from the conciliator’s main objective.

The debtor may suggest a conciliator but the president of the local Court is not obliged to take this suggestion into account.

2.3 Objectives of the Conciliator¹⁵⁵

The conciliator’s role is to put an end to the company’s difficulties by promoting and encouraging the debtor company to enter into an amicable agreement with its main creditors and, if applicable, its usual commercial partners.

It is not the conciliator’s role to assist the directors in managing the company or to supervise the company, nor does the conciliator have the power to impose a conciliation agreement, although the conciliator may put forward suggestions regarding running the business and maintaining employment levels.

The conciliator must report back to the president of the local Court on the progress of the conciliation and on any useful information concerning the debtor.

2.4 Duration

2.4.1 Time Constraints¹⁵⁶

The conciliator is appointed for a maximum of four months, with a possible extension limiting the total duration of his mission to five months.

At the end of this period, it is not possible to open another conciliation, until three months have passed. It is therefore not uncommon for companies to file for a *mandat ad hoc* during this three month period or to start with a *mandat ad hoc* and then open conciliation proceedings.

2.4.2 Stay of proceedings

Since conciliation proceedings are not insolvency proceedings, there is no stay on individual proceedings. Creditors may bring individual proceedings against the debtor during conciliation, including enforcement proceedings. However, creditors will often agree to a temporary postponement of proceedings.

Furthermore, the French Commercial Code provides companies with limited protection against creditor claims during the conciliation by: i) permitting a company to request the president of the local Court to postpone or spread out payments due to creditors for a period of up to two years.¹⁵⁷ and ii) obtaining a temporary suspension against the enforcement of measures taken by creditors.

2.5 Outcome of conciliation proceedings

2.5.1 Conciliation agreement

When the company reaches a conciliation agreement with one or more of its creditors or commercial partners, it may apply to the president of the local Court or to the local Court to have the agreement acknowledged or approved.

2.5.1.1 Acknowledgement of the conciliation agreement

¹⁵² Article L. 611-13 of the French Commercial Code.

¹⁵³ Article L. 611-14 of the French Commercial Code.

¹⁵⁴ Insol International’s Electronic Newsletter 15 July, 2014 - Yet another major change in French law and recommendations at EU level, Anker Sorensen

¹⁵⁵ Article L. 611-7 of the French Commercial Code.

¹⁵⁶ Article L. 611-6 of the French Commercial Code.

¹⁵⁷ Articles L. 611-7 of the French Commercial Code and 1244-1 of the French Civil Code.

The debtor may opt for the acknowledgement of the conciliation agreement by filing a joint motion with those creditors who are party to the agreement with the president of the local Court. To accelerate the process, creditors may authorise the company to file the motion on their behalf.

Before acknowledging the agreement, the president will check that the conciliation agreement exists and that the company has declared that it is not in cessation of payments or will no longer be by entering into the agreement.

On acknowledgement of the agreement, it is filed at the Court registry where all parties to the agreement may obtain an official copy. The content of the agreement remains confidential, as the Court registry will not provide copies to third parties.¹⁵⁸ The acknowledged agreement does not affect third parties, including creditors who are not a party to it. Such creditors may still bring claims against the company for payment of sums due to them.

No appeal can be lodged against the order acknowledging the agreement.

The main purpose of the acknowledgement of the conciliation agreement is to make the agreement enforceable against the creditors who are party to it, whilst the content and existence of the agreement remains confidential.

2.5.1.2 Approval of the conciliation agreement¹⁵⁹

Alternatively, the company may opt for the approval of the conciliation agreement. In this case, the existence of the judgment approving the agreement will be published in the official gazette but the content of the agreement will remain confidential.¹⁶⁰

The motion for approval must be filed before the end of the conciliation period.

The directors of the company, the creditors who are party to the conciliation agreement, the representatives of the workers' council, the conciliator and the public prosecutor¹⁶¹ must all be given notice of the approval proceedings and are invited to attend the hearing.

To obtain approval, the company must satisfy three conditions:

- the company is not in cessation of payments or will no longer be in this state by entering into the agreement;
- the terms of the agreement will achieve continuity of the company's business;
- the interests of creditors who are not party to the agreement are protected.

Once satisfied in respect of these three conditions, the Court's judgment containing its approval of the conciliation agreement but not the terms and conditions of the agreement will be filed at the Court registry, where any interested party can access it.¹⁶²

The main reason for getting the conciliation agreement approved is because of the consequences/benefits (see below) if the debtor subsequently goes into formal insolvency proceedings.

To this effect, debtors and creditors will normally seek to obtain the approval of a conciliation agreement (as opposed to an acknowledgement) for the following reasons:

¹⁵⁸ Articles L. 611-8 of the French Commercial Code and R. 611-39 of the French Commercial Code.

¹⁵⁹ Article L. 611-8, II of the French Commercial Code.

¹⁶⁰ Article R. 611-40 of the French Commercial Code.

¹⁶¹ Article L. 611-9 of the French Commercial Code.

¹⁶² Article L. 611-10 al 2 of the French Commercial Code.

- If creditors grant any new financing, services or goods to keep the company afloat, they will benefit from priority if the company subsequently enters into insolvency proceedings (a ‘New Money Privilege’);¹⁶³ The 2014 Reform increased the protection of new money creditors by extending the scope of their privileged status from contributions made in the approved conciliation agreement to all contributions made during the course of the conciliation process. In addition, creditors are now given a real incentive to make new money contributions since they will be treated as proper privileged creditors if the debtor is subsequently subject to safeguard or reorganisation proceedings: the Court cannot impose delays for their reimbursement, only they can accept them (Article L. 626-20 I. 3° of the French Commercial Code). On paper, this is a positive innovation but in practice, national creditors or creditors with a large presence and activity in France¹⁶⁴ may be urged, including by governmental bodies who have recently demonstrated strong state intervention,¹⁶⁵ to accept delays.
- If the company subsequently enters into insolvency proceedings, the date of cessation of payments decided by the Court will not pre-date the Court’s approval of the agreement,¹⁶⁶ unless fraud is proven, and therefore, the payments made and securities granted under the conciliation agreement cannot be declared null and void.
- Certain guarantors of the company, may invoke the approved conciliation agreement against creditors who are party to the agreement. This applies to guarantors who have guaranteed a security (caution), are co-debtors, or have granted a personal security.¹⁶⁷

The judgment approving the conciliation agreement is subject to appeal.

2.5.1.3 Waiver of part of the claim of creditors in the public sector

In certain circumstances, the debtor may obtain a waiver from its public creditors as to part of their claims, pre-emption rights, and position in the ranking of creditors as holders of a charge or mortgage (See Section 3.3.3).

2.5.1.4 Further role for the conciliator after acknowledgment or approval of the conciliation agreement

The 2014 Reform enshrined existing practices regarding conciliation agreements (whether acknowledged or formally approved) by codifying the appointment of the conciliator (at the end of his mission) as a *mandataire à l’exécution de l’accord*. The latter’s role will then consist in the supervision of the enforcement of the agreement once it has been reached.¹⁶⁸ The implementing decree adds, what seemed self-evident, that the *mandataire à l’exécution de l’accord* must agree to take on this role.¹⁶⁹ This was a useful innovation as it reinforced the effectiveness of conciliation agreements. It also created a logical new mission for the conciliator who helped reach the agreement and eventually enables the parties to the agreement to be informed in a timely manner by the *mandataire* of any issue arising during the implementation of the agreement.

2.5.1.5 Pre-packs

The 2014 Reform introduced a new Court-authorized pre-pack sale during *mandat ad hoc*¹⁷⁰ or conciliation proceedings,¹⁷¹ upon the debtor’s request and consultation of the key creditors, for the partial or total transfer of its business, to be subsequently implemented in safeguard or insolvency proceedings.¹⁷² This further expands the *mandataire ad hoc* and conciliator’s role and codifies existing practices (see Appendix under “Three important recent updates in French insolvency law”).

¹⁶³ Article L. 611-11 of the French Commercial Code.

¹⁶⁴ Recent history in France (and elsewhere, for example American hedge fund Elliot Management) shows that foreign creditors who do not have a large presence in the debtor’s country and who may rely on their home Courts, for example because of jurisdiction and choice of law clauses, are less pressure-sensitive.

¹⁶⁵ One of the former Ministers of the Economy and Productive Recovery, has been largely involved in recent sales of French companies, such as Ascometal or Alstom, in order for the French government to retain a say in jobs and decision-making in the selection of acquirers of companies in strategic sectors.

¹⁶⁶ Article L. 631-8 of the French Commercial Code.

¹⁶⁷ Article L. 611-10-2 of the French Commercial Code.

¹⁶⁸ Article L. 611-8 III of the French Commercial Code.

¹⁶⁹ Article R. 611-40-1 of the French Commercial Code.

¹⁷⁰ Article L. 642-2 of the French Commercial Code.

2.5.1.6 Other innovations of the 2014 Reform common to both pre-insolvency proceedings.

The 2014 Reform also introduced two sets of innovative provisions in Article L.611-16 of the French Commercial Code.

Firstly, any contractual provision, which modifies an ongoing agreement by reducing the rights or increasing the obligations of the debtor on the sole basis that the latter has obtained the opening of conciliation proceedings or the appointment of a *mandataire ad hoc*, is paralyzed.

More importantly, this should render inapplicable in France termination, forfeiture, acceleration, default and penalty clauses that are often included in loan agreements and contracts with foreign companies until different provisions based on other criteria are put in place.

Secondly, also paralyzed is any contractual provision which, due to the mere appointment of a *mandataire ad hoc*, or the opening of conciliation proceedings, charges the debtor with creditors' advisory fees incurred in relation to the *mandat ad hoc*, or conciliation proceedings, in excess of an amount set by a resolution (*arrêté*) of the Minister of Justice, which is 75% of the advisor's fees.

2.5.2 Failure of the proceedings

2.5.2.1 No conciliation agreement

In the event the conciliator does not obtain creditor approval to enter into a viable conciliation agreement, the president of the local Court will bring the conciliation proceedings to an end.¹⁷³ This decision is then notified to the debtor and communicated to the public prosecutor;

If the debtor is not in cessation of payments for more than 45 days, the debtor subject to on-going conciliation proceedings may file a motion to open accelerated safeguard proceedings which may force recalcitrant financial creditors to come to an agreement.¹⁷⁴

2.5.2.2 Refusal to approve the conciliation agreement

If the company is not in cessation of payments, it may still be possible to file a motion to obtain the acknowledgement of the conciliation agreement even where the approval of the conciliation agreement has failed.

Insolvency proceedings

3. Safeguard proceedings

When considering whether to enter into safeguard proceedings or to use pre-insolvency proceedings, it is important to evaluate the difference in level of assistance and interference in the company's management.

Safeguard proceedings are public proceedings, benefiting from more powerful tools than the pre-insolvency proceedings whereby recalcitrant creditors, who may not agree to a moratorium in the pre-insolvency proceedings, can be bound by the terms of a restructuring plan voted by a qualifying majority of the creditors (see hereafter under 3.4.1).

3.1 Filing

3.1.1 Motion¹⁷⁵

Under safeguard proceedings, a company in difficulty but without being in cessation of payments may file a motion for the Court's assistance and protection in order to turn itself around.

- Only the director of a company can file a motion to open safeguard proceedings.

¹⁷¹ Article L. 611-7-1 of the French Commercial Code.

¹⁷² Article L. 611-7 section 1 of the French Commercial Code.

¹⁷³ Article L. 611-7 al 6 of the French Commercial Code.

¹⁷⁴ Articles L. 628-1 to L. 628-7 of the French Commercial Code.

¹⁷⁵ Article L. 620-1 of the French Commercial Code.

- Safeguard proceedings may only be opened when the debtor is experiencing difficulties which it cannot overcome alone.
- The Court will look into the financial, economic, social and legal situation of the company (the turnover, the annual income, the implementation of a restructuring plan, etc.) as on the day of opening proceedings and not on the day the motion is filed.¹⁷⁶

3.1.2 Filing¹⁷⁷

Certain corporate information and documents must be filed with the motion to open proceedings which must be dated, signed and certified as true by the company.

3.2 Players in the safeguard proceedings

3.2.1 The Court-appointed administrator¹⁷⁸

A Court-appointed administrator will assist or supervise the company during safeguard proceedings. As with the *mandat ad hoc* and conciliation proceedings, the company may propose an administrator, but the Court has the right to refuse this proposal and appoint an administrator of its choosing.

During the observation period, (see below), the company's business continues to be run by its directors under the supervision of the administrator. However, certain powers are vested in the administrator including whether the company's ongoing contracts (other than employment contracts) should be terminated.

As from 3 April 2016,¹⁷⁹ the appointment in safeguard proceedings (and also in the other insolvency proceedings) of two *mandataires judiciaires* or *administrateurs judiciaires* is mandatory if the debtor company operates three or more businesses in another jurisdiction in France from the one where it is registered. It is also mandatory when (i) the debtor controls at least two companies undergoing *sauvegarde*, *redressement* or *liquidation judiciaires* proceedings, or (ii) when the debtor company is controlled or owned by a company subject to ongoing insolvency proceedings and the company itself holds or controls at least one other company which is also subject to insolvency proceedings. These entities will have to meet the following turnover levels:

- 20 million euros generated by the debtor, or
- 20 million euros generated by one of the companies controlled by the debtor, or by the company controlling the debtor; the notion of control being set out under Articles L. 233-1 or L. 233-3 of the French Commercial Code.

3.2.2 The *juge-commissaire*¹⁸⁰

Certain decisions (those not in the ordinary course of business or decisions as to sale of assets) require the prior approval of the *juge-commissaire*, the judge nominated to monitor the proceedings.

3.2.3 The *mandataire judiciaire*¹⁸¹

As well as the administrator, the Court will also appoint one or two *mandataire(s) judiciaire(s)*, from the list of *mandataires judiciaires* registered within the Court's jurisdiction.

The *mandataire judiciaire* has one objective: to represent creditors' interests and, more specifically, to receive their claims and verify whether they exist.

¹⁷⁶ Commercial chamber of the Court de cassation 26 June 2007, n° 06-20.820.

¹⁷⁷ Articles R. 611-22 and R. 621-8 of the French Commercial Code.

¹⁷⁸ Articles L. 621-4 and L. 622-1 of the French Commercial Code.

¹⁷⁹ The publication date in the French Official Gazette being 3 April 2016.

¹⁸⁰ Articles L. 621-4 and L. 621-9 of the French Commercial Code.

¹⁸¹ Articles L. 621-4 and L. 622-20 of the French Commercial Code.

3.2.4 The *contrôleurs*¹⁸²

Additionally, up to five creditors may be appointed by the *juge-commissaire* as *contrôleurs*, if requested. The *contrôleurs* complement the role of the *mandataire judiciaire* in protecting the interests of creditors and assisting the *juge-commissaire* in his mission to supervise the running of the business.

3.2.5 The Court

As from 1 March 2016, specific commercial Courts will deal with *sauvegarde*, *redressement* and *liquidation judiciaires* proceedings where the debtor is a legal entity exceeding a certain size. The outcome sought is the management of complicated matters in a more efficient manner by concentrating large insolvencies within a limited number of Courts. These Courts will have jurisdiction where the following criteria are met:¹⁸³

- (i) entities employing 250 or more employees with a turnover of at least 20 million euros and/or
- (ii) entities with a turnover of more than 40 million euros irrespective of the number of employees or (iii) companies which hold or control other entities where the total combined number of employees is 250 or more and where they have a combined total turnover of at least 20 million euros or (iv) companies which hold or control other entities, irrespective of the number of employees and where the combined turnover is at least 40 million euros.
- proceedings where the international jurisdiction of the Court is determined according to acts taken as per the European Union and related to insolvency proceedings.
- proceedings under which the international jurisdiction of the Court results from the presence in its jurisdiction of the debtor's centre of main interests.
- conciliation proceedings initiated by the debtor, at the request of the Public Prosecutor or by decision of the president of the commercial Court, when the debtor is an entity or a group fulfilling the conditions cited above at 1 (i) to (iv).

The specialized Courts will also have jurisdiction for any proceeding regarding a company held or controlled, as per Articles L.233-1 and L.233-3 of the French Code of Commerce, by another company and in respect of which an insolvency proceeding has been commenced before a specialized Court.¹⁸⁴ In such cases, all proceedings will be handled by one and the same Court regardless of the commencement date of the different proceedings.

The specialized Courts are the following:

- Bobigny;
- Bordeaux;
- Dijon;
- Evry;
- Grenoble;
- Lyon;
- Marseille;
- Montpellier;
- Nanterre;
- Nantes;
- Nice;
- Orléans;
- Paris;
- Poitiers;
- Rennes;
- Rouen;
- Strasbourg;
- Toulouse; and
- Tourcoing

¹⁸² Article L. 621-10 of the French Commercial Code.

¹⁸³ Article L. 721-8 of the French Commercial Code.

¹⁸⁴ Article L. 662-8 of the French Commercial Code.

Given that there are only 19 Courts (18 commercial Courts and the commercial section of the high Court of Strasbourg) selected to deal with such insolvency matters, the affected proceedings will be dealt with by specialized professionals who will develop an expertise in complex matters. This should in the longer term lead to greater efficiency and competency to the benefit of the economy as a whole.

Finally, as from 1 March 2016, one Court will have jurisdiction to deal with insolvency proceedings commenced against a company held by another company or controlling another company, where the holding company or the controlled company is subject to insolvency proceedings commenced before that Court. This will make the various practitioners' tasks much easier in such cases. This aspect is also innovative and welcome.

3.3 During the proceedings

The Court will automatically stay all payments and all ongoing interest on payments (with limited exceptions, such as the enforcement of retention of title clauses and loans of more than one year), to grant the company a breathing space to draw-up a restructuring plan to be submitted to the Court for approval.

The Court will open an observation period which lasts six months and may be renewable once and in very limited circumstances, twice, for the purposes of preparing and obtaining the approval from the Court on a restructuring plan. The observation period comes to end upon approval of the restructuring plan by the Court.

3.3.1 Creditors' committees

Usually under safeguard proceedings, creditors' committees will be formed. The Court has discretion to create creditors' committees even where the required thresholds are not met (i.e 150 employees and an annual turnover of 20 million euros).¹⁸⁵

The committees are composed as follows:¹⁸⁶

- the first committee: trade creditors (suppliers who individually are owed receivables representing at least 3% of the total amount of the company's supplier liabilities);
- the second committee: banking establishments, financial and credit institutions (including hedge funds)¹⁸⁷ and finance companies regardless of the size of their claim; and
- the third committee: bondholders convened in the form of a meeting, if any.¹⁸⁸

The purpose of the committees is to allow the creditors to discuss and vote on the proposed restructuring plan.¹⁸⁹

3.3.2 Safeguard restructuring plan

With the assistance of the administrator, the company (through its directors) draws up a draft restructuring plan.¹⁹⁰ The term of the plan will be fixed by the Court, subject to a maximum of ten years.¹⁹¹

The plan is very flexible, for example by allowing the company to treat each committee differently if economically justifiable to do so.

Since the 2014 Reform, any creditor who is a member of a creditor committee is also entitled to draw up and submit a draft restructuring plan which will be presented to the committees.¹⁹²

¹⁸⁵ Article L. 626-29 of the French Commercial Code.

¹⁸⁶ Article L. 626-30 of the French Commercial Code.

¹⁸⁷ Pursuant to Article L. 626-30 of the French Commercial Code, hedge funds all credit institutions and those assimilated to these institutions, as well as all those that purchased a claim from these institutions, from a supplier of goods or from a service provider also members of the second committee.

¹⁸⁸ Article L. 626-32 of the French Commercial Code.

¹⁸⁹ Article L. 626-30-2 of the French Commercial Code.

¹⁹⁰ Article L. 626-30-2 al 1 of the French Commercial Code.

¹⁹¹ Article L. 626-12 of the French Commercial Code.

¹⁹² Article L. 626-30-2 of the French Commercial Code.

The restructuring plan may provide for:¹⁹³

- the postponement of repayment of claims;
- the reduction or full relief from interest payments;
- debt forgiveness also known as “debt cram down”;
- debt for equity swaps, meaning the conversion of claims into equity/shares if the debtor is a joint stock company
- reserved increase of share capital; and
- the issuing of convertible bonds (obligations convertibles en actions).

3.3.3 Partial waiver of claims of creditors in the public sector¹⁹⁴

The debtor may obtain a waiver from its public creditors as to part of their claims, pre-emption rights, and their ranking between creditors holding a charge or mortgage.

3.4 Outcome of the safeguard proceedings

3.4.1 Approval by creditors and the Court of the draft restructuring plan

Not all creditors will vote on the proposed restructuring plan. Creditors will not vote if:

- the plan does not modify their payment terms; and
- their claim is to be fully reimbursed in cash pursuant to the plan.¹⁹⁵

All committee creditors vote in their respective committee and the approval threshold is two thirds of the total value of the claims of all the creditors who actually vote. If this majority is achieved, the dissenting minority will be bound by the decision of the majority.¹⁹⁶

Voting must take place in each committee within 20 to 30 days of receiving the draft plan¹⁹⁷ and within six months from the opening of safeguard proceedings.¹⁹⁸

Non-committee creditors, including state creditors, are consulted individually. If they cannot come to an agreement, the Court cannot reduce their claims but can defer or reschedule the due date for payment.¹⁹⁹

Before approving the plan, the Court will ensure that all creditors’ interests are protected. The Court can reject the restructuring plan in order to protect creditors even though it would safeguard the company’s business and clear most of its debts.²⁰⁰

Once approved by the Court, creditors will be bound by the plan and all its terms become enforceable. Individuals or legal entities in their position as guarantors may invoke the terms of the plan. This does not concern every guarantor of the company but only those who guarantee a security (caution), are co-debtors, autonomous guarantors or have granted a personal security.²⁰¹

3.4.2 Failure of the safeguard proceedings

The Court has the power to convert safeguard proceedings into judicial reorganisation or judicial liquidation in the following circumstances:²⁰²

¹⁹³ Article L. 626-30-2 of the French Commercial Code.

¹⁹⁴ Article L. 626-6 of the French Commercial Code.

¹⁹⁵ Articles L. 626-5 al 4 and L. 627-3 of the French Commercial Code.

¹⁹⁶ Article L. 626-30-2 al 4 of the French Commercial Code.

¹⁹⁷ Article L. 626-30-2 al 3 of the French Commercial Code.

¹⁹⁸ Article L. 626-34 of the French Commercial Code.

¹⁹⁹ Articles L. 626-5 and L. 626-6 of the French Commercial Code.

²⁰⁰ Article L. 626-31 of the French Commercial Code.

²⁰¹ Article L. 626-11 of the French Commercial Code.

²⁰² Article L. 622-10 of the French Commercial Code.

- if evidence is brought during the observation period that the company was at the opening of safeguard proceedings or is now in cessation of payments; and
- if it appears manifestly impossible to adopt the plan and/or the company would rapidly become insolvent if the safeguard came to an end.

4. Accelerated safeguard proceedings (*sauvegarde accélérée*)

This procedure, created further to the 2014 Reform, evolved from a fairly recent procedure called the accelerated financial safeguard (which has now been incorporated as a subset of the SA and described hereafter under section 4.4). It is aimed at implementing a restructuring plan, already negotiated during preliminary conciliation proceedings, despite the opposition of minority creditors, by forcing a vote through creditors' committees.

4.1 Filing

Only debtors who are under on-going conciliation proceedings and who have been in “cessation of payments” for less than 45 days on the date of filing²⁰³ may file for an SA.

A debtor who applies for an SA must convince the Court that the restructuring plan elaborated during the conciliation proceedings will not only address the financial difficulties it faces but will also be adopted by the creditors' committees (described in section 3.3.1 above)²⁰⁴ including the bondholders. As a result of this, the formation of creditors' committees is always mandatory during an SA procedure.²⁰⁵

Certain documents must be attached to the motion²⁰⁶ and certain conditions must be fulfilled by the debtor, as follows:²⁰⁷

- the company's accounts must be certified by a statutory auditor, or prepared by an accountant or the company must establish consolidated financial statements pursuant to Article L. 233-16 of the French Commercial Code.; and
- the company's turnover must equal or exceed 3 million euros per year; or
- the company's balance sheet total must equal or exceed 1.5 million euros; or
- the company has 20 or more employees on the date of filing for the SA.

4.2 During the proceedings

Many of the provisions of the French Commercial Code apply to both the SA and the general safeguard proceedings²⁰⁸ but, unlike the general safeguard proceedings, fast-track proceedings follow directly on from conciliation proceedings during which a restructuring is negotiated.

One of the main objectives of these proceedings is to act as leverage against dissenting minority creditors by converting a conciliation agreement with the key creditors, which would require unanimous approval, into a mandatory restructuring plan which does not require unanimity.

Creditors who have taken part in the conciliation proceedings will be considered as having already filed their proof of debt with the *mandataire judiciaire*.²⁰⁹

Other creditors with claims born before the opening of the proceedings are also affected²¹⁰ and must therefore proceed to the filing of their claims. They will, however, likely not be seriously affected by the plan as it results from the negotiations having taken place during the conciliation.

²⁰³ Article L. 628-1-4 of the French Commercial Code

²⁰⁴ Articles L. 628-1 of the French Commercial Code.

²⁰⁵ Article L. 628-4 of the French Commercial Code.

²⁰⁶ Article R. 628-2 of the French Commercial Code.

²⁰⁷ Articles L. 628-1 and D628-3 of the French Commercial Code.

²⁰⁸ Article L. 628-1 al 1 of the French Commercial Code.

²⁰⁹ Article L.628-7 of the French Commercial Code.

²¹⁰ Article L.628-6 of the French Commercial Code.

4.3 Outcome of these proceedings

4.3.1 Adoption of the safeguard plan

The plan will be adopted if approved by the creditors' committees in the same condition as in an ordinary safeguard procedure.²¹¹

After the Court's approval to proceed under an SA, the creditors have three months to vote on and adopt the restructuring plan (instead of six months under the standard safeguard proceedings).²¹²

4.3.2 Non-adoption of the plan

If the plan is not adopted by the creditors within the given time limit, the Court will bring the SA to an end.²¹³ If the company is in cessation of payments, the Court will open judicial reorganisation or liquidation proceedings.

4.4 The accelerated financial safeguard (*sauvegarde financière accélérée* – SFA)

The SFA, originally created in 2010 was the inspiration for the SA. Since the 2014 Reform it has become a specific kind of SA aimed at implementing a restructuring plan without affecting non-financial creditors.²¹⁴ The overall mechanisms of the SFA are identical to those of the SA with a couple of notable exceptions:

Only financial creditors (mainly banking establishments²¹⁵ and bondholders) are affected by the SFA. Trade creditors are not directly affected and their claims will be payable in accordance with their terms. As such, only the banking establishments' committee and, as the case may be, the bondholders' committee are gathered and called upon to approve the plan.²¹⁶

The deadline for the adoption of the restructuring plan is reduced to a single month (which may be extended by an additional month).²¹⁷

The first SFA was opened on 27 February 2013 by the Commercial Court of Nanterre against the company Soflog-Telis. Here, the company was in conciliation proceedings but one of the five banks in a bank pool, creditor of the company, refused to sign the conciliation agreement which required unanimity. Due to the dissenting bank, the company decided to file for an SFA, to convert the conciliation agreement into a mandatory restructuring plan forcing the dissenting bank to abide by what was accepted by the other four banks of the bank pool under conciliation proceedings.

More recently, in December 2015, an SFA procedure was used to restructure the bank debt of a company named DPAM, as a first step in its sale process to another market player in the children's clothing sector.

5. Judicial reorganisation (*redressement judiciaire*)

Judicial reorganisation is very similar to the standard safeguard proceedings except for the fact that the company needs to be in cessation of payments when filing for *redressement judiciaire*.

The purpose of these proceedings is to safeguard the company's business, maintain its activities, preserve as many jobs as possible and clear its debts.

²¹¹ Article L. 628-8 of the French Commercial Code with reference to Article L. 626-31.

²¹² Article L. 628-8 of the French Commercial Code.

²¹³ Article L. 628-6 of the French Commercial Code.

²¹⁴ Article L. 628-9 of the French Commercial Code.

²¹⁵ Banking establishments include all legal entities whose customary business activity is the carrying out of banking transactions or linked with such transactions such as banking and financing operations and also institutions which provide means of payment. Basically, this group mainly includes banks, financial institutions, leasing companies etc. Article L. 511-1 of the French Financial and Monetary Code.

²¹⁶ Article L. 628-10 of the French Commercial Code.

²¹⁷ Article L. 628-10 of the French Commercial Code.

5.1 Filing²¹⁸

A motion to open reorganisation proceedings may be filed by the company, a creditor or the public prosecutor. The Court can no longer bring its own motion to open judicial reorganisation proceedings.²¹⁹

The company is under an obligation to file a motion to open either judicial reorganisation or judicial liquidation proceedings when it is in a state of cessation of payments. The motion must be filed within 45 days of the date of cessation of payments (unless the company has already decided to enter into conciliation proceedings).

5.2 The administrators

Occasionally, the Court may decide that an administrator should take over the management of the company but generally²²⁰ the company will continue to be managed by its directors although the administrator will be granted more extensive powers by the Court than compared to those granted to the administrator in safeguard proceedings.

The administrator's objective will still be to assist and supervise the company, to assess the company's financial situation, come up with solutions to the company's difficulties and report back to the Court.²²¹

5.3 Stay on payments during the proceedings

As well as for safeguard proceedings, judicial reorganisation provides for a stay on payments upon the opening of proceedings by the Court and an observation period of up to 12 months (possibly extended by a further six months).²²³

The purpose of the observation period is to:

- give the company time to implement its own reorganisation plan (the continuation plan), if it can evidence that it will be in a position to repay its creditors over a maximum period of 10 years;²²⁴ or
- allow potential acquirers, who must be third parties, to present offers (sales plans) for the company's business.²²⁵

5.3.1 Restructuring continuation plan and sales plans

5.3.1.1 Restructuring continuation plan

- A) During judicial reorganisation, a restructuring plan may be drawn up by the administrator with the assistance of the directors. The plan will need the approval of the Court, which will be subject to the Court being satisfied that all creditors are sufficiently protected under the plan.²²⁶

For the Court to adopt the plan, the company must show that the plan will enable it to continue operating its business. If the Court determines that the plan is not viable, the Court can, unlike under safeguard proceedings, require a sale of business plan (the plan de cession) to be drawn up.²²⁷

If the company does not appear to be viable, or if no offer is lodged during the observation period, the Court also has the power to open judicial liquidation proceedings.²²⁸

²¹⁸ Article L. 631-4 and L. 631-5 of the French Commercial Code.

²¹⁹ Constitutional Council Decision dated 7 December 2012, n°2012-286.

²²⁰ Article L. 631-9 of the French Commercial Code.

²²¹ Article L. 631-12 of the French Commercial Code.

²²² Articles L. 631-14 and L. 622-7 of the French Commercial Code.

²²³ Articles L. 631-7 and L. 621-3 of the French Commercial Code.

²²⁴ Articles L. 626-12 and L. 631-19 of the French Commercial Code.

²²⁵ Article L. 631-22 of the French Commercial Code.

²²⁶ Articles L. 631-19 and L. 626-1 to L. 626-32 of the French Commercial Code.

²²⁷ Articles L. 631-15-II, L. 631-21-1 and L. 631-22 of the French Commercial Code.

²²⁸ Articles L. 631-15-II of the French Commercial Code.

B) Cram down of recalcitrant shareholders in reorganisation proceedings. A reform implemented in 2015, which came into force on 8 August 2015 for some of its measures, sets out two ways in which the commercial Courts may force out recalcitrant shareholders who may oppose the plan. These powers are only available within reorganisation proceedings. They are not available in safeguard or liquidation proceedings.

Nor will they apply to any pre-insolvency process such as conciliation and *mandat ad hoc*. This is consistent with the notion that in such proceedings coercion is anathema to what is expected and sought by the parties. Also, it would be difficult to justify expropriation or dilution of shareholders in companies that may not be seriously in trouble.

Since entry into force of the 2014 Reform,²²⁹ the committee creditors²³⁰ of a company in *sauvegarde* or *redressement judiciaire* have been allowed to submit a reorganisation plan. The 2015 reform (known as the Macron Law) now allows them, as well as shareholders, who present a reorganisation plan, to “cram down” recalcitrant shareholders. “Cram down” will happen where the recalcitrant shareholders in question have sufficient voting power to block the proposed reorganisation plan.²³¹ In this scenario, and provided a number of strict conditions are met, the commercial Courts may take steps which will lead to either (i) the forced dilution of shareholders, or (ii) the forced sale of dissenting shareholders’ shares.

5.3.1.2 Sales plan

Before making an offer, potential offerors may obtain limited information about the company from the registry of the Court where the company is registered. The register will detail the debtor’s assets and liabilities and also state the time within which offers may be made.²³²

Offers may be made within a specific period commencing with the date the proceedings are opened until the deadline fixed by the Court (or by the administrator in reorganisation proceedings).²³³

The length of this period varies and is often influenced by the debtor’s financial situation and the availability of cash flow. Because the administrator is personally liable for debts incurred during his administration, he will wish to present a report to the Court for review and adoption well before funds dry up. The report will analyse and evaluate all offers and recommend one of them to the Court.²³⁴

Offers made by directors of the company or their immediate relatives (in the second degree) may not be accepted.²³⁵

The key points when presenting an offer are:

- the Court can only consider and choose offers in respect of an autonomous business activity comprising assets and some or all of the corresponding employees. The Court will exclude offers in respect of assets only;
- an offer, once filed, is binding until the Court makes its decision in relation to the sales plans filed;²³⁶
- an offer must set out all relevant information provided under Article L.642-2-II of the French Commercial Code including a description of the assets and activities in respect of which the offer is made, the price and payment conditions etc;

²²⁹ Order n°2014-326 of 12 March 2014 regarding pre-insolvency measures and insolvency proceedings (*Ordonnance portant réforme de la prévention des difficultés des entreprises et des procédures collectives*)

²³⁰ *Tout créancier membre d’un comité*, Article L. 626-30-2 of the French Code of Commerce

²³¹ “The Macron Bill about to introduce a right to remove shareholders of distressed companies : a new threat for investors or new opportunities for creditors of French companies in need of turnaround ? », INSOL International Electronic Newsletter, April 2015, Brice Mathieu ; Also further changes to French corporate and insolvency legislation, INSOL, International Electronic Newsletter, 15 October 2015, Anker Sorensen.

²³² Article R. 642-40 of the French Commercial Code.

²³³ Article L. 642-2-I of the French Commercial Code.

²³⁴ Article L. 642-5 paragraph 1 of the French Commercial Code.

²³⁵ Article L. 642-3 of the French Commercial Code.

²³⁶ Article L. 642-2-V of the French Commercial Code.

- although not encouraged by the Courts, offers frequently include conditions precedent. Typical conditions may include renegotiating key contracts, confirming orders or supplies or even obtaining authorisations from governmental authorities. Offerors must notify the Court by the hearing date whether the conditions have been met and, if not, whether the offer still stands;
- the administrator files all offers made with the Court registry, where they are at the disposal of any interested party;²³⁷
- once an offer has been filed, it can only be amended by improving it within two working days before the hearing.²³⁸

If the offer is approved by the Court, the payment of the purchase price, which is ratified by the Court, clears most securities and charges over the assets sold.²³⁹ This, however, will not affect security held by the creditor who financed the acquisition of the assets secured by the charge. In other words, *liability for special securities over assets guaranteeing the repayment of a loan granted to the insolvent company for the financing of the asset sold under the restructuring sales plan shall be conveyed to the purchaser. The Purchaser shall be required to pay to the creditor the instalments agreed with the creditor and that remain due as of the sale of assets under the plan.*²⁴⁰

Only those employees whose positions, on a no name basis, are referred to in the offer adopted by the Court will be transferred with the business. The Court does not have the power to impose the transfer of all employees to the buyer, although the number of employees included in an offer will be a factor taken into account by the Court when deciding which offer to accept.

Employees who are not transferred to the purchaser will be made redundant.

5.3.2 Agreement with public creditors to waive their claim²⁴¹

In judicial reorganisation proceedings, as in conciliation and safeguard proceedings, the debtor may come to an agreement with its public creditors, listed under Article D. 626-9 of the French Commercial Code, with regard to waiving part of their claims.

The types of claims a public creditor may waive are listed and ranked in accordance with the French Commercial Code. Their ranking is as follows:

- Legal costs, price increases and fines.
- Interest for late payment and moratorium interest.
- Principal sums due (but these cannot be waived in full).

The exact agreement reached with public creditors will depend on the outcome of negotiations with the company's private creditors as the French Commercial Code provides that both efforts must be coordinated.

The decision to waive the claims of public creditors is subject to the prior approval of the CCSF (Committee regrouping the directors of financial services and representatives of the public entities concerned).

Creditors in the public sector can also decide to waive their pre-emption rights, their ranking as holders of a charge or mortgage, to abandon these rights altogether, or even to postpone payment.

5.4 Outcome of the proceedings

5.4.1 Restructuring continuation plan

In principle, the rules applicable to the restructuring continuation plan are the same as those that apply to the safeguard restructuring plan (see section 3 above), except:

²³⁷ Articles L. 642-2-IV and L. 642-4 of the French Commercial Code.

²³⁸ Article R. 642-1 paragraph 3 of the French Commercial Code

²³⁹ Articles L. 642-12 of the French Commercial Code

²⁴⁰ Article L. 642-12 of the French Commercial Code.

²⁴¹ Articles L. 626-6 and L. 631-19-I of the French Commercial Code.

- if the plan provides for redundancies, the workers' council or the workers' representatives will need to be informed and consulted and their opinion (avis) will need to be given at least one working day prior to the hearing ruling on the plan (Article L. 631-19-III of the French Commercial Code);
- if the plan provides for redundancies, the redundancies must take place within one month after the Court decision adopting the plan (Article L. 631-19-III §2 of the French Commercial Code);
- the adoption of the plan may be conditional upon the replacement or revocation of the directors at the request of the public prosecutor (Article L. 631-19-1 of the French Commercial Code);
- the Court may hold that shares or any other rights giving access to share capital may not be transferred to or held by director(s) and may direct that voting rights will be held for a fixed period by a Court agent (Article L. 631-19-1 of the French Commercial Code);
- the Court may decide to sell such shares or other rights giving access to the share capital (Article L. 631-19-1 of the French Commercial Code);
- directors and representatives of the workers' council shall be heard or called in front of the tribunal (Article L. 631-19-1 of the French Commercial Code); and
- guarantors who may rely on the safeguard plan may not rely on the provisions of the restructuring plan (Article L. 631-20 of the French Commercial Code).

If the restructuring plan is not adopted or is not held to be viable, the Court may impose a sales plan.

5.4.2 Sale of the business – sales plan

If the offer is approved by the Court, the payment of the purchase price ratified by Court clears most securities and charges over the assets sold. This however will not affect the security held by the creditor who financed the acquisition of the assets secured by the charge²⁴² (see section 5.3.1 under judicial reorganisation).

Following the sale, creditors will be repaid from the proceeds of the sale depending on their ranking, as determined by the French Commercial Code.

5.4.3 Failure of the reorganisation proceedings

If at any time during the reorganisation proceedings, the Court concludes that the company is in a situation where the judicial reorganisation may no longer save the business and that, the business is no longer viable, the Court will open judicial liquidation proceedings.²⁴³

If the Court does not approve the plan, the Court will open judicial liquidation proceeding.²⁴⁴

6 Judicial liquidation

6.1 Filing

A company in cessation of payments is under an obligation to file a motion to open judicial liquidation proceedings if judicial reorganisation would have no prospect whatsoever of saving the business.²⁴⁵

As with judicial reorganisation, the company, a creditor or the public prosecutor may open judicial liquidation, (provided that the company is not in conciliation proceedings).²⁴⁶

The motion must be filed within 45 days of the date of cessation of payments.²⁴⁷

²⁴² Article L. 642-12 of the French Commercial Code

²⁴³ Articles L. 631-15-II, L. 631-19 and L. 631-22 of the French Commercial Code.

²⁴⁴ Article L. 631-22 of the French Commercial Code.

²⁴⁵ Article L. 640-1 of the French Commercial Code.

²⁴⁶ Article L. 640-5 of the French Commercial Code.

²⁴⁷ Article L. 640-4 of the French Commercial Code.

The documents and evidence which must be filed with the motion are the same as for judicial reorganisation, but must also show that the opening of reorganisation proceeding is “manifestly impossible”.²⁴⁸

6.2 The liquidator

On the opening of judicial liquidation, the insolvency Court will appoint one or more liquidators²⁴⁹ (see 3.2.1 of the Appendix for the mandatory appointment of two liquidators). If more than one liquidator is appointed, each liquidator has the power to represent the debtor.

If the judicial liquidation proceedings supersede a judicial reorganisation, the mandataire *judiciaire* will usually be appointed as liquidator. Unlike the other pre-insolvency and insolvency proceedings, the liquidator not only takes over the management of the company but also represents the creditors.

The liquidator’s objective is to sell the assets of the insolvent company in the most profitable way and to pay off the creditors in order of priority out of the sales proceeds.²⁵⁰ It is rare for there not to be a shortfall of assets, in which case, as set out in the answer to the questions above, de jure and de facto directors may be held liable.²⁵¹

6.3 During the proceedings

Generally, the business of the company will cease to facilitate the winding-down of the company and to prevent existing debts increasing. However, the business may continue for three months (and possibly a further three months thereafter) with a view to selling the business (in whole or in part) or if it is in the public interest or the interest of creditors for it to continue.²⁵²

The liquidator may sell the assets in two different ways. First by selling the business in whole or in part as a going concern, but if this is not possible, by selling the company’s assets on a piecemeal basis.

Three important recent updates in French insolvency law

1. The 2012 Petroplus Reform

Amongst the recent reforms in French insolvency law, the “Petroplus” Law adopted on 1 March 2012 (Petroplus Law) aimed at preventing the misappropriation of assets of companies in difficulty.

The Petroplus Law introduced two important measures:

- for the president of the Court to authorise the seizure of assets of third parties during safeguard and reorganisation proceedings;
- on the approval of the *juge-commissaire*, for the seized assets to be sold by the Court and the proceeds deposited at the *Caisse des Dépôts et des Consignations*. The proceeds will then be used to pay legal costs and to make good the breach of social and environmental obligations committed by the debtor company.

The Petroplus Law gave rise to a number of questions including what if the assets seized on the Court’s approval were subject to guarantees in favour of third parties and does the right of seizure conflict with property rights granted under the European Convention of Human Rights (see Question 7).

To our knowledge, this law has rarely been applied.

²⁴⁸ Article R. 640-1 of the French Commercial Code

²⁴⁹ Article L. 641-1, II of the French Commercial Code.

²⁵⁰ Article L. 641-4 of the French Commercial Code.

²⁵¹ Article L. 651-2 of the French Commercial Code.

²⁵² Article L. 641-10 and R. 641-18 of the French Commercial Code.

2. The liability of foreign or French parent companies as co-employer of its French subsidiary

The French *Cour de cassation* has recently upheld case law developed by the lower Courts under which parent companies, foreign or French, may be held liable for the redundancies of employees of their underperforming subsidiaries as a “co-employer”.

The French *Cour de cassation* laid down three criteria for considering whether a parent company may be a “co-employer”: (i) an interest in the subsidiary (for example, an 80% holding in the subsidiary’s share capital or a lack of real autonomy by the subsidiary); (ii) activities (for example, the parent and the subsidiary being involved in the same business activity); and (iii) shared management (for example, one or more directors sitting on both the parent’s and the subsidiary’s board).

The most debated cases were *Jungheinrich*, *Jungheinrich A.G*, *Jungheinrich Finance Holding* and *Aspocomp* in 2011, in which the *Cour de cassation* challenged the principle that companies are separate legal personalities. (This case law is especially relevant in the context of jurisdiction and applicable law in a cross-border scenario under Article 19 of the EC Regulation n° 44/2001 dated 22 December 2000, which provides that the “employer” can be brought before the tribunal where the employment was usually performed). Elevating the notion of “employer” to that of “co-employer” has never been referred to or upheld by the CJEU.

More recently, the *Cour de cassation* restricted its own case law in various decisions and ruled that the coordination of economic action between various companies of the same group, the economic domination resulting from the membership to a group, the fact that the managers of the subsidiary are employees of other group companies and that the group has funded the redundancy plan do not suffice to characterize a co-employment situation.

3. The introduction of “prepacks” in French insolvency law

The introduction of pre-packs in French insolvency law may impact the nature and purpose of either judicial reorganisation or liquidation proceedings, which could be used in some instances essentially as a conduit for the sale of businesses organised in prior pre-insolvency proceedings, rather than proceedings per se (See 2.5.1.5 and also 1.6 of the Appendix).

The information provided in this country chapter is correct as at 15/05/2016

GERMANY

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Identification of Directors

The position of a director is clearly defined in German corporate law setting forth that directors are individuals who were appointed by a shareholders' resolution (in the case of a company with limited liability) or a supervisory board resolution (in the case of a stock corporation). Although it is only of a declaratory nature, the directors are required to file their appointment with the commercial register of the competent local Court.

De facto directors may, however, actually govern and control the management of the company and, therefore, may be deemed to be acting in a directorial capacity with the same duties and liabilities as the appointed directors (see 3.2.1 below).

1.2 Directors' liability

The concept of personal, civil and criminal liability of directors of German corporations (either a company with limited liability (GmbH) or a stock corporation (AG)) is based upon the limited liability of German corporations *vis-à-vis* its creditors. In the absence of personally liable partners, German corporations are not only limited in terms of personal liability of the shareholders but also in terms of the assets available in the company for distribution to the creditors. Consequently, German corporate and insolvency law provides for several rules relating to the contribution and the subsequent maintenance of the capital in German corporations. Furthermore, even more stringent duties, responsibilities and liabilities are imposed on directors once the assets of the company deteriorate, i.e. should the company encounter financial difficulties. Access to information by the creditors with respect to the financial situation of the company is restricted.

This corresponds with the director's duty to be completely aware of the financial situation of the corporation at all times. Thus, any liability arising during the twilight period is mainly imposed on the directors of the corporation, who are the so-called legal representatives of the corporation. The monitoring duties of directors are less intensive if the distressed company is not a corporation but a partnership consisting of at least one personally liable partner. In this event, any duties, responsibilities or liabilities outlined in this chapter only apply to a limited extent unless the personally liable shareholder or partner is a company which itself has limited liability.

The German Federal Court has no sympathy for directors lacking knowledge of the company's financial situation and not heeding warning signs concerning the company's deteriorating financial situation. Thus, the essential duties in the twilight period apply to directors irrespective of whether they: (i) reside abroad; (ii) have an engineering instead of a commercial background; or (iii) act as a chairman of the supervisory board rather than as a manager of the ordinary daily business. This "ideal world" approach indicates the stringent duties imposed on directors during the twilight period. Generally, financial difficulties of the company do not give rise to liabilities for the shareholders or supervisory board members *vis-à-vis* third parties. Shareholders or supervisory board members are not even entitled to act on behalf of the company (unless they are also directors of the company). In addition to the appointed and registered directors, German corporate law does not recognise the concept of non-executive directorship, so that generally all appointed directors face the same degree of liability.

1.3 “Illiquidity”, “deficit balance” and “over-indebtedness” as key indicators for the twilight period

The start and duration of the twilight period does not depend on whether a formal insolvency procedure is instituted. Contrary to other European laws (for example, the laws of the United Kingdom, which rather vaguely refer to where a director “knew or ought to have concluded that insolvent liquidation is inescapable”), German Courts and literature have established explicit methods by which prerequisites indicating the start of the twilight period will be determined, such prerequisites being illiquidity (i.e. negative cashflow 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, for example, the English “wrongful trading” concept designed to ensure that “directors do everything possible to minimise the potential loss to creditors in anticipation of an insolvent liquidation”).

Illiquidity and over-indebtedness are regarded as “absolute bankruptcy reasons” resulting in an obligation on the directors to petition for the commencement of insolvency proceedings, while impending illiquidity only gives rise to an option to do this.

Since illiquidity and over-indebtedness are so-called “indefinite legal terms”, regulators, Courts and German literature have endeavoured to find a precise definition which will determine the start and end of the twilight period.

1.4 Determination of the twilight period

1.4.1 Illiquidity

The German Insolvency Code stipulates that a debtor is illiquid if he is unable to honour payment obligations when due. Illiquidity will generally be deemed if the debtor has ceased to make payments (*prima facie* evidence).

The German Federal Court refers to specific circumstances, according to which it will be presumed a company has ceased to make payments, such as:

- a declaration by the director of the inability to honour future obligations;
- closing of the business;
- non-payment of significant operating costs, such as wage-related costs;
- execution of claims against the company.

These warning signs should be easily recognised by the directors.

However, as a result of an exception made by the German Federal Court, a debtor who is unable to pay less than 10% of its aggregate liabilities for a period of three weeks should not be regarded as being illiquid unless it can already be seen that the shortfall will exceed 10% in the near future.

If the shortfall amounts to 10% or more, illiquidity would be presumed unless, in exceptional circumstances, there is certainty or near certainty that the shortfall can be removed in the near future. However, to make use of the exception it must be deemed acceptable for the creditors to be paid with such a delay.

This exception is relevant to the duty to petition for the commencement of insolvency proceedings. In view of the potential criminal and civil liability, consulting an expert to clarify whether the debtor is illiquid or not is recommended as well as entrusting such expert with a liquidity balance.

1.4.2 Impending illiquidity

Impending illiquidity will be deemed to exist if a company is presumed to be unable to honour existing payment obligations when they become due. As mentioned above, minor shortfalls and an inability to pay less than 10% of the aggregate liabilities are not considered to be indicators of impending illiquidity.

Unlike existing illiquidity and over-indebtedness, impending illiquidity does not impose an absolute obligation on the directors to petition for the commencement of insolvency proceedings. German insolvency law has introduced impending illiquidity as an option to petition for insolvency proceedings in order to enable directors to initiate reorganisation measures, in particular the implementation of a pre-packaged reorganisation plan at an early stage of insolvency proceedings. Such a petition might be combined with a motion for a self-management order, which is derived from the concept of a “debtor in possession”. According to experience with the former German Bankruptcy Code, corporate recovery measures have frequently been interfered with by creditors executing claims by seizing the assets of the estate required to maintain and continue with the business. Following the filing of a petition for the commencement of insolvency proceedings based on impending illiquidity, protective orders by the Court may enjoin acts of execution on the debtor’s assets. However, German insolvency Courts have been reluctant to make orders for self-management due to the lack of reliability of those directors who may have caused the financial crisis of the company through mismanagement in the first place.

With respect to criminal liability, impending illiquidity in addition to already existing illiquidity and over-indebtedness is a constituent element of criminal offences pertaining to insolvency in the German Criminal Code and, therefore, indicates the start of the twilight period from a criminal law perspective.

1.4.3 Over-indebtedness

While a deficit balance (loss equal to one half of the company’s share capital), obliges the directors to convene a shareholders’ meeting (see 2.1.1 below), the over-indebtedness of a company is an absolute reason for immediately petitioning for insolvency proceedings.

Such over-indebtedness is not necessarily only reflected in the ordinary year-end balance sheet, but it may result from a special “over-indebtedness status”. Generally, directors are obliged to monitor the financial situation carefully and institute control devices such as the preparation of monthly interim balance sheets as soon as certain warning signs that the company is experiencing financial difficulties have been revealed, for example, a significant loss of share capital.

In the event that an (interim) balance sheet shows over-indebtedness, the directors have to prepare an “over-indebtedness status” in order to verify whether or not the company is actually over-indebted. Such status either has to show the assets at their going concern values or their liquidation values. In a first step, the assets are evaluated based on liquidation values. Provided there is a “positive continuation prognosis”, the directors may evaluate the assets on the basis of the company continuing as a “going concern”. The positive continuation prognosis requires that a detailed and clear medium-term business plan shows that, in operative business and financial matters, the company can survive and prosper in such a way that, during this period, an illiquidity of the company will not occur. Furthermore, it is not sufficient for the directors to simply accept the prognosis as correct and the results of the planning as “most probable”. German Courts have always held that managers must seek the advice of independent external experts with respect to such a prognosis. These experts must be convinced, to the same extent as the management, that a positive continuation prognosis exists. In the event that an “over-indebtedness status” based on going concern values still shows a negative equity, the company must be regarded as over-indebted and this actual over-indebtedness will trigger the obligation to immediately petition for insolvency proceedings.

However, the over-indebtedness test does not apply to cases where there is a “going-concern” prognosis for the business. This means that a company will not be regarded as over-indebted if there is a sufficient likelihood (more than 50%) that the company will stay cashflow solvent until the end of the next business year.

1.4.4 End of the twilight period

As a result of the commencement of insolvency proceedings, the directors’ right to manage and deal with assets of the company will pass to the insolvency administrator. Although the directors will still be registered with the commercial register, their power to act on behalf of the company will have practically ceased to exist. Thus, the directors can no longer be held liable for a breach of rules aimed at the protection of creditors.

In the event that the petition for the commencement of insolvency proceedings is rejected because the assets available in the estate are not sufficient to cover the costs of the insolvency proceedings, the insolvency Court will terminate any protective measures ordered so far, including any restrictions on the directors to dispose of the company’s assets. Consequently, the directors will regain control of the company. Since the order rejecting the commencement of insolvency proceedings leads to the dissolution of the company, the directors are now deemed liquidators who are responsible for the winding-up of the company without formal insolvency proceedings. This so-called “lack of assets liquidation” is not governed by any specific rules additional to the rules pertaining to the “ordinary” voluntary liquidation of companies, which are based on the assumption that the assets are sufficient to satisfy all creditors. Since the German Insolvency Code is not applicable outside formal insolvency proceedings, it is debatable whether directors are bound by the insolvent principle of equal treatment of creditors. In practice, the termination of protective measures ordered by the Court, namely the prohibition on execution against the debtors’ assets, will result in the lifting of the temporary restraint on execution by creditors, thereby preventing a *pari passu* distribution of assets to creditors.

1.5 Summary

The following diagram illustrates the start and duration of the twilight period in terms of civil and criminal liabilities of directors and voidability of actions (see further question 4 below).

Transactions vulnerable to being set aside	- Impending illiquidity - loss equal to one-half of the share capital	Over - indebtedness or illiquidity	Duty to petition for insolvency proceedings	Commencement of proceedings or rejection of petition due to an insufficient estate	Final liquidation (winding-up) within or without formal insolvency proceedings
Early stage of financial difficulties (up to ten years prior to petition in the event of actions intentionally harming creditors)		three week deadline to remove absolute insolvency reasons	Interim insolvency proceedings (usually up to three months)		

QUESTION 2

2. Actions potentially giving rise to liability for directors

- (a) In respect of which acts during the twilight period may a director be held personally liable or which may otherwise have adverse consequences for the director?
- (b) In relation to each act identified in (a) above:
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement?
 - (iv) Is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director? and
 - (v) What defences, if any, will be available in relation to each offence?

2.1 Criminal and civil liability

The German Civil Code provides that any person who violates a statute intended for the protection of others (protection statutes) is bound to compensate the injured party for any damage arising as a result. Any criminal statute aimed at the protection of property is deemed to be such a protection statute. Statutes which provide for the protection of creditors of a distressed company attach personal liability to directors, who are required to compensate for losses resulting from a breach of the protection statute. The following duties, directed solely against directors of a distressed company and resulting in criminal as well as civil liability, can be found in German Corporate law and the German Criminal Code. A summary of each is considered in turn.

2.1.1 Duty to convene a shareholders' meeting

Pursuant to the German Companies with Limited Liability Act and the German Stock Corporation Act, directors have the duty to convene a shareholders' meeting in the event that, upon preparation of an annual or interim balance sheet, it becomes apparent or it must be assumed by reasonable belief that the company has incurred a loss equal to one-half of its share capital. However, liability does not occur automatically with the existence of a balance sheet deficiency. Directors must constantly monitor the financial situation of the company. An action may be brought by the company seeking compensation for damages which could have been avoided by resolutions or measures which would have been adopted by a shareholders' meeting if such meeting had been convened.

2.1.2 Duty to petition for the commencement of insolvency proceedings

In practice, the most important civil and criminal liability of directors results from a failure to petition for the commencement of insolvency proceedings. Directors of a German company with limited liability, a German stock corporation, or a German partnership which consists only of companies with limited liability, have an absolute duty to petition for the commencement of insolvency proceedings without undue delay, but not later than three weeks after the occurrence of illiquidity or over-indebtedness. (See section 1.4.3 regarding the suspension of the over-indebtedness test in case of a positive cashflow prognosis.) In addition to criminal sanctions, directors will face civil liability to compensate the company, as well as the creditors of the company, who suffer loss caused by the failure of the directors to file the petition in due time.

In addition, a shareholder is under a duty to petition for the commencement of insolvency proceedings if there are no directors or the whereabouts of all the directors are unknown. In that event, the same criminal and civil liability will arise for shareholders as for directors.

2.1.2.1 *Liability vis-à-vis the company*

The Corporate law provisions impose a duty on directors to compensate the company for any payments made after illiquidity has occurred or over-indebtedness was discovered. This does not apply to payments which were consistent with the due care of a prudent businessman.

2.1.2.2 *Liability vis-à-vis the creditors*

The German Federal Court has established a rather complex method to ascertain the loss suffered by a creditor. In calculating the compensation, one has to distinguish between creditors already having claims against the company at the time the petition had to be filed (old creditors) and creditors who have entered into business relations with the company after that time (new creditors).

Assuming that the directors had filed the petition in time, the old creditors would have received a pro-rata distribution based on the assets available at that time. Thus, the total loss suffered by the old creditors has to be calculated by way of a comparison between the assets actually available in the insolvency estate and the assets which would have formed part of the estate if the directors had filed the petition in time. Since the new creditors would have been refrained from entering into business relations with a company subject to insolvency proceedings, their loss encompasses the general interest in the agreement. Such loss is probably significantly higher than the loss suffered by the old creditors. For example, a bank granting an overdraft to the company has to be treated as a new creditor in the amount of the asset portfolio being increased after the time the petition was required to be filed.

In addition, the German Insolvency Act enables an action to be brought by any person who has made an advance payment in order to avoid the petition for the commencement for insolvency proceedings being denied by reason of insufficient assets available in the insolvency estate. Compensation in such cases comprises the reimbursement of any advanced payments.

2.1.3 *Liability vis-à-vis social security authorities*

The German Criminal Code imposes sanctions on directors who intentionally fail to transfer social security contributions of employees to the social security authorities. The predecessor to the German Criminal Code expressly stated that directors would only be liable in the event that they failed to transfer social security contributions that had actually been deducted and withheld from wages. The new statute no longer requires such deduction and withholding.

The German Federal Court has now expressly confirmed that the wording of the statute has to be strictly applied. With this ruling, the German Federal Court increased the directors' responsibilities *vis-à-vis* social security authorities significantly. A conflict of duties may arise if directors are obliged to transfer social security contributions while they may incur personal liability if they initiate any payment following illiquidity and/or over-indebtedness (see 1.3).

However, the German Federal Court ruled that a director transferring social security contributions of employees to the social security authorities or income tax to the tax authorities following illiquidity and / or over-indebtedness applying the "due care of a prudent businessman" will not incur personal liability.

Furthermore, the German Federal Court also lifted such payment duty for the three-week filing period (directors who do not transfer social security payments within this period do not incur a penalty either).

Notwithstanding the above, a criminal offence will only be deemed in the event that directors fail to transfer the contributions despite funds being available or fail to arrange for safety precautions for the payment of employees' contributions when indications of illiquidity appear and tacitly accept that the contributions cannot be transferred subsequently.

With respect to civil liability, a director is required to pay compensation for the damage arising as a result of the failure to transfer social security contributions in the amount of the social security contributions not transferred.

2.1.4 Fraud

Criminal and civil liability due to trading fraudulently will attach to directors who incur further credit by way of entering into agreements with suppliers or lenders in the twilight period pretending that the company is solvent. Furthermore, long-term agreements during the course of which up-front payments by the purchaser are customary have to be carefully considered by the directors if they are aware of an impending insolvency situation at the time of the conclusion of the agreement and therefore anticipate insolvency proceedings in the near future. Civil liability of directors will be deemed by the German Federal Court in the event that a supplier has been induced by directors to render advance performance without directors having any prospects of being able to pay the consideration.

2.1.5 Crimes pertaining to insolvency

Crimes pertaining to insolvency, if governed by the German Criminal Code, expressly refer to the twilight period starting when impending illiquidity has already been established. Alternatively, such criminal statutes apply in the event of an actual over-indebtedness situation of the company, as set out above. Generally, such crimes relate to conduct which endangers creditors' rights. Crimes frequently committed in the twilight period by directors who desperately try to cope with the financial situation and seek to preserve the business by avoiding formal insolvency proceedings, comprise:

- destruction of or damage to assets in a commercially irresponsible manner;
- entering into speculative transactions;
- simulation of the existence of assets;
- breach of the duty to keep books and other statutes of commercial law relating to the accurate disclosure of the current financial situation and the prospect of the business in the books, in particular the balance sheet and the management report;
- endangering the rights of creditors on whose behalf the company holds assets on trust; and
- preferential treatment of creditors by granting them security or satisfaction to which they are not entitled, and thereby acting intentionally to the detriment of other creditors.

2.2 Civil liability

2.2.1 Liability arising from the causation of an insolvency situation

Generally, directors have to apply the “due care of a prudent businessman” when conducting company affairs. According to German literature, these principles will be violated in the twilight period in the event that the directors fail to respond immediately to a financial crisis by way of initiating corporate recovery measures. However, since such obligations are not precise, a claim to compensation by creditors can hardly be based on such an omission.

In contrast, MoMiG¹ creates director liability for causation of insolvency. This means that directors will be held liable for payments to the shareholders of the company by which the illiquidity and / or over-indebtedness was caused.

2.2.2 Breach of agreement / acting as guarantor *vis-à-vis* counter-parties

In exceptional circumstances directors can be held liable for obligations to be performed by the company. The director's liability in this case was based on the director being a guarantor of obligations of the company in connection with an agreement on the provision of collateral to a supplier. The director was held personally liable because he failed to ensure that the security provided by the company could finally be realised by the creditor. As far as the exploitation of personal trust of the directors is concerned, Court rulings generally require an additional personal warranty from directors to the effect that their declarations are correct. In this event, the third party relies on the reputation of the director rather than on the reputation of the represented company.

¹ *Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen* (Law for the Modernisation of the German Limited Liability Company Law and the Prevention of Misuse), which came into force in Germany in November 2008.

2.2.3 Group liability / piercing the corporate veil

Assuming that the director is also a dominating shareholder of the company, the concept of group liability might result in an obligation on the part of the controlling shareholder to compensate any annual net loss due to the misuse of its managerial power. The German Federal Court has expressly stated that the concept of “group liability” is also applicable in the event that the shareholder is a natural person and not a legal entity, 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 had conducted the business as a sole trader pursuing only his personal interests while intentionally neglecting the affairs of the company. Therefore, the natural person had to be regarded as a “dominating company” analogous to the concept of liability in a group consisting of corporations.

The doctrine of piercing the corporate veil has been changed to a concept of inducing a subsidiary into financial assistance which actually endangers its own separate economic and / or legal existence (in other words, it may have the consequence of causing the insolvency of the subsidiary), which will result in a liability in tort towards that company. By doing so, the German Federal Court has not created a new liability but rather given a new name to the concept of piercing the corporate veil. As this misuse is identified by the damnification of the company’s ability to meet its obligations, it has been named the “liability due to the annihilation of existence” (*existenzvernichtung*) or due to the so-called “existence-annihilating interference” (*existenzvernichtender eingriff*).

However, this of course does not mean that the managing director is free to refuse any demand to make upstream payments. The managing director needs to undertake cash-flow planning that ensures the survival of the entity, but the shareholder is free to instruct the managing directors to limit any non-essential spending (such as cap-ex and other items) to an absolute minimum to free up liquidity for up-streaming.

The absolute outside boundary is the criminal liability of management for payment of social contributions, which means that the managing director has to ensure in his cashflow planning that sufficient funds are available for the payment of due and payable social contributions. With this exception, there appears to be no general duty of the managing director to build up liquidity reserves because the managing director is afforded broad discretion in conducting the business. However, in general a breach of the standard of a prudent business manager in handling the company’s affairs may lead to civil and criminal liability of a managing director if he acts wilfully or negligently in spending cash which triggers the cash-flow insolvency of the company. In contrast, a simple management failure of the managing director will not result in any liability towards the company.

Furthermore, there is no liability towards creditors, only towards the company.

2.2.4 Breach of the capital maintenance rules

The capital maintenance rules of the German Companies with Limited Liability Act are aimed at the preservation of the assets required to maintain the registered share capital and such assets may not be distributed to the shareholders. Any distribution of assets to shareholders during the twilight period will most likely constitute a redemption of share capital. The repayment of a shareholder loan is not a violation of the capital maintenance rules. However, the directors must not make any payment to the shareholder if such payment will lead to the illiquidity of the company. The directors of the company are personally liable *vis-à-vis* the company to the extent that assets are distributed to shareholders in breach of such capital maintenance rules. This also applies to cash pool payments to affiliated companies, which comprise the assets required to maintain the registered share capital.

2.3 Liability *vis-à-vis* tax authorities

2.3.1 Obligation to transfer deducted wage taxes

The directors are obliged to deduct wage taxes from the gross amount of wages and to subsequently transfer the deductions to the tax authorities. Since tax deductions from wages are regarded as money held on trust for the benefit of the tax authorities, failure to transfer such money leads to personal liability of the directors. In the event that the cashflow is not sufficient to pay the gross amount of wages, the directors are obliged to reduce wage payments to the extent that the wage taxes calculated on the basis of the reduced gross amount of wages can be paid to the tax authorities.

2.3.2 Preference of other creditors

Generally, company creditors must be treated equally by the directors during the twilight period. As regards outstanding taxes, the directors are personally liable to the extent that other creditors have been preferred to the detriment of the tax authorities. In the twilight period, directors are required to satisfy the claims of the creditors equally on a pro rata basis in the event that the funds are not sufficient to completely satisfy all creditors.

2.4 Liability in proportion to specific involvement

The rules of procedure, respective service contracts or any oral agreement frequently provide that directors with an engineering background are primarily responsible for technical matters while financial matters are mainly covered by economists. The engineering-related directors may not be completely aware of the current financial situation of the company. Despite this, neither German corporate, commercial nor criminal law, which govern the specific duties, responsibilities and liabilities of directors, expressly attach liability pro rata to their specific involvement, nor do they allocate liability to a specific sphere of responsibilities or areas of practice. Moreover, directors are also responsible for another director's breach of duties, so that in practice each director has to use due diligence not only in his own affairs but to ensure that the other directors also meet the requirements to the same degree.

However, these principles are not consistently applied, so that a defence, such as the allocation of spheres of responsibility to other directors, might be available. In particular, the German Criminal Code requires intentional conduct unless expressly negligent conduct is subject to criminal sanction. Generally, intentional conduct can only be allocated to directors who actually fail to comply with the respective duty. In addition, intentional conduct might be deemed in the event that other directors of the managing board are completely aware of the omission of the other responsible director. Furthermore, Court rulings have imposed a supervision duty on the other directors with respect to the compliance of the director actually in charge of the relevant financial matters.

The following show whether liability will be attached according to the breach of specific duties by the respective director, or whether any director of the management board will face liability irrespective of his involvement.

2.5 Defences

2.5.1 Transactions to the benefit of the company

Defences regarding any reasonable belief of a director that a transaction is to the benefit of the company, are only available if the statutes establishing the liability have a subjective element. This applies to some statutes in the Insolvency Act governing the voidability of transactions (see below).

Furthermore, that belief might exclude the assumption of intentional behaviour as required in the Criminal Code. As far as statutes intend to protect specific counterparties, ie as public authorities or creditors dealing with an already illiquid company, that defence is not available.

Actions giving rise to liability	Liability of management board members
Duty to convene a shareholders' meeting	Joint liability
Duty to petition for the commencement of insolvency proceedings	Joint liability Liability of shareholders in case of a company without management in place.
Liability <i>vis-à-vis</i> social security authorities	Liability is allocated to directors who actually fail to transfer the social security contributions, or who were completely aware of the omission of the other responsible director.
Fraud / crimes pertaining to Insolvency	Liability is allocated to directors who actually commit the crime or who have been completely aware of the crime.
Liability arising from causing insolvency proceedings	Joint liability
Breach of agreement	Joint liability
Piercing of corporate veil	Joint liability
Breach of the capital maintenance rules	Liability of shareholders also Joint liability; at least negligence of each director required.
Liability <i>vis-à-vis</i> tax authorities	Liability is allocated to directors who actually fail to transfer the taxes provided that: (i) the allocation of duties was to be made in written form and was to be clear cut; (ii) the responsible director is reliable; and (iii) the other directors properly supervised the responsible director.

2.5.2 No default in case of qualified external consulting

A director will not be liable for payments made after the illiquidity of the company where there has been qualified external consulting. This means if the director consulted an external expert, informed him about all the circumstances relevant to the evaluation and did not petition for the commencement of insolvency proceedings in accordance with the expert's evaluation and his own validity check, that he cannot be held liable.

2.5.3 Actual involvement

As set out above, directors, irrespective of their actual involvement in financial matters and their sphere of responsibilities, must be generally aware of the company's current financial situation at all times. The German Federal Court has held that the defence of lack of knowledge of the company's insolvency situation will only be available if such lack of knowledge is not caused by the directors' negligence in exercising their observational duties and instituting financial control systems.

2.5.4 Return to solvency

The financial crisis of any distressed company need not be permanent but may be temporary. Any duties and responsibilities are related to an insolvency situation so that solvency at the time of the transaction cannot result in a liability of directors unless impending illiquidity had to be assumed. Generally, solvency after the transaction does not remedy the breach of duties. In the event of a sustainable financial recovery, enabling the company to fully satisfy any claims of creditors, it is unlikely that any criminal prosecution or civil action based on a past insolvency situation would be commenced. One exemption is with respect to the breach of capital maintenance rules. The German Federal Court held that a return to solvency would not cure the breach and any liability. Similarly, criminal proceedings may even be initiated in the event that creditors did not actually suffer any losses because most of the crimes pertaining to insolvency will be regarded as “abstract strict-liability torts”.

QUESTION 3

3. Other persons involved with the company’s affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company’s activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified under question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?

3.1 Civil and criminal liability of accomplices and participants

As a general rule, the liability of other persons involved with distressed companies can be based upon breaches of statutes of German law, as set out above, if they were accomplices to or participants in the breach. German civil law imposes joint and several liability on persons who are jointly liable for damages irrespective of their degree of involvement, while German criminal law allows reducing the punishment of an aider and abettor. In addition, German civil law provides for joint and several liability even if it cannot be determined 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

As stated in 1(a), 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). *De facto* directors may, however, actually govern and control the management of the company and, therefore, may be deemed to be acting in a directorial capacity. The German Federal Court is not inclined to regard any person (partially) involved in the management of the company as a *de facto* director given that the company will still be managed by the duly appointed and registered director. Moreover, not even management to the same extent and degree as exercised by the registered director would constitute a *de facto* directorship.

To establish liability as a *de facto* director: (i) the *de facto* director must be regarded as having conducted the business of the company decisively; (ii) with his own actions *vis-à-vis* the outside world / third parties.

3.2.2 Former directors

Directors' liability is based on conduct exercised during the period of their directorship, so that even former directors may face liabilities regarding their directorship. The German Insolvency Code also provides that former directors who have resigned or otherwise left the position of a director not earlier than two years prior to the commencement of insolvency proceedings, owe the same duties of information and co-operation towards the insolvency administrator as persons who are still directors at the time of the insolvency proceedings.

3.2.3 Supervisory board members

In addition to the Management Board members, Supervisory Board members frequently conduct the company's affairs during the twilight period. "Dominating" Supervisory Board members who tend to have a material influence on the company management, e.g. by way of exercising typical management duties, run the risk of being treated as de facto directors according to the principles set out above.

Furthermore, Supervisory Board members may face liability *vis-à-vis* the company if they fail to exercise the due care of a prudent businessman during the twilight period. Supervisory Board members may also be liable for any delay in petitioning for the commencement of insolvency proceedings. In this respect, the following will be regarded as a breach of duties:

- non-compliance with the more stringent supervising requirements in the event of a financial crisis of a GmbH;
- failure to seek advice by independent experts; and
- failure to instruct and to urge the managing directors to petition for the commencement of insolvency proceedings in the event of an insolvency situation.

3.2.4 Creditors / financing banks

Two key issues continually arise when considering unconnected third party risks providing additional credit during the twilight period. First, how safe is it for an unconnected third party in terms of criminal liability to encourage directors to continue with the business despite an insolvency situation by way of providing further (short-term) credit, thereby enabling the directors to meet the most urgent payment duties? Second, can an unconnected third party rely on security granted by the distressed company in order to secure loans granted during the twilight period?

The granting of loans at a time when the company would be insolvent without such loan may result in a violation of the director's insolvency-filing duties. This might be regarded as participation by the lender in the crime of delaying the petition for insolvency proceedings committed by the directors. Therefore, the lender has to act with the intention of improving his position to the disadvantage of third-party creditors of the distressed company. Such intention to harm third-party creditors will be presumed in any case where the lender thinks that damage to the other creditors is possible and accepts the possibility of such damage. If the lender fails to properly verify the viability of the distressed company's restructuring plans (or disregards serious doubts about such restructuring plans), the intent (*dolus eventualis*) to damage creditors may be presumed.

With respect to the civil liability of the lender, it has to be evaluated whether the granting of a loan secured by the transfer of assets of the distressed company to the lender, finally resulted in a deterioration of the assets of the distressed company compared to the assets available in the insolvency estate in the event that a petition for the commencement of insolvency proceedings would have been filed at the time of granting the loan.

The voidability of a transfer of assets of the distressed company for security purposes will also be discussed in connection with lending strategies of banks. In particular, in the event of so-called bulk securities, such as the assignment of trade receivables of the distressed company, it might be more reasonable from the commercial perspective of the lender to grant further loans or prolong existing loans in order to enhance the value of the assigned trade receivables rather than to cease funding the borrower, which would result in a deterioration of assigned trade receivables because of counter-claims filed by the customers due to the impact of the commencement of insolvency proceedings and the termination of the business of the distressed company.

Thus the granting of a loan to a distressed company is connected with several risks to third parties. In order to minimise these risks the third party needs to obtain proof that the company is expected to be able to overcome the crisis with its help before granting a restructuring credit (*sanierungskredit*). Therefore, the prospects of a successful restructuring need to be examined carefully. One way of providing the necessary proof is by obtaining independent third-party advice in this respect. As a result of various decided cases, market practice has developed whereby the debtor's plans are reviewed for the lenders by an independent third party in a so-called "restructuring opinion". The German association of advisors (IDW) has developed a standard (so called IDW S6) for such restructuring opinions. The major principle of such standard will be applied by the German Court when reviewing a restructuring opinion in a litigation. However, the lenders themselves must be convinced as to the validity of the restructuring plan.

Furthermore, the basis of the decision to lend will be a restructuring plan (*sanierungsplan*) prepared by the management of the debtor which reflects the reasons for the existing crisis and the measures to be implemented to overcome the crisis. In particular, an audit of the restructuring plan has to reach the conclusion that there is a going concern, i.e. a positive continuation prognosis (*positiv fortführungsprognose*) for the company's business at least up to the end of the following fiscal year. This restructuring plan should be reviewed by an independent expert as to its plausibility (also as regards the assumptions made by the management of the debtor in the restructuring plan). Following that review, the expert should confirm in the restructuring report to the lenders that there is a going concern forecast, i.e., a positive continuation forecast for the debtor's business at least up to the end of the following fiscal year. In particular, the experts should express the opinion that the financial position of the distressed company is, on a balance of probabilities, likely to be strong enough for the distressed company to continue its business as a going concern up to the end of the following fiscal year and that the business can be restructured (*sanierungsfähigkeit*).

Accordingly, if lenders fail to properly observe these criteria, they could be held liable under the deepening insolvency doctrine.

If lenders are held liable under the concept of deepening insolvency, their loan facility, insofar as it is related to new money, would be held invalid as a matter of German law. Further, the new money-lenders could be held liable by any new creditors of the debtor for the full amount of the loss suffered by those creditors in the insolvency. The new lenders could also be held liable by any old creditors, but only to the extent that the payout that such creditors receive in the insolvency is less than it would have been if the debtor had filed for insolvency at the time the second lien lenders provided the funding.

Furthermore, there are instances where short-term liquidity needs arise and no final restructuring plan and / or report is yet available. In that case, there can be a short extension of facilities or a granting of new money in order to avoid an illiquidity of the debtor during the time required for the plan and / or report to be formulated and finalised (usually approximately three months). New loans granted during such period, which bridge the liquidity situation until the finalisation of the restructuring plan / report, will not be regarded as delaying the insolvency.

3.3 Scope of liability

In general, the other persons involved with the company's affairs may be liable for all or part of the deficit to creditors which results from the violation of their duties in the twilight period. The deficit to creditors will be determined by way of comparison to what their financial position would have been had the other persons not violated their duties.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?**
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?**
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?**

4.1 Transactions potentially subject to an action to set aside**4.1.1 General rule / heads of challenge**

Transactions to the detriment of creditors effected prior to the commencement of insolvency proceedings might be subject to an action to set aside. Transactions will be deemed as detrimental if either the liabilities of the debtor in insolvency proceedings have been increased or the assets available in the insolvency estate have been reduced.

The legal term "transactions" encompasses all acts which either gave or made it possible for a counterparty dealing with the distressed company to receive security or satisfaction. The German Insolvency Code distinguishes between:

- (i) congruent correspondence;
- (ii) incongruent correspondence;
- (iii) directly detrimental transactions;
- (iv) intentionally harmful actions;
- (v) performance without consideration; and
- (vi) redemption of shareholder loans,

as potential heads of challenge. For each transaction, a different time limit in respect of voidability is applicable. The time limits cover transactions which are effected in the month prior to the petition for commencement, as well as transactions which are effected after such petition (in the event of merely incongruent correspondence) up to transactions effected 10 years prior to the petition for commencement (in the event of intentionally harmful actions).

From the point of view of a counterparty dealing with the company during the twilight period, it is decisive whether:

- (i) the counterparty had knowledge of the illiquidity of the company at the time of the transaction;
- (ii) the creditor had knowledge of the petition for commencement of insolvency proceedings at the time of the transaction;
- (iii) the creditor had equivalent knowledge of circumstances which compel the conclusion with respect to the illiquidity or the petition for commencement of insolvency proceedings;
- (iv) the counterparties are persons related to the distressed company and, therefore, will be deemed as having such knowledge;
- (v) the counterparty had knowledge of circumstances which compel the conclusion that the transaction was detrimental to the insolvency creditors;

- (vi) the counterparty had knowledge of the intent of the distressed company to harm its creditors (such knowledge will be presumed if the counterparty had knowledge of an impending illiquidity and of the fact that the transaction was harmful to creditors); and
- (vii) the counterparty received any performance without payment or any other consideration.

4.1.2 Voidability of transactions outside of insolvency proceedings

Any of the creditor protection measures outlined above are applicable even if formal insolvency proceedings are not commenced following the twilight period. Such voidability of transactions is governed in a separate statute (the Avoidance Act (*Anfechtungsgesetz*)). Any claim must be filed by a creditor and not by an insolvency administrator. If execution against the assets of the debtor will not result in complete satisfaction of the creditor, or it has to be assumed that any execution will not be successful, the creditor is entitled to file an action to set aside. Certainly, the time period in which an action might be attacked cannot refer to the petition for the commencement of insolvency proceedings. Therefore, whether the transaction has to be exercised by a creditor with the competent Court within a specific time period prior to the filing of an action to set aside, is decisive.

4.2 Defences

4.2.1 Benefit to the company ensuing from the transaction

A defence, such as the assumption of the parties that the transaction would be to the benefit of the company, is only permissible if the transaction was also of benefit to the company's creditors. In determining whether or not any transaction was to the benefit of creditors, only the assets of the insolvency estate available for distribution to creditors will be considered. If any transaction entered into during the twilight period resulted in the granting of security of satisfaction to a creditor who could not claim security or satisfaction at that time (since he was merely an ordinary or even subordinated creditor), the transaction will not be regarded as of benefit to creditors in subsequent insolvency proceedings.

4.2.2 Lack of knowledge of the company's insolvency position

As far as any transaction requires:

- (i) knowledge of the illiquidity situation; or
- (ii) knowledge of any circumstances that compel the conclusion as to the illiquidity situation; or
- (iii) that the creditor had knowledge that the transaction was detrimental to the insolvency creditors, or knew of circumstances that compel the conclusion in this respect,

any lack of knowledge of the financial situation of the company by the creditor has to be regarded as a permissible defence.

4.2.3 Solvency of the company at the time of or after the transaction

Since any action entered into prior to the commencement of insolvency proceedings might be subject to an action to satisfy, the German Insolvency Code does not refer to an insolvency situation at the time of or after the transaction, but refers to a specific time period which leads to the conclusion that the company is in the twilight period, irrespective of whether or not the company was solvent at the time the transaction was entered into.

4.2.4 Other defences

Transactions by the debtor with the intent of harming its creditors entered into within 10 years prior to the petition for the commencement of insolvency proceedings, can be challenged. Therefore, a lack of intent to prefer a creditor has to be regarded as a permissible defence in this respect. However, since the German Insolvency Code does not require any intent to prefer creditors with respect to the remaining potential heads of challenge, but rather considers mere knowledge of the illiquidity situation of a company by the creditor who benefits from the transaction as sufficient, the defence of a lack of intent to prefer is limited.

4.3 Incurring further credit during the twilight period

Further credit can be incurred if there is a sufficient likelihood that the company - with the support of the credit - remains solvent and can be restructured (*sanierungsfähig*). See 3.2.4 above.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Creditors / shareholders / public authorities / other third parties

Civil actions against directors will generally be brought by parties suffering damage due to a breach of duties, irrespective of whether they are suppliers, lenders, shareholders or third parties dealing with the company. In addition, tax authorities and social security authorities may file claims arising from the failure of the directors to transfer taxes and social security contributions.

Shareholders liable to make contributions to the insolvency estate cannot reasonably claim compensation from the directors since their civil liability is normally based upon: (i) a breach of the capital maintenance rules by way of a prohibited redemption of contributions; or (ii) a misuse of managerial power in favour of the controlling shareholder. Consequently, shareholders are only liable in the amount of the received payments to which they were not entitled.

5.2 Insolvency administrator as office holder for the insolvency estate

5.2.1 Joint damages of creditors

Upon the commencement of formal insolvency proceedings, the German Insolvency Code states that claims for damages by creditors who have suffered jointly and severally as a result of a reduction in the insolvency estate (joint damages), may be submitted only by the insolvency administrator during the insolvency proceedings. As outlined above (see 2.1.2.2 above), in the event of a delay in the presentation of the petition for commencement of insolvency proceedings, such joint damages will be suffered by the old creditors, since the diminution in the insolvency estate will lead to a reduction in the *pro rata* distribution of the assets of the insolvency estate. In contrast, the new creditors do not suffer joint damages due to a reduction of the insolvency estate, but have claims to the negative interest resulting from the respective agreement. Consequently, according to prevailing opinions in legal literature, such individual damages have to be assessed according to the respective agreement and, therefore, can only be claimed by the respective creditor.

5.2.2 Enforcement of claims by the insolvency administrator

Upon commencement of the insolvency proceedings, only the appointed insolvency administrator is entitled to represent and act on behalf of the company. Therefore, claims of the company, whether or not they already existed at the time of the commencement of the insolvency proceedings (even before the start of the twilight period), or those which arise following the commencement of the insolvency proceedings in the course of the continuation of the company's business, can only be enforced by the insolvency administrator. Further, only the insolvency administrator is entitled to avoid 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. Since a German corporation (such as a company with limited liability or a stock corporation) will be dissolved upon the commencement of insolvency proceedings (unless the shareholders resolve to continue the company following a successful implementation of a reorganisation plan), the insolvency administrator will not be regarded as an office holder for the company, but will represent the insolvency estate comprising the assets belonging to the company at the time of the commencement of the proceedings as well as those acquired during the course of the insolvency proceedings.

QUESTION 6

6. Remedies available

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

6.1 Introduction

A German civil Court will order directors to pay compensation to the party who suffered the damage, while a German criminal Court will sentence the directors to imprisonment or fines in accordance with the level of personal culpability. As to civil liability, compensation 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 third party dealing with the company. Transactions that are successfully challenged by the insolvency administrator will result in a Court order to return the assets to the insolvency estate. Since the German Insolvency Code provides for a detailed ranking of pre-petition claims and administrative claims, an order postponing debt owed by a company to that of other debts, is not required.

6.2 Overview

Actions giving rise to liability	Legal consequences / orders available to the Court
Duty to convene a shareholders' meeting	Compensation payable by directors to the company (civil liability). Up to three years' imprisonment or fine.
Duty to petition for the commencement of insolvency proceedings	Compensation payable to new creditors or to the insolvency administrator (joint damage). Up to three years' imprisonment or fine.
Liability <i>vis-à-vis</i> social security authorities	Compensation payable to authorities. Up to five years' imprisonment or fine.
Fraudulent trading / crimes pertaining to Insolvency	Compensation payable to crime victims. Up to five years' imprisonment or fine. Disqualification from acting as director for five years.
Liability arising from the causation of insolvency proceedings	Compensation payable to company.
Breach of agreement providing security	Compensation payable to creditor who was to be secured.
Group liability / piercing the corporate veil	Compensation payable to company.
Breach of the capital maintenance rule.	Compensation payable to company.
Liability <i>vis-à-vis</i> tax Authorities	Compensation payable to authorities.

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 the insolvency office-holder's investigation into the company's affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

7.1 Duty to co-operate

The German Insolvency Code imposes extensive duties of information and co-operation on the debtor company in favour of the insolvency administrator. If the debtor is a corporation, the duties apply to all members of the executive or supervisory boards. Additionally, other parties involved in the insolvency proceedings, such as creditors in possession of security or other parties to whom assets of the debtor were transferred by way of a potential voidable transaction, can be compelled to co-operate with the insolvency administrator.

Any resignation of directors coincidental with the commencement of insolvency proceedings will not result in a discharge of these duties to the insolvency Court, the insolvency administrator or the creditors' committee. Information and co-operation duties apply to any relevant person who left not earlier than two years prior to the commencement of the insolvency proceedings.

As to the level of co-operation, the German Insolvency Code states that the directors shall assist the insolvency administrator in the performance of his duties and shall make themselves available at the order of the Court for this purpose. Any duty may be enforced by the insolvency Court, ordering any director to make an affidavit to the effect that the information provided is correct and complete. Finally, the Court may force the debtor to appear and could take any director into custody if he refuses to comply with his information and co-operation duties.

7.2 Defence against self-incrimination / human rights laws

The German Insolvency Code does not recognise the defence of privilege against self-incrimination with regard to the aforementioned information and co-operation duties. Directors are obliged to disclose facts even if they are likely to result in criminal prosecution or administrative judicial remedies. However, the use of any such information in criminal proceedings requires the consent of the director.

QUESTION 8

8. Appeals and limitation periods

- (a) **What limitation period, if any, applies to the actions referred to above?**
- (b) **What rights of appeal are available from the decisions of the lower Courts.**

8.1 Limitation periods

Actions giving rise to liability	Limitation periods
	<p>a) Limitations on prosecution.</p> <p>b) Limitations on enforcement of claims.</p>
Duty to convene a shareholders' meeting	<p>a) five years from when the crime is committed.</p> <p>b) five years from the origination of the claim (does not depend on the shareholders' knowledge).</p>
Duty to petition for the commencement of insolvency proceedings	<p>a) five years from when the duty of directors to petition for insolvency proceedings ceased to exist (e.g. if over-indebtedness has been removed).</p> <p>b) claims of the company: five years from the origination of the claim (does not depend on the shareholders' knowledge).</p> <p>claims of creditors: three years from when the injured party has knowledge of injury.</p> <p>five years with respect to claims to reimbursement of advance payments made in order to cover costs of proceedings.</p>
Liability <i>vis-à-vis</i> social security authorities	<p>a) five years from when the liability to contribution ceased to exist.</p> <p>b) three years from when the injured party has knowledge of injury.</p>
Fraud / crimes pertaining to insolvency	<p>a) five years from when the duty of directors to petition for insolvency proceedings ceased to exist (example given if over-indebtedness has been removed).</p> <p>b) three years from when the injured party has knowledge of injury, unless contractual limitations statutes provide for a longer period.</p>
Liability arising from the causation of insolvency proceedings	<p>a) directors and shareholders: three years from when the injured party has knowledge of injury, unless contractual limitations statutes provide for a longer period (civil liability).</p> <p>b) directors: according to MoMiG five years from the origination of the claim (does not depend on the shareholders' knowledge).</p>
Breach of agreement	a) three years, unless special limitation periods apply
Piercing the corporate veil	a) three years from the origination of the claim and the obligee's awareness of circumstances giving rise to the claim and the identity of the obligor.
Breach of the capital maintenance rules	a) five years from the time of the breach.
Liability <i>vis-à-vis</i> tax Authorities	a) four years regarding tax assessment.
Disqualification of directors	Disqualified as managing director for five years following the time when sentence became final, unless Court ruling imposing disqualification provides for a longer time period.

8.2 Appeals

Generally, any decision of the first instance Court in penal or civil proceedings may be subject to appeal unless the civil Court of first instance orders compensation which does not exceed €600.

As outlined above, any disqualification of directors resulting from a sentence or side sanctions ordered by a criminal Court may be appealed against.

QUESTION 9

9. Foreign corporations

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

Any legal provisions and procedures outlined above apply to domestic corporations which do not have a personally liable shareholder or partner. With respect to liabilities *vis-à-vis* public authorities and liabilities arising from any crimes pertaining to insolvency and any breach of agreements, the aforementioned legal provisions apply irrespective of the legal form and legal seat as long as the business transactions of the company are conducted in Germany.

QUESTION 10

10. Insurance

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

10.1 Coverage available

Directors' and officers' insurance covering the exposure of directors of German corporations is emerging in the German insurance market. It has been introduced by US and British insurance companies which have substantial experience in their respective foreign markets, motivated by an urgent need of directors to protect themselves against personal liability which may arise in connection with the aforementioned actions. This has been further encouraged by a more robust attitude on the part of insolvency creditors seeking to recover their losses from directors. It is expected that the German Courts will strengthen their demands as to compliance by directors with their duties, namely their duty to petition for the commencement of insolvency proceedings and to be aware of the financial situation of the company. On the other hand, premature petitioning is not advisable because this could be regarded as a general breach of the managing duties of directors and, therefore, could lead to compensation claims by the company.

Following the approach of probably all German insurance companies, the coverage of risk does not include intentional or "consciously" negligent misconduct of directors.

Furthermore, according to common practice in the US, insurance companies used by company directors or executive staff tend to exclude protection against internal liability *vis-à-vis* the company. Such exclusion of internal liability is historically based on the risk of so-called shareholder derivative lawsuits, (that is, shareholders claiming compensation on behalf of the company from their directors). Despite the fact that such lawsuits are generally not recognised in Germany, insurance companies fear potential abuse of such coverage which could enable the directors to act collusively with the shareholders in order to enrich the assets of the company. However, the exclusion of the exposure arising from internal liability is not a satisfactory solution for directors from a practical perspective due to the fact that various cases of civil liability have resulted in a duty to compensate the company and not the outstanding creditors. In summary, protection is only available with respect to claims of outstanding creditors arising from a mere negligent breach of duties. However, even this protection may prove to be ineffective bearing in mind that, in practice, the dividing line between “mere” negligence on the one hand, and “conscious” negligence or “contingent” intention on the other, is difficult to determine.

Directors may already act in a “consciously” negligent way if they consider the existence of a financial crisis as “probable”. As far as insolvency-related crimes resulting in civil liability are concerned, criteria and procedures determining illiquidity and over-indebtedness are complex, so that the misconduct of directors in this respect is “slightly” negligent rather than “consciously” negligent or intentional. The failure to transfer deducted taxes or social contributions will be regarded as intentional or “consciously” negligent conduct if the director is completely aware of the circumstances constituting his duty as well as of the duty itself.

10.2 Claims to reimbursement or indemnification

In addition to insurance protection, indemnification for third party claims or company claims against the directors might be considered as an option.

Certainly, directors are entitled to reimbursement or indemnification by the company to the extent that the compensation claimed against the directors was payable out of the assets of the company, such as wage taxes or social security contributions.

The German Federal Court has held that a company with limited liability may indemnify directors of a company with limited liability with respect to claims of third parties arising from the implementation of instructions of shareholders urging directors to breach their duties. Apart from this, general indemnification by the company on a contractual basis is only permissible if it does not endanger the claims of outstanding creditors. This principle is applicable with respect to third party claims as well as to claims of the company against its directors.

Due to their punitive character, directors cannot recover any fines imposed in the course of criminal prosecution.

The information provided in this country chapter is correct as at 10/03/ 2017

GREECE

QUESTION 1

1. The directors and the start and duration of the “twilight” period

(a) How are directors identified / defined?

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

1.1 Identification and definition of directors

From a bankruptcy law perspective, “directors” (i.e. the group of individuals and / or entities who may be subject to personal liability) are the members of the Board of Directors when the bankrupt entity is a joint-stock company (*société anonyme*) or the statutory directors / managers when the bankrupt entity is a limited liability company or a partnership. “*De facto* directors” or “shadow directors” may also qualify as directors from a bankruptcy law perspective: these are individuals / entities that have influenced the company affairs either by delaying the filing of the bankruptcy petition or bringing about the company’s insolvency. Dominant shareholders or significant creditors (in particular credit institutions) may qualify as “*de facto* directors” in this respect (see Question 3).

1.2 Time frames that are applicable

There is no ‘one-size-fits-all’ in the period during which transactions entered into may be subject to the trustee’s avoidance powers or during which managerial acts undertaken may give rise to directors’ liability. Such a period varies depending on the type of managerial act or transaction under scrutiny.

As a general rule, for a transaction to be subject to potential avoidance by the trustee, such a transaction must have taken place during the so-called ‘suspect period’. The ‘suspect period’ runs from the actual cessation of payments until the declaration of bankruptcy; the length is defined by the Court declaring the bankruptcy. The ‘suspect period’ cannot exceed two years prior the declaration of bankruptcy.

Specific transactions defrauding creditors are subject to avoidance by the trustee if they have been entered into in the five years prior to the declaration of bankruptcy. The ‘suspect period’ plays no role with regard to these transactions.

There is a long list of managerial acts that signal serious mismanagement on the part of directors which, if they have taken place during the ‘suspect period’ or six months prior the declaration of bankruptcy, give rise to criminal liability of the directors. The six month period is of practical importance when there is either no ‘suspect period’ (because the bankruptcy has been declared on the basis of imminent, rather than actual, cessation of payments) or when such ‘suspect period’ is shorter than six months.

Managerial acts taken following the lapse of 30 days after the cessation of payments may give rise to personal liability on the part of directors for deepening insolvency, since there is an obligation on the management to file for bankruptcy within 30 days after the cessation of payments.

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 the director?

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

- (i) Is the director's liability considered to be civil, criminal or both?
- (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
- (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?
- (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 that may give rise to personal liability of the directors

2.1.1 Acts resulting in deepening the company's insolvency

This is close (although not exactly the same) to what is known elsewhere as 'wrongful trading'; it relates to actions undertaken by the management after the cessation of payments, which resulted in the dilution of the creditors' interests.

2.1.2 Acts causing insolvency

By definition, such acts have occurred prior to the cessation of payments (so outside the 'suspect period' or any kind of twilight period).

2.1.3 Acts of serious mismanagement

These include: (i) hiding assets which would have been part of the bankruptcy estate; (ii) entering into loss-making or highly-risky transactions that do not constitute prudent business decisions; (iii) selling merchandise below its real value; (iv) not keeping books of account or book-keeping in a way that does not assist in determining the bankruptcy estate; (v) hiding or compromising the company's financial statements; (vi) hiding or misreporting the company's transactions; or (vii) preferring a creditor over others, while payments have ceased or are about to cease.

2.1.4 Receipt of excessive remuneration (in particular payments in advance)

The directors may also be found liable when they have received from the company either payments in advance as remuneration, which are not provided for in the company's statute, or when they have received excessive remuneration, without such being justified by the company's financial condition.

Directors are personally liable to the State and the pension funds for taxes and / or social security contributions left unpaid.

2.2 Liability of directors

'Acts resulting in the deepening of the company's insolvency' and 'acts causing insolvency' bring about civil liability of the directors. 'Acts of serious mismanagement' and 'receipt of excessive remuneration' bring about criminal liability of the directors; however, as with every case of criminal liability, there can be concurrent action against the offenders for tortuous (civil) liability.

The liability of directors for due taxes and / or social security contributions becomes criminal when the amount due exceeds EUR 100,000.

A director can be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors. In principle, yes. The size of losses that the director shall be obliged to pay depends on the type of managerial act, for which she is held liable. There are different methods for calculating losses depending on the type of managerial act which has caused the loss to the creditors / bankruptcy estate.

With respect to liability arising because of 'acts resulting in the deepening of the company's insolvency' or 'acts causing insolvency' there needs to be evidence that the specific defendant directors have been involved in those acts, as their liability requires either intention or negligence on their part. The same applies to criminal (or civil) liability for 'acts of serious mismanagement'. Liability for due taxes and / or social security contributions may attach though to directors independent of their specific involvement, particularly if they are senior members of management.

The "relevant" period that apply to acts during the twilight period is discussed under section 1.2.

2.3 Available defences

For liability arising because of 'acts resulting in the deepening of the company's insolvency' the director can be relieved of liability if he was not aware of the cessation of payments and his non-awareness of such cessation cannot be attributed to his intention or negligence. Liability may not exist in cases where the acts were part of a turnaround plan, for which the director made a good faith determination that it could avoid the company's insolvency. Directors may also invoke contributory negligence of the creditors when the latter entered into transactions with the failing company while the directors were aware that the company was already in a cessation of payments. There can be practical difficulties in calculating the creditors' losses caused by the acts.

For liability arising because of 'acts causing the company's insolvency', directors may have the defences that are available in shareholder lawsuits in the ordinary course of business (e.g. business judgement rule). If the company was entering the zone of insolvency (the period prior to the cessation of payments), then more conservative management is warranted on the part of directors.

QUESTION 3

3. **Other persons involved with the company's affairs who may be liable in relation to their actions during the relevant period**
- (a) **In addition to those persons referred to in 1(a) above, can others be held liable for their action or inaction during the relevant period?**
 - (b) **In respect of which acts or failure to act may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?**
 - (c) **Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?**

3.1 Other persons involved with the company's affairs who may be liable

In theory (although it is rarely enforced in practice) credit institutions that have extended loans to failing companies may be held liable for helping create a false impression to the market that the company is solvent. Likewise, credit institutions may be held liable *vis-à-vis* the estate's creditors if they abruptly cut the credit line to a solvent company.

Dominant shareholders, particularly a parent entity within a corporate group, may also be held liable in case they have been instrumental in influencing management in a way that caused the company's insolvency or deepened the company's insolvency.

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

See section 3.1.

3.3 Third parties who may be held liable

This will vary on a case-by-case basis and depends on what evidence can be presented in order to prove the quantum of the losses that the third persons' actions caused to the creditors.

QUESTION 4

4. Transactions during the relevant period

- (a) On what basis may transactions with the company in the relevant period be set aside?**
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?**
- (c) On what basis may directors and other persons properly incur further credit during the relevant period?**

4.1 Transactions during the relevant period

There are three types of transactions that are subject to the trustee's avoidance powers.

4.1.1 Transactions that are mandatorily revoked by the trustee

These are mainly transactions whereby the company has: (i) disposed of an asset without consideration or where the consideration received is of considerable lower value than the asset disposed; (ii) preferred one creditor over other creditors by making a payment that is not yet due, or by making a payment-in-kind while payment in cash was formerly agreed (selective payments); and (iii) provided security to a creditor during the 'suspect period' as security for an antecedent debt without such security having been agreed at the time the credit was first extended.

4.1.2 Transactions that may be revoked by the trustee

This can be any transaction having taken place during the 'suspect period' which was harmful to the company in that the terms were unfavourable for the company or the transaction deprived the company of cash flow, which was required for the turnaround or the enlargement of the bankruptcy estate.

4.1.3 Transactions defrauding creditors

These are transactions subject to avoidance entered into within five years prior to the declaration of bankruptcy, provided that the intention of the directors was to prefer a creditor over others and the preferred creditor knew that the directors had such intention at the time of the transaction.

4.2 Available defences

'Transactions that are mandatorily revoked by the trustee', the parties affected by the trustee's avoidance powers may assert that: (i) that the disposal of the asset without consideration was done in the ordinary course of business and did not cause a material diminution of the bankruptcy estate; or (ii) that the security was provided on the basis of an obligation contemporaneously assumed by the company.

For 'transactions that may be revoked by the trustee', the third parties affected by the trustee's avoidance powers may show that they were not aware that the company had ceased payments when they entered into the transaction with it.

For 'transactions defrauding creditors', the parties affected by the trustee's avoidance powers may show that they were not aware of the intention of the directors to defraud creditors.

4.3 Incurring credit during the twilight period

This can only be decided on a case-by-case basis, as all transactions entered into during the 'suspect period' (including credit arrangements) may be subject to avoidance, if the counterparty was aware of the cessation of payments. However, while avoidance may be tackled on the basis of the non-awareness defence, receiving credit during the 'suspect period' may expose directors to the risk of liability for deepening insolvency, as new creditors of the bankruptcy estate are added to the cohort of existing creditors.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

For the cases, wherein liability of the directors and/or other persons identified in Question 3 above is criminal, the Public Prosecutor nominally brings the action. In practice, the criminal complaint (or a mere report) that precedes the criminal proceedings is filed by the trustee or a third party (e.g. creditor) affected by the insolvency.

For cases wherein such liability is civil, the action against directors and / or other persons identified in Question 3 can only be brought by the trustee. There is, in theory, scope for creditors to take action independently against directors for acts which have caused the insolvency, but this route has not been so far confirmed in case law.

For the cases where the liability of the directors is to the State or the pension funds for due taxes and / or social security contributions, enforcement is by the competent tax offices or pension funds on the basis of the rules for the collection of fiscal debts.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

In respect of the acts giving rise to personal liability of the directors, the trustee commences proceedings against the persons liable to pay damages to the bankruptcy estate. In theory, a creditor may be able show standing to take action against a director for acts that have caused insolvency, in which case, damages would be paid not to the bankruptcy estate but to the creditor directly. However, this has not yet been confirmed by Greek case law as a possibility.

In respect of the transactions subject to the trustee's avoidance powers, the trustee files a remedy before the Bankruptcy Court requesting that the Court: (a) unwinds the said transactions; and (b) orders the counterparties, who transacted with the insolvent company, to put back to the bankruptcy estate what they received from the company. Defendants in such lawsuit are not only the counterparties, who transacted with the insolvent company, but also any successors thereof who were in bad faith when transacting with the original counterparty. If a creditor requests in writing that the trustee commences such an avoidance action, but the trustee does not take action within two months from such request, then the creditor has the right to proceed with the filing.

QUESTION 7

7. Duty to co-operate

- (a) **To what extent are directors and other persons identified in Question 3(a) above obliged to co-operate with the insolvency office-holder's investigation into the company's affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

7.1 Obligations to co-operate with the investigation into the company's affairs

There is a general duty to co-operate with the trustee and the supervising judge of the Bankruptcy Court that requires directors (but not necessarily "*de facto*" directors) to inform these two officers on all issues relevant to the company's balance sheet and the reasons for bankruptcy. This includes the provision of information on issues such as the contracts entered into by the company, its personnel, assets, bank accounts, creditors, etc. Further, the directors of the bankrupt company should assist the trustee in taking over the bankruptcy estate by drafting the balance sheet at the time of the declaration of bankruptcy, by delivering the keys to the business' premises, the passwords for the business' servers and the books of the company. If the directors do not deliver the books of the company to the trustee, there is the risk of criminal liability.

7.2 Applicable human rights laws

The trustee has the right to review the bankrupt company's correspondence and e-mail correspondence. This is regarded as an intrusion to the debtor's privacy, so the trustee may not open such correspondence for the first time without the directors of the bankrupt company being present at such opening. The limitations in Article 6 European Convention of Human Rights apply to the extent that a potential criminal liability of the directors is at stake, but the application thereof in bankruptcy proceedings has not so far been tested in case law.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What appeals are available from the decision of the lower Courts?

8.1 Limitation periods

The trustee's avoidance powers are in principle subject to a one-year limitation starting from the point in time that the trustee became aware of the transaction, which is subject to avoidance; but in any case, the right to seek avoidance is subject to a maximum of two-year limitation starting from the declaration of bankruptcy.

The right to seek damages from the directors on the basis of their civil liability is subject to the regular limitation of 20 years. However, in practice when the bankruptcy proceedings close and the trustee loses its status, no person shall have standing to seek such damages from the directors, unless Greek case law confirms the position that creditors can take action independently against the directors.

8.2 Appeals

The ruling of the Bankruptcy Court on the avoidance remedy is directly enforceable against the counterparties who transacted with the bankrupt company and their potential successors. However, such counterparties may appeal the ruling either before the Appellate Court or with an appeal-in-cassation before the Supreme Court and request that the enforceability of the Bankruptcy Court ruling is suspended up until such superior Courts issue their ruling on the appeals.

The rulings of the Court on the liability of directors are subject to the standard remedies of appeal and appeal-in-cassation.

QUESTION 9

9. Foreign corporations

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

If the centre of main interests ("COMI") of a corporation registered overseas is in Greece, then the Greek Bankruptcy Court has jurisdiction to open the bankruptcy proceedings and Greek bankruptcy law will apply (*lex fori concursus*), including all of the rules presented hereinabove.

QUESTION 10

10. Insurance

Is directors' and officers' (D&O) 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?

D&O insurance is available in Greece and, depending on the insurance policy, it may provide coverage to directors against any civil liability which may arise in connection with the bankruptcy of a company. However, such insurance does not normally cover intentional acts or criminal liability of the directors.

The information provided in this country chapter is correct as at 01/03/ 2017

HONG KONG

New legislation

On 3 March 2014, the Companies Ordinance (Cap 622) (CO Cap 622) came into force, which resulted in the provisions of the old Companies Ordinance (Cap 32) being separated, with the provisions relating to Hong Kong insolvency regime being retained in the newly renamed Companies (Winding up and Miscellaneous Provisions) Ordinance (Cap 32) (CWUMPO). The CO Cap 622 has not overhauled or supplemented the existing insolvency procedures; however, it has impacted Hong Kong's insolvency regime, by, amongst others things, formalising the role of directors of a company.

Efforts at reforming Hong Kong's corporate insolvency regime are ongoing. On 13 February 2017, the Companies (Winding Up and Miscellaneous Provisions) (Amendment) Ordinance came into operation and amended the CWUMPO and its subsidiary legislation to increase protection of creditors, streamline the winding up process and strengthen regulation under the winding up (CWUMPO Amendment). The measures intended to enhance the protection of creditors include:

- granting the Court the power to set aside transactions at an undervalue entered into by a company within five years before the commencement of its winding up;
- introducing standalone provisions on the setting aside of transactions which are unfair preferences;
- extending the relevant period for invalidating a floating charge created in favour of a connected person; and
- introducing a new provision to claw back payments made by a company out of capital in respect of the redemption or buy-back of its own shares.

This chapter focuses on the existing legal position. However, where it is known that the old provisions of the CWUMPO will apply, this has been highlighted. As the CWUMPO Amendment may not apply to winding-up proceedings / transactions / conduct commenced / entered into / taken place prior to 13 February 2017 (being the date when the CWUMPO Amendment came into operation), it will be particularly important to take appropriate advice to confirm that the law applies as described in this chapter. It is possible that there will be substantial changes to Hong Kong insolvency regime in the next few years with the introduction of a rescue procedure to be known as "provisional supervision" and a statutory concept of insolvent trading but there is no certainty as to when (or even if) these further changes will occur. Accordingly, they are not considered in detail in this chapter.

QUESTION 1

1. The directors and the start and duration of the “twilight” period

(a) How are directors identified / defined?

(b) 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 Identifying a director

Under Hong Kong legislation, a director is defined as “any person occupying the position of director (by whatever name called)”,¹ and therefore includes those persons who are called by other names but participate in decisions of the type made by directors. Further, the acts of a person acting as a director are valid even if it is later discovered that there was “a defect in the appointment of the person as a director”.²

As such, in determining whether a person is a “director”, it is important to look beyond formal appointments and consider the role of “shadow directors” and “*de facto*” directors (notwithstanding the fact that failure to comply with registration formalities for the appointment of directors would amount to an offence under the CO Cap 622). Hong Kong law likely mirrors English law in respect of the meaning of these concepts and the position is explained in more detail below.

1.2 *De facto* and shadow directors

There are persons under Hong Kong law who are recognised and treated in the same way as directors despite not being formally appointed. The concept of “*de facto*” directors originated under common law to deal with persons who, though not technically appointed as directors as a matter of company law, should still be treated as directors due to the function they carry out and role they play in the affairs of the company. In addition, Hong Kong legislation has adopted the concept of “shadow directors” to cover those persons who are not directors or do not have any formal role in the decision-making process of a company but are nevertheless controlling the company through its directors from behind the scenes.

1.2.1 *De facto* directors

A “*de facto*” director is a person, who whilst not formally appointed (due to a technical default in his appointment or otherwise) or registered as a director, nonetheless acts as and performs the functions of a director and is treated as such by the rest of the board. The recent English cases of *Holland v Commissioners for Her Majesty’s Revenue and Customs* [2010] UKSC 51 (the Supreme Court) and *Smithton Ltd (formerly Hobart Capital Markets Ltd) v Naggar* [2014] EWCA Civ 939 consider what constitutes a *de facto* director and may well guide the Hong Kong approach. The most relevant tests to consider are therefore likely to be whether the person was the sole person directing the affairs of the company (or acting with others equally lacking in a valid appointment) or if there were others who were true directors, whether he was acting on an equal footing with the others in directing its affairs; whether there was a holding out by the company of the individual as a director and whether the individual used the title and, taking all the circumstances into account, whether the individual was part of the “corporate governing structure”. In particular, the *Holland* case also considered when an individual (sole) director of a corporate director will be deemed a *de facto* director of the company in respect of which the corporate director is a director.

¹ Section 2(1) CO Cap 622.

² Section 461 CO Cap 622.

There is no distinction under Hong Kong law between de facto and formally appointed directors. Both owe the same duties and are under the same statutory obligations. *De facto* directors may be exposed to additional liability if they dispose of company property because the fact that they are not directors means that they lack the necessary authority. Unless the shareholders in general meeting resolve to ratify the disposals, de facto directors may be liable to compensate the company for the value of the assets wrongfully disposed of. This right of action vests in the company. As such, any actions taken by de facto directors during the twilight period are equally relevant.

De facto directors have the ability to bind the company in making contracts with third parties acting in good faith in their capacity as agents of the company with actual and / or apparent authority. Under principles of general agency law, they are not personally liable under those contracts but may be liable in damages for breach of an implied warranty of authority if they can be deemed to have warranted that they had authority to act on behalf of the company when no such authority existed.

1.2.2 Shadow directors

A shadow director is defined under Hong Kong law as “a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act”.³

There have been few cases in Hong Kong in which the meaning of “shadow director” has been considered. The English Court of Appeal decision in *SSTI v Deverell* (2000) (in which the statutory definition of shadow director in the Companies Act 1985 was reviewed) has not expressly been considered by the Hong Kong Courts although the approach taken in interpreting the relevant provision has been considered and followed.⁴

1.3 The “twilight” period – overview

Notwithstanding Hong Kong’s return to Chinese sovereignty in 1997, Hong Kong remains a common law jurisdiction and the law relating to corporations is largely based on the law of England prior to the implementation of the recommendations of the Cork Report.⁵ As in England, when considering whether a transaction may be vulnerable to attack or might result in personal liability, a key question is whether the company was insolvent either at the time of, or as a result of, the transaction. The twilight period effectively runs for the duration of the company’s insolvency until the commencement of liquidation.

A company is insolvent when it is unable to pay its debts. In many jurisdictions there are two separate tests used to establish whether a company is able to pay its debts. They are:

- (a) the “cash-flow” test - a company is insolvent when it is unable to pay its debts when they fall due; and
- (b) the “balance sheet” test - a company is insolvent when its assets are insufficient to meet its liabilities.

By virtue of the CWUMPO Amendment, it is now specifically provided that, in order to set aside a transaction as a transaction at an undervalue or unfair preference or to invalidate a floating charge, the company has to be unable to pay its debts within the meaning of S 178 CWUMPO⁶ either at the time of, or as a result of, the transaction.

³ Sections 2(1) CO Cap 622.

⁴ *Fred Lee v Lee Yuk Man* [2007] HKCFI.

⁵ This chapter refers to a number of post 1997 English cases. Technically these cases are not binding precedents in Hong Kong, but the Hong Kong Courts have often found relevant English decisions to be highly persuasive.

⁶ Section 178(1) CWUMPO provides that a company shall be deemed to be unable to pay its debts:

- (a) if (i) a creditor, by assignment or otherwise, to whom the company is indebted in a sum then due equal to or exceeding HK\$10,000 (or such amount as the Financial Secretary may prescribe under section 178(4) CWUMPO), has served on the company a written demand (A) in the prescribed form requiring the company to pay the sum so due; and (B) by leaving it at the registered office of the company; and (ii) the company has, for 3 weeks after the service of the demand, neglected to pay the sum, or to secure or compound for it to the reasonable satisfaction of the creditor; or
- (b) if execution or other process issued on a judgment, decree or order of any Court in favour of a creditor of the company is returned unsatisfied in whole or in part; or
- (c) if it is proved to the satisfaction of the Court that the company is unable to pay its debts, and, 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.

In the absence of certain specified triggers (an unpaid judgment debt or statutory demand) it is somewhat unclear whether S 178 CWUMPO is a “balance sheet” or “cash-flow” test.⁷ A company is insolvent if it is proved to the satisfaction of the Court that the company is unable to pay its debts (which is broadly speaking a “cash flow” test formulation even though the legislation does not go on to say “as they fall due”) and in determining this, the Court shall take into account contingent and prospective liabilities of the company (which is more of a “balance sheet” test). In practice, it appears that the Court may apply either a “balance sheet” or a “cash flow” test when determining whether or not a company is unable to pay its debts within the meaning of S 178 CWUMPO.

The obligations of the directors of a company change fundamentally once a company is insolvent. In normal circumstances where a company is solvent, directors owe their duties to the company, that is, primarily to its present and future members, who are entitled to ratify any breaches of duty by the directors. Where a company is insolvent however, it is the creditors rather than the members which are likely to suffer as a result of such breaches. Accordingly, where the directors of an insolvent company exercise their duties they must have regard primarily to the interests of the creditors and must exercise their powers with a view to minimising the potential loss to creditors.

1.4 Vulnerability periods

Assuming that a company was unable to pay its debts at the time of a transaction, such a transaction will be vulnerable to attack only if it was entered into within the “clawback period” as provided for under Hong Kong law. In this regard, the various clawback periods under Hong Kong law, being periods terminating at the commencement of liquidation, are:

- (a) transactions at an undervalue – 5 years (Ss 265D and 265E CWUMPO);
- (b) unfair preferences - 6 months (2 years for connected persons or associates⁸) (Ss 266 to 266B CWUMPO);
- (c) payments out of capital in respect of the redemption or buy-back of a company’s own shares⁹ – 12 months (S 170A CWUMPO);
- (d) floating charges - 12 months (2 years for connected persons¹⁰) (Ss 267 and 267A CWUMPO);
- (e) extortionate credit transactions - 3 years (S 264B CWUMPO);
- (f) disposition after presentation of petition - from date of presentation (S 182 CWUMPO); and
- (g) fraudulent conveyances - no time limit (S 60 Conveyancing and Property Ordinance).

Prior to the CWUMPO Amendment, transactions at an undervalue are only vulnerable in personal bankruptcy.

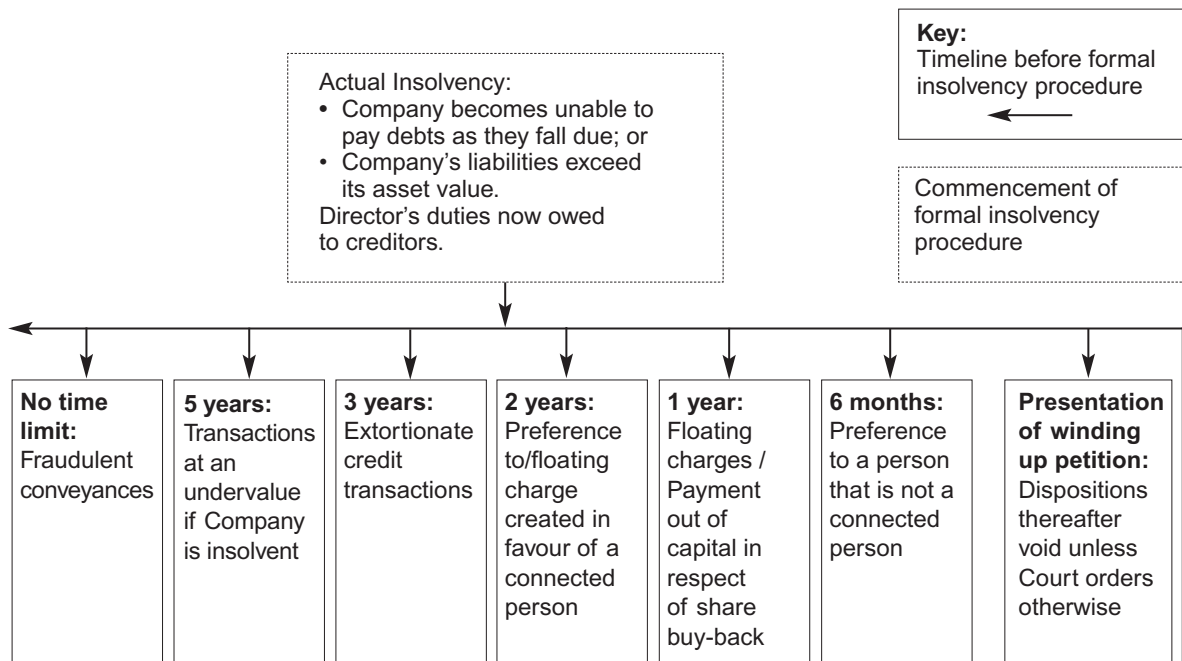
We set out below a “time line” summarising the statutory provisions mentioned above.

⁷ In any event, the distinction between the balance sheet test and the cash-flow test may already have been blurred by the English Supreme Court’s decision in *BNY Corporate Trustee Services Ltd v Neuberger Berman Europe Ltd (on behalf of Sealink Funding Ltd)*; *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc* [2013] UKSC 28 discussed in the England chapter.

⁸ For unfair preferences given by the company before 13 February 2017.

⁹ This does not apply in relation to a payment out of capital in respect of the redemption or buy-back of a company’s own shares that has taken place before 13 February 2017.

¹⁰ This does not apply to a charge created on the undertaking or property of a company before 13 February 2017.



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:
- Is any resulting liability against a director civil, criminal or both?
 - Can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?
 - Will liability attach to individual directors in proportion to their specific involvement?
 - 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
 - What defences, if any, will be available in relation to each offence?

2.1 Introduction

Hong Kong law provides a fairly wide range of acts for which a director may be held personally liable during the “twilight period” although there is currently no equivalent to the English law provision for wrongful trading (although see New Legislation section at the beginning of this chapter).

Proceedings against directors (and other persons who may be caught by these provisions) based on the statutory provisions described in 2.2 to 2.7 below are uncommon, with the exception of proceedings against officers for failing to keep proper accounts.

2.2 Fraudulent trading¹¹

- (a) Although Hong Kong does not yet have ‘wrongful’ or ‘insolvent’ trading legislation, directors can become liable for fraudulent trading. As is the case under English law,¹² actual dishonesty is an essential element to establish liability for fraudulent trading under Hong Kong law. As is the case in other jurisdictions with provisions similar to S 275 CWUMPO, it is relatively rare for persons to be found liable for fraudulent trading due to the difficulty of proving dishonesty.

Liability for fraudulent trading is incurred if it can be shown in the course of the winding-up of a company that ‘any business of the company has been carried on with the intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose’.¹³ The elements of this provision are:

- (i) the company must be in liquidation for civil liability to be incurred (S 275(1) CWUMPO) whereas criminal liability may be incurred irrespective of whether the company is in liquidation or not (S 275(3) CWUMPO);
 - (ii) there must be actual intention to defraud creditors or to achieve a particular fraudulent purpose whilst running the business¹⁴ or recklessness as to whether the carrying on of the business would result in the creditors being defrauded;
 - (iii) the standard of proof for civil liability is the balance of probabilities (i.e. the civil standard of proof)¹⁵ whereas for criminal liability proof ‘beyond reasonable doubt’ is required; and
 - (iv) any ‘knowing party’ to the dishonest running of the business may incur liability, which may therefore extend beyond any director, shadow director or officeholder (potentially to a financier who funded a fraudulent trade knowing it was being done dishonestly or recklessly).¹⁶
- (b) (i) Liability may be civil and/or criminal depending on whether the company is in liquidation (see 2.2(a)(i) above).
- (ii) Any damages award is to compensate the company for any loss caused and is not intended as a punitive measure.¹⁷ The Court has a wide discretion in this regard and a ‘knowing party’ may be held liable for all loss caused.
 - (iii) Although the Court has a wide discretion, it will exercise that discretion with regard to proportionality.
 - (iv) There is no specific period before commencement of the insolvent liquidation during which the dishonest act must have been committed either in relation to civil or criminal liability.
 - (v) The main defence is absence of dishonesty. A person who is alleged to have committed this offence need only show an honest belief that there was a reasonable prospect that the company would be able to pay the debts which it incurred to avoid liability. It is immaterial that objectively the director would be considered imprudent or incompetent in holding such a view.

2.3 Fraud by officers of companies which have gone into liquidation¹⁸

¹¹ Section 275 CWUMPO.

¹² Section 213 IA 1986.

¹³ Section 275 CWUMPO.

¹⁴ This includes a single act and it need not be established that a series of acts were conducted.

¹⁵ *Aktieselskabet Dansk Skibsfinansiering v Wheelock Marden and Co Ltd* [2000] HKCFA 31.

¹⁶ *Re Bank of Credit and Commerce International SA (No.2), Banque Arabe et Internationale D'Investissement SA v Morris* [2000] All ER (D) 1437).

¹⁷ This is true even where the claim is brought by a creditor or contributory. The claim is not limited to the loss of the relevant creditor or contributory but is instead limited by the loss of the company. See *Kong Mou Holdings Ltd v Cheung Sheun Lung and Others* [2004] HKCFI 192.

¹⁸ Section 273 CWUMPO.

- (a) It is an offence for an officer¹⁹ of a company:
- (i) to make or cause to be made any gift, or transfer of or charge on or to have caused or connived in the levying of any execution against the property of the company; or
 - (ii) to have concealed or removed any part of the property of the company since, or within two months before, the date of any unsatisfied judgment or order for payment of money obtained against the company, in each case, with the intent to defraud creditors.
- (b) (i) Liability under this provision is criminal.
- (ii) A person guilty of this offence is liable to imprisonment and a fine.
 - (iii) The Court determines the length of the term of imprisonment and / or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.
 - (iv) The relevant act may be committed:
 - (A) in respect of (a)(i) above, any time before the commencement of the liquidation; and
 - (B) in respect of (a)(ii) above, any time after the date of any unsatisfied judgment or order for payment of money obtained against the company or within two months prior to such judgment or order.
 - (v) The main defence is absence of intent to defraud creditors.

2.4 Offences by officers of companies in liquidation²⁰

2.4.1 Fraud in anticipation of winding-up²¹

- (a) It is an offence for any officer²² or shadow director²³ of a company, whether past or present to:
- (i) conceal any part of the property of the company to the value of HK\$100 or upwards or conceal any debt due to or from the company;
 - (ii) fraudulently remove any part of the property of the company to the value of HK\$100 or upwards; or
 - (iii) pawn, pledge or dispose of any property of the company which has been obtained on credit and has not been paid for, unless such pawning, pledging or disposing is in the ordinary course of the business of the company.
- (b) (i) Liability for each of the above offences is criminal.
- (ii) A person guilty of offences (a)(i) and (ii) above is liable to both imprisonment and a fine whereas liability for offence (a)(iii) above is limited to imprisonment.
 - (iii) The Court determines the length of the term of imprisonment and / or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.
 - (iv) The relevant act may be committed:
 - (A) within 12 months before the commencement of the winding-up of the company; or

¹⁹ Officer includes the directors, managers and secretary of the company (see 3.2 below).

²⁰ Section 271 CWUMPO.

²¹ Sections 271(1)(d), (e) and (o) CWUMPO.

²² Officer includes the directors, managers and secretary of the company (see 3.2 below).

²³ A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 1.3.5 above).

(B) any time after the commencement of winding-up.

(v) Possible defences are:

(A) for offences (a)(i) and (iii), absence of intent to defraud; and

(B) for offences (a)(i), (ii) and (iii), any officer may be excused by the Court if shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused²⁴.

2.4.2 Misconduct in the course of winding-up²⁵

(a) It is an offence for any officer²⁶ or a shadow director²⁷ of the company, whether past or present:

- (i) not, to the best of his knowledge and belief, to fully and truly disclose to the liquidator all the property, real and personal, of the company and how, to whom, for what consideration and when the company disposed of any such property (except any disposals in the ordinary course of its business);
- (ii) not to deliver up to the liquidator any real and personal property of the company in his custody or control (including any books and papers of the company);
- (iii) in the knowledge or belief that a false debt has been proved by any person, to fail to inform the liquidator within one month;
- (iv) to prevent the production of any book or paper affecting or relating to the property or affairs of the company after commencement of the winding-up;
- (v) to make any material omission in any statement relating to the affairs of the company; and
- (vi) to attempt to account for any part of the company's property by fictitious losses or expenses.

(b) (i) Liability for each of the above offences is criminal.

(ii) A person guilty of any of the above offences is liable to both imprisonment and a fine.

(iii) The Court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.

(iv) The relevant act in relation to each of the above offences may be committed at any time before the commencement of or during the winding-up of the company, except for offence (a)(vi) which must occur either after the commencement of the winding-up or at any meeting of creditors of the company within 12 months prior to the commencement of the winding-up.

(v) Possible defences are:

(A) for offences (a)(i), (ii) and (v) above, absence of intent to defraud;

(B) for offences (a)(iv) above, absence of intent to conceal the state of affairs of the company or to defeat the law; and

(C) for each of the above offences, any officer may be excused by the Court if shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused.²⁸

²⁴ Section 903 CO Cap 622. The Court rarely makes such orders.

²⁵ Sections 271(1)(a), (b), (c), (f) (g) (h) and (l) CWUMPO.

²⁶ Officer includes the directors, managers and secretary of the company (see 3.2 below).

²⁷ A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 1.3.5 above).

²⁸ Section 903 CO Cap 622. The Court rarely makes such orders.

2.4.3 Falsification of company's books²⁹

- (a) It is an offence for any officer³⁰ or a shadow director³¹ of the company, whether past or present to:
- (i) conceal, destroy, mutilate or falsify any book or paper affecting or relating to the property or affairs of the company, or to be privy to any such action;
 - (ii) make any false entry in any book or paper affecting or relating to the property or affairs of the company, or to be privy to such action; or
 - (iii) fraudulently part with, alter, make any omission in any document affecting the property or affairs of the company, or to be privy to any such action.
- (b) (i) Liability for all of the above offences is criminal.
- (ii) A person guilty of any of the above offences is liable to both imprisonment and a fine.
 - (iii) The Court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.
 - (iv) The relevant act may be committed within 12 months before the commencement of the winding-up of the company or during the course of the winding-up.
 - (v) Possible defences are:
 - (A) for offence (a)(i) and (ii) above, absence of intent to conceal the state of affairs of the company or to defeat the law;
 - (B) for each of the above offences, any officer may be excused by the Court if it can be shown that he has acted honestly and reasonably and, having regard to all the circumstances of the case, he ought fairly to be excused.³²

2.4.4 False representation to creditors³³

- (a) It is an offence for any officer³⁴ or shadow director³⁵ of the company, whether past, or present to falsely represent or commit any fraud for the purpose of obtaining the consent of the company's creditors or any of them to an agreement with reference to the state of the company's affairs or to the winding-up.
- (b) (i) Liability for this offence is criminal.
- (ii) A person guilty of this offence is liable to both imprisonment and a fine.
 - (iii) The Court determines the length of the term of imprisonment and / or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.
 - (iv) The representation may be made any time before or after the commencement of winding-up.
 - (v) The defence is absence of intent to mislead the company's creditors into giving their consent on the basis of a false premise.

²⁹ Section 271(1)(i), (j) and (k) CWUMPO.

³⁰ Officer includes the directors, managers and secretary of the company (see 3.2 below).

³¹ A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 1.3.5 above).

³² Section 903 CO Cap 622. The Court rarely makes such orders.

³³ Section 271(1)(p) CWUMPO.

³⁴ Officer includes the directors, managers and secretary of the company (see 3.2 below).

³⁵ A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 1.3.5 above).

2.5 Liability where proper records are not kept³⁶

- (a) It is an offence for an officer³⁷ or shadow director of a company who knowingly and wilfully authorises or permits the failure³⁸ to keep accounting records³⁹ during the two years before commencement of the winding-up (or between incorporation of the company and its winding-up if a lesser period). Accounting records must be sufficient (i) to show and explain the company's transactions; (ii) to disclose with reasonable accuracy, at any time, the company's financial position and financial performance; and (iii) to enable the directors to ensure that the financial statements comply with CO Cap 622; and must contain (1) daily entries of all sums of money received and expended by the company, and the matters in respect of which the receipt and expenditure takes place; and (2) a record of the company's assets and liabilities.
- (b) (i) Liability for this offence is criminal.
- (ii) A person guilty is liable to both imprisonment and a fine.
- (iii) The Court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.
- (iv) The relevant act must have taken place within two years prior to the commencement of winding-up.
- (v) It is a defence if the accused can prove both an absence of dishonesty and that in the circumstances the failure was excusable.
- (c) Under the CO Cap 622, the category of persons who can be liable for offences committed by officers and shadow directors has been widened. The CO Cap 622 introduced a concept of responsible person, replacing the formation of "officer who is in default" with the aim of strengthening the enforcement regime by extending the scope to cover reckless acts and omission of officers. Under the previous legislation, "officer who is in default" was defined as an officer or shadow director of a company who "knowingly and wilfully authorises or permits the default, refusal or contravention". However, the threshold imposed rendered prosecution against officers difficult.

By contrast, under CO Cap 622, a responsible person is liable for an offence if the person authorises or permits, or participates in, the contravention or failure. A responsible person includes officers or shadow directors of a company or non-Hong Kong company as well as officers or shadow directors of a company that is an officer or shadow director of the company or non-Hong Kong company.⁴⁰

2.6 Penalty for falsification of books⁴¹

- (a) It is an offence for any officer⁴² of the company (whether past or present) or a contributory to destroy, mutilate, alter or falsify any book, papers or securities, or make any false or fraudulent entry (or be privy to such entry) in any register, book of account or document of the company with the intent to defraud or deceive any person.
- (b) (i) Liability for this offence is criminal.
- (ii) A person guilty of any of the above offences is liable to both imprisonment and a fine.

³⁶ Section 274 CWUMPO. Liability under this provision constitutes a ground for determining whether or not a director is unfit to be a director under 15th Schedule and Section 168H CWUMPO (see 2.10.4(iii) below).

³⁷ Officer includes the directors, managers and secretary of the company (see 3.2 below).

³⁸ Section 351(2) CWUMPO.

³⁹ If the winding up of a company commences before the expiry of the period of 2 years beginning on the first day of the company's first financial year that begins on or after 13 February 2017, the meaning of "proper" books of account as set out in the former section 274(2) CWUMPO will apply for a part of the record keeping period (whether in whole or in part) with a financial year of the company that begins before 13 February 2017.

⁴⁰ Section 3 CO Cap 622.

⁴¹ Section 272 CWUMPO.

⁴² Officer includes the directors, managers and secretary of the company (see 3.2 below).

- (iii) The Court determines the length of the term of imprisonment and/or the amount of the fine according to the gravity of the wrongdoing as a punitive measure, not as a means of compensating the company.
- (iv) The relevant act may be committed any time before or during the course of the winding up of the company.
- (v) A defence is absence of intent to defraud or deceive any person.

2.7 Misfeasance⁴³

- (a) A past or present officer⁴⁴ or any person who has taken part in the formation or promotion of the company will be liable if found to have misapplied or retained or become liable or accountable for any money or property of the company or is found guilty of any misfeasance, breach of duty or breach of trust.
- (b) (i) Liability for this offence is civil.
- (ii) Any damages award is designed to compensate the company for any loss caused and is not intended as a punitive measure. The Court has a wide discretion to compel the officer to repay or restore the money or any part of it with interest as it considers just, having regard to proportionality.
- (iii) The time within which the relevant act must have been committed is limited only by the Limitation Ordinance.⁴⁵
- (iv) Any officer of the company may be excused by the Court if it can be shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused.⁴⁶

2.8 General fiduciary duties owed to a company

- (a) The duties of a director are those applying to all fiduciaries. A director must act with the utmost good faith towards the company, that is, its present and future members. However, as a company approaches insolvency, directors must also begin to take into account the interests of the company's creditors. When a company is insolvent, the interests of the creditors override the interests of the members. The fiduciary duties of directors are as follows:
 - (i) to act honestly and in good faith in the best interests of the company;
 - (ii) to exercise their powers for a proper purpose;⁴⁷
 - (iii) to avoid any conflict between their duties as a director and their personal interests; and
 - (iv) not to make a secret profit.
- (b) (i) Liability for breach of a director's fiduciary duty is civil.
- (ii) Liability is for all loss caused to the company by the breach of duty subject to the usual rules of recoverability based on considerations of causation and remoteness of damage.

⁴³ Section 276 CWUMPO.

⁴⁴ Officer includes directors, managers and secretary of the company (see 3.2 below).

⁴⁵ Limitation Ordinance (Cap 347).

⁴⁶ Section 903 CO Cap 622.

⁴⁷ In the case of *Grand Field Group Holdings Ltd v Chu King Fai & Ors* (No 3) [2014] HKCU 1470 (appeal on other issues dismissed – see [2016] 1 HKLRD 1316), the Court held that in order to establish liability on the part of the director, it is only necessary for a plaintiff to provide that either the director did not honestly believe what he was doing was in the company's best interests or that the powers conferred on him had been exercised for an improper use. Given this, it is important that in exercising the powers conferred on him, a director must hold an honest belief that it is for the best interests of the company and the exercise of power must be for proper purposes.

- (iii) Directors found to have acted in breach of their fiduciary duties are jointly and severally liable for the entire loss. However, the Court can allocate contributions as between the defendant directors taking into consideration their respective levels of culpability.⁴⁸
- (iv) The time within which action must be taken against a director is limited only by the Limitation Ordinance.⁴⁹
- (v) Any director may be relieved by the Court from liability for a breach of fiduciary duty in whole or in part on such terms as the Court thinks fit if it can be shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused.⁵⁰

2.9 Statutory duties of skill and care

- (a) The CO Cap 622 has introduced a statutory duty for directors and shadow directors⁵¹ to exercise reasonable care, skill and diligence when carrying out their duties,⁵² replacing the common law duties previously applicable to directors.

The test for what would constitute reasonable care, skill and diligence has both subjective and objective components and is similar to the common law duties previously in place. In performing their duties, directors are required to apply the care, skill and diligence that would be exercised by a reasonably diligent person with:

- (i) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and
 - (ii) the general knowledge, skill and experience that the director has.
- (b) (i) Liability for breach of this duty is civil.
 - (ii) The Court will award damages to compensate the company for the loss that has been suffered as a result of the director's breach of duty.
 - (iii) Directors found to have acted in breach of their statutory duty of skill and care are jointly and severally liable for the entire loss. However, the Court can allocate contributions as between the defendant directors taking into consideration their respective levels of culpability.⁵³
 - (iv) The time within which action must be taken against a director is limited only by the Limitation Ordinance.⁵⁴
 - (v) Any director may be relieved by the Court from liability for a breach of statutory duty of skill and care in whole or in part on such terms as the Court thinks fit if shown that he has acted honestly and reasonably and having regard to all the circumstances of the case he ought fairly to be excused.⁵⁵

2.10 Standard of fiduciary and statutory duties owed by executive and non-executive directors

The Courts have declined to make any distinction between executive and non-executive directors when assessing whether a director has met the requirements imposed by his fiduciary and statutory duties. However, the Court may take into account the 'position' of the director, such as whether his functions are discharged on a part-time basis.⁵⁶

⁴⁸ Civil Liability (Contribution) Ordinance (Cap. 377).

⁴⁹ Limitation Ordinance (Cap 347).

⁵⁰ Section 903 CO Cap 622.

⁵¹ A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 1.3.5 above).

⁵² Section 465 CO Cap 622.

⁵³ Civil Liability (Contribution) Ordinance (Cap. 377).

⁵⁴ Limitation Ordinance (Cap 347).

⁵⁵ Section 903 CO Cap 622.

⁵⁶ *Equitable Life Assurance Society v Bowley* [2003] B.C.C. 829.

The fiduciary and statutory duties of a director may be extended by contractual arrangement (e.g. a director who has a service contract may have additional contractual duties) but they cannot be limited or reduced by way of contractual arrangement. Section 468 CO Cap 622 prohibits any provision in a contract or in a company's memorandum or articles of association which exempts any officer of the company from liability for breach of duty.

In the absence of an employment contract, a non-executive director will not owe any contractual duties of care to the company. It is accepted that the non-executive director may rely on his co-directors to carry out various tasks and functions. However this does not abrogate his responsibility to inform himself about the company's affairs and to join with his co-directors in supervising and controlling them. The non-executive director may rely on a co-director to the extent that any matter lies within the co-director's sphere of responsibility having regard to the way the business of the company is organised and where there exist no reasons for supposing that this reliance is misplaced. Note that the extent to which a non-executive director may reasonably rely on the executive directors and other professionals to perform his own duties is an area in which the law is developing and has been described as 'fact sensitive'.

2.11 Liability of directors to disqualification for acts in the twilight zone⁵⁷

The provisions in the CO providing for disqualification of directors are based upon the Company Directors Disqualification Act 1986 (CDDA).⁵⁸ Under Hong Kong law, a Court may order that a person who is appointed as a director be disqualified or, if not holding such a position, be restricted from being a director or taking part in the management, formation or promotion of a company, for a period of up to fifteen years. Under S 168C CWUMPO, "company" is widely defined to include unregistered companies, or registered companies, whether they may be incorporated in or outside of Hong Kong.

There is no definitive 'twilight zone' for directors in respect of disqualification. Some grounds for disqualification do not require that the company is insolvent either at the time or after the person commits the relevant acts. Where the company is required to be or subsequently to have become insolvent, there are no specific periods in which the director must have committed the acts prior to the insolvency of the company.

As under the CDDA, there is no provision under Hong Kong law for automatic disqualification. It should be noted that where a person is found liable for fraudulent trading, the Court has a discretion to make a disqualification order against such person irrespective of whether an application for a disqualification order is made.⁵⁹

Apart from where a disqualification order is made as part of the sentence imposed following conviction for a crime, disqualification proceedings have been held to be civil in nature. However, a person who contravenes a disqualification order commits a criminal offence and is liable to imprisonment and a fine.⁶⁰

2.11.1 Grounds for disqualification

There are six grounds for disqualification. The three grounds which can apply to a company outside of insolvency are:

- (i) where any person has persistently breached requirements of the CO for the filing of any return, account or other delivery to the Registrar;⁶¹
- (ii) where a person is convicted of an indictable offence in connection with the promotion, formation, management or liquidation of the company or in connection with the receivership or management of a company's property or any other indictable offence which involves fraud or dishonesty;⁶² and

⁵⁷ Part IVA CWUMPO.

⁵⁸ See 2.15 of the England Chapter.

⁵⁹ Section 168L CWUMPO.

⁶⁰ Section 168M CWUMPO.

⁶¹ Section 168F CWUMPO.

⁶² Section 168E CWUMPO. Examples include section 273 and section 276 of CWUMPO.

(iii) where it appears to the Financial Secretary from a report made to him that it is expedient in the public interest that a disqualification order should be made against a person who is or has been a director or shadow director of any company, he has applied to the Court and the Court is satisfied that the person's conduct makes him unfit to be concerned in the management of a company.

The three remaining grounds require that the company is insolvent at the time of the relevant conduct or subsequently becomes insolvent. These grounds are:

(iv) where, in the course of a winding up of a company, it appears that a person is guilty of fraudulent trading (criminal liability) or otherwise guilty while being an officer⁶³ or shadow director⁶⁴ of the company of any fraud or breach of duty.^{65,66}

(v) where a Court is satisfied that the conduct of a past or present director⁶⁷ or shadow director⁶⁸ of an insolvent company, makes him unfit to be concerned in the management of a company⁶⁹ (the Court has no discretion as to whether the director is disqualified in the event that unfitness is proved);⁷⁰ and

(vi) where a director is found liable for fraudulent trading (even if no application for a disqualification order was made).⁷¹

There is no statutory definition of 'unfitness' but certain factors may be taken into account when determining the fitness of a director. These are listed in the Fifteenth Schedule of the CWUMPO. The list includes factors that apply whether a company is solvent or not, such as breach of fiduciary duty, misfeasance and misapplication of company property, and those factors which apply specifically to insolvent companies, such as the causes of the company's insolvency and the company entering into any transaction or giving any unfair preference which is liable to be set aside.⁷² The list is not exclusive and may be modified by order of the Financial Secretary. The Court will look at any matters or acts relevant to the conduct of the affairs of the company and its insolvency, such as the statutory requirements for keeping proper books of account, delivering the company's property to the liquidator and compiling the statement of affairs. Except with the leave of the Court, an action for disqualification relying on the ground of unfitness must be made within four years of the date of commencement of winding-up or within four years from the date on which a receiver's appointment is terminated.⁷³

2.11.2 Length of disqualification

The period of disqualification is in the Court's discretion subject to the maximum period being generally 15 years (and the Court having jurisdiction where disqualification arises on conviction of an indictable offence).⁷⁴ The Hong Kong Court has applied the guidelines set down by the English Court of Appeal which divides cases into three categories according to their severity:⁷⁵

(i) 1 - 5 years for cases which are relatively not very serious;⁷⁶

(ii) 6 - 10 years for serious cases which do not merit the top bracket;⁷⁷ and

⁶³ Officer includes directors, managers and secretary of the company (see 3.2 below).

⁶⁴ A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 1.3.5 above).

⁶⁵ Conviction under section 275 of CWUMPO is not required, the Court need only to have taken the view that the person is guilty of such an offence.
⁶⁶ Section 168G CWUMPO.

⁶⁷ A director includes a person duly appointed as a director and any person occupying the position of director by whatever name called (see 1.2.1 above).

⁶⁸ A shadow director is a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act (see 1.3.5 above).

⁶⁹ Section 168H CWUMPO.

⁷⁰ Section 168H(1) CWUMPO.

⁷¹ Section 168L CWUMPO.

⁷² Sections 182, 265D or 266 CWUMPO (see section 4 below).

⁷³ Section 168I(2) CWUMPO.

⁷⁴ Section 168E(3) CWUMPO.

⁷⁵ *Re Observers Travel Enterprise Co Ltd (In Liquidation)* [2001] HKCFI 78 applying *Re Sevenoaks Stationers (Retail) Limited* (1991) CoA.

⁷⁶ There is a minimum requirement of a one-year period where a director is disqualified on the grounds of being unfit (Section 168H) (*Re Emperor Hotel* [2002] 3 HKLRD 805). A number of cases in Hong Kong have referred (applying *Re Sevenoaks Stationers (Retail) Limited* (1991) (CoA)) to a minimum period of 2 years. However, this is not correct and subsequent cases have shown that disqualification periods of less than 2 years can be ordered.

⁷⁷ An example was in *Re Observer Travel Enterprise Co Ltd* where the director was found to have lacked commercial probity and had personally benefited from the creditor's expense and was disqualified for a period of six years.

- (iii) 10 -15 years for particularly serious cases, including where a director is disqualified for a second time.

Enforcement of disqualification orders in Hong Kong is primarily the responsibility of government regulators (particularly the Official Receiver’s Office), however the following should be noted:

- (i) if a Court finds a person liable for fraudulent trading under S 168L CWUMPO, it may make a disqualification order whether or not it has been applied for;
- (ii) an application for disqualification relying on (A) conviction of an indictable offence under S 168E CWUMPO or (B) where it appears a person is guilty of fraudulent trading (criminal liability) or otherwise guilty while being an officer of any fraud or breach of duty in the course of the winding-up of the company under S 168G CWUMPO, may also be brought by the Financial Secretary, the liquidator or any past or present member or creditor of any company against which that person has committed an offence or default; and
- (iii) an application for disqualification relying on one of the two ‘unfitness’ grounds⁷⁸ may be brought by either the Official Receiver or the Financial Secretary as long as it is considered to be in the public interest.⁷⁹ Liquidators and receivers have a duty to report any matter which appears to relate to the unfitness of a director to the Official Receiver who may then report the matter to the Financial Secretary with a view to determining whether there is a case for disqualification proceedings on the ground of unfitness.

2.11.3 Duty to co-operate

Liquidators have the power under the CO CWUMPO to require directors to provide certain information and deliver up the company’s property to them and the Court may penalise directors for failing to co-operate (see S 7 below for more detail).

Disqualification proceedings on the grounds of unfitness under S 168H CWUMPO must be brought within four years of the date of commencement of winding-up or the date on which a receiver’s appointment is terminated unless leave of the Court is obtained. There is no time limit prescribed for an application relying on any other ground.

2.11.4 Foreign corporations

There is no territorial restriction to the jurisdiction of the Hong Kong Court to make a disqualification order. Provided that either the company in question or some other company with which the person has been connected is the subject of insolvency proceedings in Hong Kong, an order can be made against a foreign national or resident abroad in relation to a Hong Kong incorporated company or registered overseas company or any unregistered company incorporated outside Hong Kong and can be based on acts committed abroad.

2.12 Liability of directors involved in share redemption or buy-back out of capital

- (a) The CWUMPO Amendment has introduced a new provision to claw back payments made by a company out of capital in respect of the redemption or buy-back of its own shares.⁸⁰ Where a company is being wound up; and
 - (i) it has made a payment out of capital in respect of the redemption or buy-back of any of its own shares (payment out of capital) from a person (past shareholder) under Division 4 of Part 5 of CO Cap 622;
 - (ii) the aggregate amount of the company’s assets and the amounts paid by way of contribution to its assets is insufficient for payment of its debts and liabilities, and the costs, charges and expenses of the winding up; and

⁷⁸ i.e. under section 168H CWUMPO in relation to an insolvent company or under section 168J CWUMPO following investigation.

⁷⁹ Section 168(1) CWUMPO.

⁸⁰ Section 170A CWUMPO.

- (iii) the winding up commenced on, or within 1 year after, the date on which the payment out of capital was made, then the directors who signed the solvency statement as required under S 259(1) of CO Cap 622 in relation to the payment out of capital (except a director who shows that he had reasonable grounds for forming the opinion expressed in the statement) are jointly and severally liable with the past shareholder to contribute an amount not exceeding the amount of the payment out of capital.
- (b) (i) Liability under this provision is civil.
- (ii) A director who signed the solvency statement is liable to contribute an amount not exceeding the amount of the payment out of capital.
 - (iii) The directors are jointly and severally liable with the past shareholder to contribute to the company's assets. However, the Court can allocate contributions as between the defendant directors taking into consideration their respective levels of culpability.
 - (iv) The winding up must commence on, or within 1 year after, the date on which the payment out of capital was made.
 - (v) A director who shows that he/she had reasonable grounds for forming the opinion expressed in the statement will not be liable to contribute to the company's assets under this provision. Further, this provision does not apply in relation to a payment out of capital in respect of the redemption or buy-back of a company's own shares that took place before 13 February 2017.

QUESTION 3

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

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the "twilight" period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 Introduction

Hong Kong law is similar to English law in that it may impose liability on a wide variety of persons who have been involved in the management of a company during the twilight period depending on the particular act or offence. Hong Kong law recognises that a company's affairs during this time may not only be influenced by those formally appointed as directors but also by a wide range of other people. If such people have caused loss to the company and its creditors during this time, they may also be found personally liable for such loss.

As discussed in 1.3 above, liability first extends in certain circumstances to those persons who act as directors but have not been formally appointed, that is, "shadow directors" and "*de facto*" directors. In addition, officers of the company (apart from directors) who are involved in the affairs of the company during the twilight period may also be held liable, as can third parties who are not in any way involved in the management of the company but who may be a party to transactions during the twilight period which are vulnerable to challenge, such as unfair preferences. Liability may also arise where a third party has knowledge of a breach of duty of a director when entering into a transaction and either fraudulently assisted in that breach and/or received property from the company with knowledge of that breach. Under general equitable principles, such a person may be

liable as a constructive trustee of such property and be liable to return it or to pay compensation to the company.

3.2 Officers

Liability for many of the offences set out in 1.4 above is not limited to those persons acting as directors but, by reference to the ‘officers’ of the company, extends to other persons who are managing the affairs of the company. This is a defined term in the CO Cap 622 meaning a director,⁸¹ manager or company secretary; a manager is defined as ‘a person who performs managerial functions in relation to the company under the directors’ immediate authority’ but does not include receivers and special managers.⁸² This definition suggests that a manager is limited to only those at a more senior level who are exercising managerial functions as such person must be ‘under the immediate authority’ of the board.

3.3 Shareholders

Where a company is being wound up; and

- (i) it has made a payment out of capital in respect of the redemption or buy-back of any of its own shares (payment out of capital) from a person (past shareholder) under Division 4 of Part 5 of CO Cap 622;
- (ii) the aggregate amount of the company’s assets and the amounts paid by way of contribution to its assets is insufficient for payment of its debts and liabilities, and the costs, charges and expenses of the winding up; and
- (iii) the winding up commenced on, or within 1 year after, the date on which the payment out of capital was made, the past shareholder is jointly and severally liable with the directors (who signed the solvency statement) to contribute an amount not exceeding the amount of the payment out of capital.⁸³

3.4 Other third parties that may be held liable

The following third parties may be found liable for misfeasance or breach of duty owed to the company:⁸⁴

- (i) provisional liquidators or liquidators of the company;
- (ii) receivers or managers of the property of the company;
- (iii) any other persons who are or have been concerned, or are taking or have taken part, in the promotion, formation or management of the company.

Third parties may be held liable for some of the above offences.

- (i) If a third party receives property as a result of a transaction at an undervalue (on or after 13 February 2017) or an unfair preference, that person will be liable to return the property and/or provide compensation as the Court thinks fit with a view to restoring the position to what it would have been had the unfair preference not occurred.⁸⁵
- (ii) If a third party receives property of the company which has been disposed of after the winding-up order has been made without the Court’s consent, that disposal will be void.⁸⁶

⁸¹ This includes de facto directors by virtue of the definition of director (see 1.2.1).

⁸² Section 2(1) CO Cap 622.

⁸³ Section 170A CWUMPO.

⁸⁴ Section 276 CWUMPO.

⁸⁵ Sections 266C CWUMPO.

⁸⁶ Section 182 CWUMPO.

- (iii) A third party will be liable for fraudulent trading if that person is knowingly party to the carrying on of a business with an intent to defraud creditors.⁸⁷ As stated above, the 'carrying on of a business' need only constitute a single act. It is likely that an employee who merely carries out orders will not be liable but that a person must have taken a positive step.⁸⁸
- (iv) Any third party who has dishonestly assisted in a breach of duty by a director or other officer of a company or knowingly received property arising from such a breach will be liable for any loss arising. This applies to all circumstances and is not limited to actions taken in the 'twilight zone' and falls within the Hong Kong Court's equitable jurisdiction.
- (v) Any third party who takes in or receives property belonging to a company knowing it to have been pawned, pledged or disposed of in the course of the winding up of the company (or 12 months prior its commencement) for the purpose of obtaining credit and which has not been paid for incurs criminal liability. It is a defence if the third party can prove an absence of intent to defraud.⁸⁹

3.5 Summary

Liability may attach to persons not formally appointed as directors for the following offences:

Offences / activity	Persons liable	Extent of liability
Fraudulent trading (s.275 CWUMPO)	Any person who was knowingly a party to the carrying on of the business for a fraudulent purpose (including persons dealing with the company who receive property with knowledge of the fraud)	Same as for director
Fraud by officers of companies which have gone in to liquidation (s.273 CWUMPO)	Officers of the company at the time of the fraud	Same as for director
Offences by officers of companies in liquidation (s.271 CWUMPO)	Any officer or shadow director of the company at the time of the offence. A s.271(o) offence includes third parties who take property of the company in the knowledge that is pawned, pledged or disposed of for the purpose of obtaining credit which has not been paid for (see 3.3.2(v) above)	Same as for director
Liability where proper accounts not kept (s.274 CWUMPO)	Officers and shadow directors ⁹⁰ (who knowingly and wilfully authorise or permit the default) of the company at the time of the default	Same as for director
Falsification of books (s.272 CWUMPO)	Officers or contributories of the company at the time of the offence	Same as for director
Misfeasance (s.276 CWUMPO)	Any officer, provisional liquidator or liquidator, receiver or manager of the property of the company, and any person who has taken part in the promotion, formation or management of the company	Same as for director

⁸⁷ Section 275 CWUMPO.

⁸⁸ This is the common law position under English Law (see *Re Bank of Credit and Commerce International SA (No 2) Banque Arabe et Internationale D'Investissement SA v Morris and others* [2000] All ER (D) 1437).

⁸⁹ Section 271(2) CWUMPO.

⁹⁰ Section 351(2) CWUMPO specifies that a "defaulting officer" includes officers and shadow directors.

Offences / activity	Persons liable	Extent of liability
Unfair preference (ss.266 to 266B CWUMPO)	Creditor, surety and guarantor	The Court has discretion to restore the position of the parties to what it would have been had the preference never been made (e.g. return of property)
Transaction at an undervalue (ss.265D and 265E CWUMPO)	Recipient of property/benefit	The Court has discretion to restore the position of the parties to what it would have been had the transaction never been made (e.g. return of property)
Fraudulent conveyance (s.60 Conveyancing and Property Ordinance)	Recipient of property/benefit	The Court has discretion to restore the position of the parties to what it would have been had the disposition never been made (e.g. return of property)
Dishonestly assisting or knowingly receiving property or assets in breach of duty	Any person with the requisite degree of “knowledge” who knowingly assists in a breach of duty owed by a person to a company or knowingly receives property from a breach of duty owed to the company	Where requisite knowledge and other applicable conditions are satisfied, a person may be held to be a constructive trustee of the property and required to return such property or pay compensation equal to the loss caused
Liability involved in share redemption or buy-back out of	Past shareholders	Same as director

3.6 Legislative remedies for protection of interests

Hong Kong’s corporate governance regime also provides for a wide range of remedies that may affect third parties or contractual counterparties in certain circumstances. As well as restating existing provisions relating to the protection of companies’ or members’ interests under the old Companies Ordinance Cap 32, the CO Cap 622 has also introduced the following key initiatives aimed at fostering shareholder protection:

- (i) extending the scope of the unfair prejudice remedy to cover proposed acts and omissions; and
- (ii) enhancing the Court’s discretion in granting relief in cases of unfair prejudice.

Under the old legislation, a member of a company was entitled to petition the Court if the affairs of the company were being, or had been, conducted in a manner unfairly prejudicial to the interests of the members generally or of some part of the members; however, it was unclear whether a petition could be bought in respect of a course of action at the proposal stage.

The CO Cap 622 has sought to remove this uncertainty and provides that the Court may exercise the power to grant remedies if there is any actual or proposed act or omission of the company (including one done or made on behalf of the company) which is or would be prejudicial to the interests of the members.⁹¹ Further, under CO Cap 622, the Court can make any order it sees fit to give relief,⁹² and expressly allows the Court to order any person to pay damages as the Court sees fit.

⁹¹ Section 724(1)(b) CO Cap 622.

⁹² Section 725 CO Cap 622.

If, in relation to a company, a person engages in conduct that constitutes a contravention of the CO Cap 622 or a breach of any fiduciary duty owed to the company (or other director's duty owed to the company), then the Court may order remedies including damages and a declaration that any contract is void or voidable.⁹³

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Introduction

The provisions under Hong Kong law allowing transactions which are to the detriment of a company and / or unfairly beneficial to a counterparty to be overturned reflect the English law provisions. Prior to the CWUMPO Amendment, there were no means by which a person could challenge transactions which were at an undervalue in relation to a corporate insolvency.⁹⁴ This considerably weakened the Hong Kong regime as the alternatives, unfair preference and fraudulent conveyance, both require *mens rea* on the part of the person acting on behalf of the company. The position has changed since 13 February 2017, and the Court is now allowed to set aside transactions at an undervalue and restore the position of the parties to what it would have been had the company not entered into the relevant transaction.

4.2 Summary of heads of challenge

The potential heads of challenge which may lead to transactions with the company being set aside retrospectively, resulting in the counterparty losing the benefit of the transaction, are as follows:

- (a) unfair preferences;
- (b) transactions at an undervalue (entered into on or after 13 February 2017);
- (c) fraudulent conveyances;
- (d) extortionate credit transactions;
- (e) granting of floating charges for past value;
- (f) transactions entered into in breach of a director's fiduciary duties;
- (g) transactions comprising onerous property;
- (h) transactions constituting a disposition of company property after the commencement of the winding-up; and
- (i) transactions comprising an unregistered charge.

⁹³ Section 729 CO Cap 622.

⁹⁴ The equivalent English law provisions are sections 238 and 423 IA 1986.

4.3 Unfair preference

An unfair preference occurs when an act of the company, whilst it is insolvent but before the commencement of its winding-up, has the effect of putting a creditor in a better position in the company's winding-up than it would have been in had the company not taken such action. The liquidator is the only person who may challenge such transactions. If the challenge is successful, the Court has a wide range of powers to exercise in its discretion to restore the position of the parties to what it would have been if the company had not entered into the relevant transaction.⁹⁵

4.3.1 Conditions for setting aside the transaction

The following conditions must be satisfied to challenge a transaction successfully:

- (1) the company must be in liquidation and the application challenging the transaction must be made by the liquidator;⁹⁶
- (2) the transaction must take place during the 'relevant' period which ends with the commencement of the winding-up of the company.⁹⁷ The applicable period depends on the identity of the preferred person and is:
 - (A) two years for an unfair preference given to a connected person (or an 'associate' for an unfair preference given before 13 February 2017); and
 - (B) six months for an unfair preference given to any other person.
- (3) the company is unable to pay its debts within the meaning of S 178 CWUMPO (or 'insolvent'⁹⁸ for an unfair preference given before 13 February 2017) at the time of or becomes unable to pay its debts within the meaning of S 178 CWUMPO (or 'insolvent' for an unfair preference given before 13 February 2017) as a result of the transaction.

Prior to the CWUMPO Amendment, there was no satisfactory definition of an 'associate' of a company,⁹⁹ because the application of unfair preference provisions to companies is achieved only by incorporation of the relevant sections of the Bankruptcy Ordinance (which apply only to individuals). There are some categories of associate as defined in the Bankruptcy Ordinances which obviously have no application to a company, such as spouses or relatives. The persons falling within the definition of 'associate' which are relevant to a company are as follows:

- (i) any person in partnership with a company;
- (ii) any person who employs or is employed by the company (directors and other officers are treated as employees under this provision);
- (iii) a person who is a trustee of a trust where the beneficiaries of the trust include or the terms of the trust confer a power that may be exercised for the benefit of the company or an associate of the company; and
- (iv) another company which is 'controlled' by the company in liquidation or if the company in liquidation and associates of that company together have control.¹⁰⁰

It should be noted that those persons not falling within the definition of associate are as follows:

- (i) a holding or parent company of the company in liquidation or any other company in the same group which is not under the control of the company in liquidation;

⁹⁵ Section 266 CWUMPO.

⁹⁶ Section 50(1) Bankruptcy Ordinance (Cap 6) / section 266(1) CWUMPO.

⁹⁷ The commencement of the winding-up of the company for the purpose of this section is the day on which the relevant petition to wind-up the company was presented or, in the case of a voluntary winding-up, the date of the relevant resolution.

⁹⁸ A company is 'insolvent' where it is unable to pay its debts as they fall due or the value of the company's assets is less than the amount of its liabilities (taking into account contingent and prospective liabilities) (see section 51(3) Bankruptcy Ordinance (Cap 6)).

⁹⁹ Section 51B Bankruptcy Ordinance (Cap 6).

¹⁰⁰ One company (A) is controlled by another (B) where (i) the directors of A or of another company which has control of A are accustomed to act in accordance with the directions or instructions of B (except if B is giving advice in a professional capacity) or (ii) B is entitled to exercise or control the exercise of one-third or more of the voting power at any general meeting of A or of a company which has control of A (section 51B(8) Bankruptcy Ordinance (Cap 6)).

- (ii) the spouse or relatives of a director (directors are associates but only because they are regarded as employed by the company); and
- (iii) shadow directors.

Pursuant to the new S 265A of the CWUMPO, a person is connected with a company if that person is (a) an associate of a director or shadow director of the company; or (b) an associate of the company. The new definition of ‘associate’ as set out in Ss 265B and 265C of CWUMPO has clarified its application in the context of corporate insolvency and has expanded to include the following (amongst others):

- (i) a spouse, cohabitant or relative of a person;
- (ii) a relative of a spouse or cohabitant of a person;
- (iii) a spouse or cohabitant of a relative of a person;
- (iv) an employer or employee of a person;
- (v) a director, shadow director or other officer of a company;
- (vi) a holding or parent company of a company;
- (vii) any other company in the same group which is not under the control of the company;
- (viii) a company controlled by a person, together with the associates of that person (if any).

What is an unfair preference?

A company gives an unfair preference if:

- (1) the person who is preferred is one of the company’s creditors, or a surety or guarantor for any of the company’s debts or liabilities;¹⁰¹ and
- (2) the company does anything or suffers anything to be done which has the effect of putting that person in a better position in the event of the company’s insolvency than if that thing had not been done.

The test to determine whether a creditor has been preferred is whether the creditor is better off in the event of the company’s winding-up, so that the statutory order of priorities is in some way disturbed.

4.3.2 Defences

The Court shall not make an order against a person under this section unless the company who gave the unfair preference was influenced in deciding to give it by a desire to give a preference to that person.¹⁰² This is a question of fact. The English Court’s decisions and comments on the equivalent section of the Insolvency Act will be regarded as persuasive in Hong Kong.¹⁰³

If the creditor is a connected person / an ‘associate’ (depending on the date of the preference) of the company (unless by reason only of being its employee), there is a presumption that the company was influenced by such a desire, unless the contrary is shown.¹⁰⁴ For unfair preferences given prior to 13 February 2017, as directors and other officers of a company were only associates by virtue of being deemed to be employees, this presumption would not apply to them.

¹⁰¹ Section 50(3)(a) Bankruptcy Ordinance (Cap 6) / section 266A CWUMPO.

¹⁰² Section 50(5) Bankruptcy Ordinance (Cap 6) / section 266(4) CWUMPO.

¹⁰³ See 4.4.5 and 4.4.6 of the England Chapter.

¹⁰⁴ Section 50(5) Bankruptcy Ordinance (Cap 6).

The Court may not make an order if:

- (i) it would prejudice any interest in the property which was acquired from a person other than the company and was acquired in good faith and for value, or prejudice any interest deriving from such interest; or
- (ii) it would require a person who has received a benefit from the unfair preference in good faith and for value to pay a sum to the liquidator (except where the payment is in respect of an unfair preference given at a time when he was a creditor of the company).¹⁰⁵

There is a presumption that the benefit of the preference was not acquired in good faith if the creditor had notice of the circumstances amounting to the unfair preference or of the liquidation proceedings at the time of the unfair preference or the preferred person was a connected person / an 'associate' (depending on the date of the preference) of the company or the creditor to whom the company gave the unfair preference.¹⁰⁶

4.4 Transactions at an undervalue¹⁰⁷

Following the CWUMPO Amendment, provisions on transactions at an undervalue were introduced into corporate insolvency in Hong Kong.

A transaction at an undervalue is a transaction entered into at a time when the company is insolvent or becomes insolvent as a result of the transaction and it later goes into 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 liquidator is the only person who may challenge the transactions. If the challenge is successful, the Court has a wide range of powers to exercise in its discretion to restore the position of the parties to what it would have been if the company had not entered into the relevant transaction.¹⁰⁸

The provisions on transactions at an undervalue do not apply in relation to a transaction at an undervalue entered into by a company before 13 February 2017.

4.4.1 Conditions for setting aside a transaction at undervalue

The following conditions must be satisfied to challenge a transaction successfully:

- (1) the company must be in liquidation and the application challenging the transaction must be made by the liquidator;¹⁰⁹
- (2) the transaction must take place at a time in the period of five years ending with the day on which the winding up of the company commences;¹¹⁰ and
- (3) the company is unable to pay its debts (within the meaning of S 178 CWUMPO) at that time of or becomes unable to pay its debts (within the meaning of S 178 CWUMPO) in consequence of the transaction.¹¹¹ This condition will be presumed to be satisfied, unless the contrary is shown, in relation to a transaction at an undervalue which is entered into by the company with a connected person (otherwise by reason of being its employee).¹¹²

4.4.2 What is a transaction at an undervalue?

A company enters into a transaction with a person at an undervalue if it:

- (1) makes a gift to that person or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration; or

¹⁰⁵ Section 51A(2) Bankruptcy Ordinance (Cap 6).

¹⁰⁶ Section 51A(3) Bankruptcy Ordinance (Cap 6) / section 266C(4) CWUMPO.

¹⁰⁷ Section 265D CWUMPO.

¹⁰⁸ Section 265D CWUMPO.

¹⁰⁹ Section 265D CWUMPO.

¹¹⁰ Section 266B CWUMPO. The commencement of the winding-up of the company for the purpose of this section is the day on which the relevant petition to wind-up the company was presented or, in the case of a voluntary winding-up, the date of the relevant resolution.

¹¹¹ Section 266B(2) CWUMPO.

¹¹² Section 266B(3) CWUMPO.

- (2) enters into a transaction with that person for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company.¹¹³

4.4.3 Defences

The Court must not make an order under this provision if it is satisfied that:

- (1) the company entered into the transaction in good faith and for the purpose of carrying on its business; and
- (2) at the time it did so, there were reasonable grounds for believing that the transaction would benefit the company.¹¹⁴

Further, the Court may not make an order if:

- (i) it would prejudice any interest in the property which was acquired from a person other than the company and was acquired in good faith and for value, or prejudice any interest deriving from such interest; or
- (ii) it would require a person who has received a benefit from the transaction in good faith and for value to pay a sum to the liquidator (except where that person was a party to the transaction).¹¹⁵

There is a presumption that the benefit of the transaction at an undervalue was not acquired in good faith if the third party had notice of the fact that the company entered into the transaction at an undervalue or of the liquidation proceedings at the time of the acquisition or receipt, or the third party was a connected person of the company or the person with whom the company entered into the transaction.¹¹⁶

4.5 Fraudulent conveyance¹¹⁷

A transaction may be set aside by the Court if it amounts to a disposition of property with the 'intent to defraud creditors'. Although the relevant provision is found in the Conveyancing and Property Ordinance, it applies not only to land but to all forms of property. A liquidator, creditor or other person thereby prejudiced may apply to Court for relief. There are no specific time limits attached to this section. This provision is rarely relied upon due to the difficulty in proving the intention to defraud.

The main defences are (i) absence of intention to defraud creditors, and (ii) that the property was disposed of for valuable or upon good consideration and in good faith to any person not having, at the time of the disposition, notice of the intent to defraud creditors.

4.6 Extortionate credit transactions¹¹⁸

4.6.1 Conditions

The Court may set aside or vary a transaction for or involving the provision of credit to the company if:

- (1) the company is or has been a party to the transaction;
- (2) the company is in liquidation;
- (3) application is made by the liquidator;
- (4) the transaction was 'extortionate'; and

¹¹³ Section 265E CWUMPO

¹¹⁴ Section 265D(4) CWUMPO.

¹¹⁵ Section 266C(4) CWUMPO.

¹¹⁶ Section 266C(4) CWUMPO.

¹¹⁷ Section 60 Conveyancing and Property Ordinance (Cap 219).

¹¹⁸ Section 264B of CWUMPO and is derived from the equivalent provision under English law (section 244 IA 1986).

- (5) the transaction was entered into within three years before the commencement of the voluntary winding-up or date of the winding-up order.

A transaction is regarded as extortionate if, having regard to the risk accepted by the person providing the credit:

- (1) the terms of it are or were such as to require grossly extortionate payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of the credit; or
- (2) it otherwise grossly contravenes ordinary principles of fair dealing.

This provision aims to prevent oppression where one of the parties is taking improper advantage of an imbalance in bargaining power.

There is a rebuttable presumption that a transaction is extortionate if an application is made under this provision.¹¹⁹

4.6.2 Defences

There are no statutory defences.

4.7 Effect of floating charge

The relevant provision seeks to prevent an insolvent company creating a floating charge over its property to secure past debts and so prefer the creditor to which the charge is provided to the prejudice of general unsecured creditors.¹²⁰

4.7.1 Conditions for setting aside

A liquidator of an insolvent company may treat a charge as void if:¹²¹

- (1) the charge was created as a floating charge (whether or not it is still floating at the time of the commencement of the winding-up);
- (2) it was created¹²² during the 'relevant' period which ends with the commencement of the winding-up of the company. The applicable period depends on the identity of the person in whose favour the charge is created and is:

(A) two years for a floating charge created in favour of a connected person; and

(B) 12 months for a floating charge created in favour of any other person;¹²³

for any floating charges created before 13 February 2017, the relevant period was 12 months prior to the commencement of the winding-up.

- (3) the company was unable to pay its debts within the meaning of S 178 CWUMPO (or 'insolvent' for a floating charge created before 13 February 2017) at the time it was created¹²⁴ unless the charge was created on or after 13 February 2017 in favour of a connected person (in which case there is no requirement that the company was unable to pay its debts); and
- (4) the charge was given otherwise than for new consideration.

¹¹⁹ Section 264B(3) CWUMPO.

¹²⁰ Section 267 CWUMPO. The purpose of this section is the same as the equivalent provision under English law (section 245 IA 1986) but the Hong Kong provision is less detailed, such that English case law in respect of section 245 IA 1986 may not apply in Hong Kong.

¹²¹ No application needs to be made by the liquidator to the Court unless the property is controlled by the party claiming security.

¹²² The date of creation being defined to be the date of creation included on the relevant registration certificate issued by the Companies Registrar – *Active Base Limited v Roderick John Sutton and Others* [2009] HKCFCA 111.

¹²³ Section 267A CWUMPO.

¹²⁴ Section 267A CWUMPO.

A charge will be valid to the extent of any cash paid to the company at the time or subsequent to the creation of the charge in consideration of the charge, together with interest on that amount at the rate specified in the charge or consideration agreement or at the rate of 12 per cent. per annum (whichever is less). A charge created on and from 13 February 2017 will also be valid to the extent that money has been paid at the direction of the chargor or property or services have been supplied to the chargor.

This section does not have a retrospective effect and therefore does not apply to avoid any payment received in respect of a floating charge created and enforced within the 12 months prior to the commencement of the winding-up.

4.7.2 Defences

There are no specific statutory defences except to the extent that it can be proved that the company was solvent immediately after the charge was created or that the charge is valid to the extent that any new consideration was given.

It is worth considering two practical situations:

- (a) Refinancing or rollover - in a two party situation this usually involves the discharge of an old debt and the creation of a new debt. Even where it cannot be said that the arrangement is a sham, a paper transaction such as this may not amount to new consideration meaning that a floating charge provided at such time may be challenged.
- (b) Overdraft turnover – a bank which operates an overdraft may benefit from the fact that fresh consideration may be provided at any time after the creation of the security. Drawings out of the account, even if replaced by payments into the account, represent new credit for these purposes¹²⁵ – 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 / statutory duties

If the directors cause the company to contract with another party on terms disadvantageous to the company, they may be in breach of their statutory duty to put the company’s interests first and exercise reasonable care, skill and diligence (see 2.9 above). The Court has powers under S 729 CO Cap 622 to, *inter alia*, declare a contract void or voidable. Where the counterparty has knowledge of this, the company may have proprietary or restitutionary rights to recover the property. These are rights under the general law and, whilst not dependent upon insolvency, are more likely to be examined and/or exercised in a formal insolvency.

4.9 Disclaimer of onerous property in case of company wound up¹²⁶

A liquidator in the course of the winding-up of a company may, with leave of the Court, disclaim ‘onerous’ property of the company notwithstanding that the liquidator has attempted to sell, take possession or exercise any act of ownership in relation to the property. If the liquidator does not disclaim the property within 12 months of the commencement of winding-up (or if the liquidator does not know of such property one month after the commencement of the winding-up, within 12 months of becoming aware of it), consent of the Court for an extension of this period must be obtained.

‘Onerous’ property includes (i) land burdened with onerous covenants, (ii) shares or stock in companies, (iii) unprofitable contracts and (iv) any other property which is unsaleable or not readily saleable by reason of some onerous act or payment being required.

The purpose of the disclaimer is to determine the rights, interest and liabilities of the company with respect to the property of the company as from the date of the disclaimer and therefore does not affect rights and liabilities already accrued. Third parties may only be effected to the extent necessary to release the company and its property from liability. Any person suffering loss or damage as a consequence of the disclaimer becomes a creditor of the company and may prove the amount of any loss as a debt in the winding-up of the company.¹²⁷

¹²⁵ This is known as the rule in *Clayton’s Case* (1816) 1 Mer 572.

¹²⁶ Section 268 CWUMPO.

¹²⁷ Section 268(7) CWUMPO.

If the liquidator fails to take action in respect of burdened property, any interested person may force the liquidator to make a decision by serving notice. If the liquidator fails to give notice of intention to apply to the Court for leave to disclaim within 28 days after receipt of the notice to him, the liquidator will lose the right to disclaim on the expiry of such period.

4.10 Avoidance of dispositions of property after commencement of winding-up.¹²⁸

In a winding-up by the Court, any disposition of the property¹²⁹ of the company, including things in action, transfer of shares, alteration in status of the members of the company, shall be void if made after the commencement of the winding-up unless the Court otherwise orders. The purpose of this section is to preserve the status quo and support the principle of *pari passu* distribution of the company's assets.

The commencement of the winding-up is the date of presentation of the winding-up petition.

This section applies to all dispositions unless a Court order is obtained validating the transaction. An application may be made by the company, liquidator, contributory or any interested person for a validating order. Leave will only be given if the disposition will not materially prejudice the company's creditors or it is likely to improve the position of all the company's creditors (for example, if the disposition enables the company to trade profitably).

4.11 Failure to register a charge

Hong Kong operates a system of registration of security similar to the system in England. If a Hong Kong incorporated company creates any security (in Hong Kong or elsewhere) over property located in Hong Kong or elsewhere, or an overseas company with a place of business in Hong Kong creates security over property located in Hong Kong, that security must be registered within one month of its creation.¹³⁰ Failure to do so renders the security void against a liquidator and any creditor of the company, and the company and every responsible person¹³¹ of the company may be liable to a fine. It is the company's duty to register the charge¹³² but any person who is interested in the charge¹³³ may and should do so.

Those charges that must be registered are:

- (a) charge on uncalled share capital of the company;
- (b) charge created or evidenced by an instrument which if executed by an individual would require registration as a bill of sale;
- (c) charge on land wherever situated or any interest therein but not including a charge for any rent or other periodical sum issuing out of land;
- (d) charge on book debts of the company;
- (e) floating charge on the undertaking or property of the company;
- (f) charge on calls made but not paid;
- (g) charge on instalments due, but not paid, on the issue price of shares;
- (h) charge on a ship or any share in a ship;
- (i) charge on an aircraft or any share in an aircraft; and

¹²⁸ Section 182 CWUMPO.

¹²⁹ The property of a company includes the balance standing to the credit of a company in a bank account, as well as a tax refund paid by the Inland Revenue Department to a third party at the direction of a company. In *Re AGL Logistics (Hong Kong) Ltd* [2016] 5 HKLRD 737, at the request of the company's sole director, a tax refund was paid to a third party. It was unlikely that the liquidators could recover the refund from the third party. The liquidators brought proceedings against the Commissioner of Inland Revenue. The Hong Kong Court of Appeal upheld the decision of Court of First Instance that the Commissioner of Inland Revenue was liable to pay the refund to the liquidators. C.f. payment made by a bank out of an overdrawn account at the direction of the company after the presentation of a petition, which does not constitute a disposition of the property of the company for the purposes of section 182 CWUMPO (*Re Super Seed Ltd* [2015] 4 HKC 200).

¹³⁰ Where the security is created outside Hong Kong and comprises property situated outside Hong Kong, the security must be registered within one month after the date on which a certified copy of the specified instrument could, if despatched with due diligence, have been received in Hong Kong in due course of post (section 335(5)(a)(ii) CO Cap 622).

¹³¹ Responsible person includes officers or shadow directors of a company or non-Hong Kong company as well as officers or shadow directors of a company that is an officer or shadow director of the company or non-Hong Kong company (see 2.5(c) above).

¹³² Section 335 CO Cap 622.

¹³³ Section 335(3) CO Cap 622.

- (j) charge on goodwill, on a patent or a licence under a patent, on a trademark or on a copyright or a licence under a copyright.

Under CO Cap 622, charges over bank accounts are not registrable. In addition, a shipowner's lien on subfreights are not "charges on book debts" or floating charges, and are therefore not registrable.

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

As mentioned in paragraph 2.12 above, legislation which would impose liability for insolvent trading has yet to be enacted in Hong Kong. In the absence of such legislation, it is not necessary for directors to analyse, when incurring credit, whether the company is insolvent and has any prospect of avoiding insolvent liquidation. Incurring credit during the twilight period is not, therefore, as hazardous as it may be in other jurisdictions, such as England. Even in the absence of insolvent trading legislation, however, directors must have regard to the interests of creditors if the company is or may become insolvent.

Conceivably the incurring of further credit which cannot be satisfied in full when due and which results in a reduction in creditors' recoveries may result in a claim by a liquidator for damages for breach of duty.

A reckless incurring of credit by directors during the twilight period, without proper consideration of the prospects of repayment in full, may lead to disqualification proceedings.

In order to be free of the risk of personal liability or vulnerability to disqualification proceedings, a director should not incur credit during the twilight period unless, following proper consideration, he is satisfied that there is a reasonable prospect that the credit can be discharged in full when due. Provided that a director exercises reasonable care, skill and diligence and acts honestly and in good faith, however, for as long as there is no insolvent trading legislation in Hong Kong it is unlikely that the incurring of credit during the twilight period will result in the director being personally liable or in disqualification.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in question 3 above?

5.1 Introduction

A liquidator is required to review the action taken by directors and other persons involved in the affairs of the company during the twilight period as part of his duty to collect and then realise all the property and assets of the company for the benefit of creditors. If the circumstances require, he is obliged also to bring proceedings to obtain compensation for the company for any loss caused to the company by persons interested in the company, including directors. As a result, it is the liquidator who in most cases is empowered to bring proceedings against directors. Even in those cases where other persons interested in the company may bring proceedings against directors (as listed in the table below), the proceedings are usually commenced by the liquidator. This rule does not apply to criminal proceedings.

5.2 Criminal proceedings

The Secretary for Justice is responsible for bringing criminal proceedings in Hong Kong against directors and any other persons. A liquidator is under a duty to bring any offences to the attention of the Secretary for Justice and, in the event that an offence is not reported, any person may apply to Court for a direction that the matter be referred.¹³⁴

¹³⁴ Section 277(1) CWUMPO.

There is a general right for any person to bring criminal proceedings by way of private prosecution, however, the Secretary for Justice may at any stage in proceedings before a magistrate intervene and assume the conduct of the proceedings.¹³⁵

Criminal offences that may be brought against directors can be summarized as follows:

- (a) Fraudulent trading (S 275 (3) CWUMPO);
- (b) Fraud by officers of companies in liquidation (S 273 CWUMPO);
- (c) Falsification of books (S 272 CWUMPO);
- (d) Liability where proper records are not kept (S 274 CWUMPO); and
- (e) Offences by officers of companies in liquidation (S 271 CWUMPO).

5.3 Civil proceedings

The insolvency regime in Hong Kong allows persons other than the liquidator to bring civil proceedings against directors for certain actions. Where an action for contribution to the company's assets is successful, any recoveries made will form part of the company's assets and be for the benefit of all creditors.

Only the Financial Secretary and Official Receiver may bring proceedings for disqualification on the grounds of unfitness to be a director (Ss 168H and 168I CWUMPO).

Activity / transaction	Person able to bring proceedings
Misfeasance	Official Receiver, liquidator, creditor or contributory ¹³⁶
Fraudulent trading (civil liability) (s.275(1) CWUMPO)	Official Receiver, liquidator, creditor or contributory
Unfair preference	Liquidator only
Transaction at an undervalue	Liquidator only
Fraudulent conveyance	Liquidator or any creditor
Extortionate credit transaction	Liquidator only
Disqualification as a director • s.168E, F and G CWUMPO	Official Receiver, Financial Secretary, liquidator and any past or present member or creditor against which that person has committed an offence or default (disqualification under s.168F CWUMPO may also be made by the Registrar)
• s.168H CWUMPO	Financial Secretary or Official Receiver (if in the public interest)
• s.168K CWUMPO	At the Court's discretion

¹³⁵ Section 14(1) of the Magistrates Ordinance (Cap.227).

¹³⁶ A contributory is defined as any person liable to contribute to the assets of a company in the event of it being wound up and includes any person alleged to be a contributory prior to the final determination of those persons deemed contributories (section 171 CWUMPO).

QUESTION 6

6. Remedies available

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

Claim / offence	Remedy available
Misfeasance (s.276 CWUMPO)	The Court may order a director to repay or restore the money or property (or any part of it) with interest at such rate as the Court thinks just or to contribute such sum to the assets of the company by way of compensation in respect of the misfeasance or breach of trust as the Court thinks just.
Fraudulent trading Criminal Liability (s.275(3) CWUMPOO)	If convicted following trial by jury, the penalty is up to five years imprisonment and / or a fine (unlimited) and, on summary conviction, up to 12 months imprisonment and a fine of up to HK\$150,000.
Civil liability (s.275(1) CWUMPOO)	A director may be held liable for all of the debts or other liabilities of the company (without limitation) as the Court may direct. In exercising its discretion, the Court is seeking to compensate the company for any loss and not to apply any punitive measure. Where a Court makes a declaration under this section that a director is liable for all or any of the debts or liabilities of the company the Court (i) may make an order that he be disqualified from acting as a director for a period of up to 15 years (irrespective of whether an application was made for such an order), and (ii) may give further directions to effect the declaration, such as imposing a charge on any debt or obligation due from the company to him or the deferral of debts due from the company to him.
Liability involved in share redemption or buy-back out of capital ¹³⁷	The directors who signed the solvency statement in relation to the payment out of capital (except a director who shows that he/she had reasonable grounds for forming the opinion expressed in the statement) are jointly and severally liable with the past shareholder to contribute an amount not exceeding the amount of the payment made by the company out of capital in respect of the share redemption or buy-back.
(i) Unfair preference (ii) Transaction at an undervalue (on or after 13 February 2017)	The Court may make such order as it thinks fit for restoring the position to what it would have been had the transaction or the unfair preference not occurred. For example, it may order: (a) any property that was transferred as part of the transaction to be vested in the company; (b) any property which represents the application of the proceeds of sale of the property or money wrongfully transferred to be vested in the company; (c) the release or discharge of any security given by the company; (d) any person to pay such sums representing the value of any benefits received by him from the company in breach of this section to the company; (e) any obligations of a surety or guarantor which were released or discharged in breach of this section to be revived on terms as the Court thinks fit; (f) security to be provided for the discharge of any obligation imposed by or arising under the order; and (g) any person whose property is vested by the order in the company, or on whom obligations are imposed, to be able to prove in the winding-up of the company for debts or other liabilities which arose from or were released or discharged under or by, the transaction or the giving of the preference.

¹³⁷ This does not apply in relation to a payment out of capital in respect of the redemption or buy-back of a company's own shares that has taken place before 13 February 2017.

Claim / offence	Remedy available
	Any order under this section cannot prejudice any interest in property acquired from a person (other than the company) in good faith and for value, or any interest deriving from such an interest. It must not require a person who received a benefit from the transaction or the unfair preference in good faith and for fair value to make payment except where that person was a party to the transaction with the company or was a creditor of the company at the time of the transaction.
Fraudulent conveyance	A transaction declared to be a fraudulent conveyance will be void. Any third party in possession of the property will be deemed to be holding the property on constructive trust for the liquidator. The Court can order the property to be re-vested in the liquidator as part of the company's assets.
Extortionate credit transaction	The Court may make any of the following orders: (a) set aside the whole or any part of any obligation created by the transaction; (b) vary the terms of the transaction or the terms on which any security for the purpose of the transaction is held; (c) require any person who is or was a party to the transaction to pay the liquidator any sums paid to that person by the company by virtue of the transaction; (d) require any person to surrender to the liquidator any property held by him as security for the purposes of the transaction; and (e) direct accounts to be taken between any persons.
Fraud by officers of companies in liquidation	If convicted following trial by jury, the penalty is up to two years imprisonment and/or a fine up to HK\$150,000 and, on summary conviction, up to six months imprisonment and a fine of up to HK\$50,000.
Falsification of books	If convicted following trial by jury, the penalty is up to two years imprisonment and/or a fine up to HK\$150,000 and, on summary conviction, up to six months imprisonment and a fine of up to HK\$50,000.
Failure to keep proper records	If convicted following trial by jury, the penalty is up to two years imprisonment and/or a fine up to HK\$150,000 and, on summary conviction, up to six months imprisonment and a fine of up to HK\$50,000.
Offences by officers of companies in liquidation	If convicted following trial by jury, the penalty is up to two years imprisonment and/or a fine up to HK\$150,000 and, on summary conviction, up to six months imprisonment and a fine of up to HK\$50,000.
All offences under s.271CWUMPO (except for (o))	If convicted following trial by jury, the penalty is up to five years imprisonment and, on summary conviction, up to two years imprisonment.
s.271(o) CWUMPO (Pawn, pledge or disposal of property of the company obtained on credit which has not been paid for)	The director may be ordered to compensate the company for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit obtained in breach of his fiduciary duty. The Court also has powers under section 729 CO Cap 622 to grant an injunction, order damages to be paid to any other person, and declare a contract void or voidable.
Breach of fiduciary duties Breach of duties of skill and care	The director may be ordered to compensate the company for loss and damage caused by breach of his fiduciary duty. The Court also has powers under section 729 CO Cap 622 to grant an injunction, order damages to be paid to any other person, and declare a contract void or voidable.

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 the insolvency officer-holder's investigations into the company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Introduction

There is no provision in the CO imposing a general duty on directors and other persons involved in the affairs of a company to co-operate with a liquidator, a provisional liquidator or the Official Receiver, as can be found under English law in S 235 of the Insolvency Act 1986. Liquidators in Hong Kong must rely on the specific provisions which are set out below when investigating the company's affairs.

7.2 Obligation to assist with delivery of property to liquidator¹³⁸

Any contributory, trustee, receiver, banker, agent or officer¹³⁹ of the company on notice from the liquidator must pay, deliver, convey, surrender or transfer any money, property, books or paper to which the company is entitled to the liquidator within the time specified in the notice.

7.2.1 Sanctions

In the event of non-compliance with the liquidator's demand, the Court may make an order on application of the liquidator for such payment, delivery, or transfer.¹⁴⁰

7.3 Power to summon persons suspected of having property of the company¹⁴¹

Persons suspected of having in their possession property of the company or of having information concerning the company or its affairs or property may be examined in private by the Court. Prior to the CWUMPO Amendment, the application was usually made by the liquidator but, if he would not, any creditor or contributory might apply.¹⁴² The new position is that the Court may make an order of its own motion, or on the application of the provisional liquidator or liquidator of the company (or where a winding up order has been made, the Official Receiver as well).¹⁴³

Any time after the appointment of a provisional liquidator, the making of a winding-up order or commencement of voluntary winding up, the Court may summon to appear before it any of the following persons:

- (a) any officer of the company;
- (b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; and
- (c) any person whom the Court thinks capable of giving information concerning the promotion, formation, trade, dealings, affairs or property of the company.¹⁴⁴

¹³⁸ Section 211 CWUMPO.

¹³⁹ Officer includes directors, managers and secretary of the company (see 3.2 above).

¹⁴⁰ Company Winding-Up Rules r 67.

¹⁴¹ Section 221 CWUMPO (for applications made before 13 February 2017) / sections 286B and 286C CWUMPO (for applications made on or after 13 February 2017).

¹⁴² A liquidator need not show a prima facie case when applying for a private examination, only 'mere suspicion' (*Re Gold Co* (1879) 12 Ch D 77), whereas a creditor or contributory seems to have to prove a prima facie case (*Re Rolls Razor Ltd (No 2)* [1970] Ch 576).

¹⁴³ Section 286B(2) CWUMPO.

¹⁴⁴ Section 286B(3) and (4) CWUMPO.

Any of the above persons may be required by the Court to do any of the following:

- (a) attend before the Court;
- (b) be examined on oath, provide responses in writing and sign any document containing such responses;
- (c) submit to the Court an affidavit containing (i) an account of the person's dealings with the company; and/or (ii) information concerning the promotion, formation, trade, dealings, affairs or property of the company; and
- (d) produce any books and papers in that person's custody or power relating to the company or the promotion, formation, trade, dealings, affairs or property of the company (without prejudice to any lien).¹⁴⁵

The old S 221 of the CWUMPO prior to the CWUMPO Amendment was silent as to the examinee's obligation to answer questions put to him. In this regard, the new S 286D of the CWUMPO states that a person is not excused from complying with a direction or requirement imposed on him under Ss 286A, 286B or 286C (private and public examinations) only on the ground that to do so might tend to incriminate the person. Nevertheless, if any answer or affidavit provided in compliance with these provisions might tend to incriminate the person, the requirement and the question and answer (or affidavit) will not be admissible in evidence against the person in criminal proceedings (other than the offence of false statements and the offence of perjury).

7.3.1 Sanctions

If a person is summoned to attend the Court for examination after being provided a reasonable sum for expenses and fails to attend, the Court may, by warrant, cause the person to be apprehended and brought before the Court for examination (subject to there being no lawful impediment to the attendance made known to the Court).

7.4 Power to order public examination of officers¹⁴⁶

Where a company is being wound up (either by the Court or voluntarily), the Official Receiver or liquidator may apply to the Court for the public examination of an officer¹⁴⁷ in relation to the promotion or formation or conduct of the business of the company or as to his conduct and dealings as an officer. The Court may only make such an order if the liquidator or Official Receiver has submitted to the Court a report stating that in his opinion a fraud has been committed by that officer of the company in relation to the company since its formation (or that person in the promotion or formation of the company).

The old S 222 of the CWUMPO prior to the CWUMPO Amendment was silent as to the examinee's obligation to answer questions put to him. In this regard, the new S 286D of the CWUMPO states that a person is not excused from complying with a direction or requirement imposed on him under Ss 286A, 286B or 286C (private and public examinations) only on the ground that to do so might tend to incriminate the person. Nevertheless, if any answer or affidavit provided in compliance with these provisions might tend to incriminate the person, the requirement and the question and answer (or affidavit) will not be admissible in evidence against the person in criminal proceedings (other than the offence of false statements and the offence of perjury).

7.4.1 Sanctions

The Court may issue a warrant for the arrest of a person or officer who is to be subject to a public examination on proof of service of the notice informing such person of the time and place for the examination, if:

- (a) such officer or person fails to attend the examination and no good cause is shown by him for such failure; or

¹⁴⁵ Section 286B(1) CWUMPO.

¹⁴⁶ Section 222 CWUMPO (for applications made before 13 February 2017) / section 286A CWUMPO (for applications made on or after 13 February 2017).

¹⁴⁷ Officer includes directors, managers and secretary of the company (see 3.2 above).

- (b) the Official Receiver or liquidator can satisfy the Court that such officer or person has or is about to abscond before the hearing with a view to avoiding examination.¹⁴⁸

7.5 Company's statement of affairs¹⁴⁹

Where a winding-up order has been made or a provisional liquidator has been appointed, either the liquidator or provisional liquidator may require certain people to submit and verify by affidavit a statement of affairs of the company. The statement must show the particulars of assets, debts, liabilities, names, addresses and occupations of its creditors, securities held by the company and any other information required by the liquidator or provisional liquidator. Any of the following persons may be required to provide and verify such statements:

- (a) current or former directors or officers of the company;
- (b) any person who has taken part in the formation of the company at any time within one year before the relevant date;
- (c) any current employee of the company (or any person employed by the company within the previous 12 months) whom the liquidator or provisional liquidator considers to be capable of giving the information; and
- (d) any person who is or has been within that year an officer of, or in the employment of, a company which is, or within that year was, an officer of the company.

7.5.1 Sanction

Any person who defaults in complying with the requirements of this provision commits an offence and is liable for a fine of up to HK\$50,000 and a daily default fine of HK\$300.¹⁵⁰ In addition, it is also an offence to make any material omission in the statement of affairs and such person will be liable to a fine and imprisonment.¹⁵¹

7.6 Sanction for failing to discover the company's property and papers¹⁵²

Section 271 (Offences by officers of companies in liquidation) creates various offences for past and present officers of a company, whether the action occurred prior to or during the course of the winding-up of the company, if such officer:

- (a) fails to the best of his knowledge and belief to disclose to the liquidator the property of the company and when any property was disposed of;¹⁵³
- (b) fails to deliver up the liquidator all property of the company in his custody or control, including books and papers;¹⁵⁴
- (c) fails for a period of one month to inform the liquidator of any debt known or believed by that person to be false which has been submitted for proof in the liquidation;¹⁵⁵ or
- (d) after the commencement of the winding-up, prevents production of books and papers relating to the company's property or affairs.¹⁵⁶

¹⁴⁸ Companies (Winding-up) Rules rr.49-56.

¹⁴⁹ Section 190 CWUMPO.

¹⁵⁰ Section 190(5) CWUMPO.

¹⁵¹ Section 271(1)(f) CWUMPOO (see 2.4: above).

¹⁵² Section 271 CWUMPO.

¹⁵³ Section 271(1)(a) CWUMPO.

¹⁵⁴ Section 271(1)(b) and (c) CWUMPO.

¹⁵⁵ Section 271(1)(g) CWUMPO.

¹⁵⁶ Section 271(1)(h) CWUMPO.

7.7 Human rights

The Hong Kong Bill of Rights Ordinance (BORO) came into effect on 8th June, 1991. It embodied the provisions of the International Covenant on Civil and Political Rights (ICCPR) as applied to Hong Kong. The Basic Law of Hong Kong (Article 39) provides that the rights and freedoms enjoyed by Hong Kong residents shall not be restricted unless prescribed by law, and that such restriction shall not contravene the provisions in the ICCPR and International Covenant on Economic Social and Cultural Rights (ICESCR). Despite various amendments made to the BORO at the time of the handover in 1997 (mainly to ensure that the BORO did not prevail over the Basic Law), the Court has regarded the BORO as intended to implement the ICCPR and provide a yardstick against which to test the validity of Hong Kong law.

The directors and others identified in question 3 will have rights under the BORO. In an insolvency context, a director or other person under BORO will be able to:

- (a) require that a particular provision of insolvency law is construed in accordance with those rights or otherwise declared incompatible; or
- (b) claim that the insolvency practitioner is a public authority and is acting unlawfully in breach of the BORO.

The application of the BORO will affect:

- (a) legislation - primary and subordinate legislation will be read in a way that is compatible with the BORO. If this is not possible, the Court may make a declaration of incompatibility. In the case of subordinate legislation, the Court may give relief against any incompatibility provided that this is not inconsistent with the primary legislation; and
- (b) public authorities and the Government - it will be unlawful for public authorities and the Government (and any person or corporate entity acting on its behalf) to act in a way which is incompatible with a person's rights under the BORO. A victim may bring proceedings under the BORO for judicial review or damages if the nature of the act is public. As officers of the Court, the Official Receiver, liquidators and provisional liquidators are all "public authorities" when carrying out functions of a public nature.

It should be noted that the Court's interpretation of the BORO takes precedence over the rights afforded to individuals under the ICCPR and, in addition, the rights under the BORO are not absolute as they may be limited by authorised interference by the Government on the grounds of necessity. There have been few successful challenges under the BORO since 1997 and they have been limited to Hong Kong's criminal and administrative law.¹⁵⁷

Those rights under the BORO which may be of some relevance are as follows:

- (a) Article 10 - Equality before Courts and right to a fair and public hearing

All persons shall be equal before the Courts and tribunals. In the determination of any criminal charge, or of rights and obligations in a suit at law, everyone shall be entitled to a fair and public hearing by a competent, independent and impartial tribunal established by law. The press and the public may be excluded from all or part of a trial for reasons of morals, public order (order public) or national security in a democratic society, or when the interest of the private lives of the parties so requires, or to the extent strictly necessary in the opinion of the Court in special circumstances where publicity would prejudice the interests of justice; but any judgment rendered in a criminal case or in a suit at law shall be made public except where the interest of juvenile persons otherwise requires or the proceedings concern matrimonial disputes or the guardianship of children.

¹⁵⁷ For further information on Hong Kong's BORO see: Jump starting the Hong Kong Bill of Rights in its Second Decade? The Relevance of International and Comparative Jurisprudence by Andrew Brynes, HKU.

(b) Article 4 - No slavery or servitude

No one shall be required to perform forced or compulsory labour with the exception of any work or service which forms part of the civil obligations. An argument that work that a director may be required to do in complying with obligations to co-operate with an investigation into the company's affairs following its insolvency is forced labour, contrary to Article 4, is unlikely to succeed as the duties of co-operation are most likely to be viewed as part of a directors' normal civic obligations.

(c) Article 14 - Protection of privacy, family, home, correspondence, honour and reputation

This provides that no one shall be subjected to arbitrary or unlawful interference with his privacy and correspondence. This article may give grounds for challenge where the investigation intrudes into the director's personal correspondence. The requirement that the interference be 'arbitrary or unlawful' means that the interests of creditors are likely to prevail over most arguments that any examination or investigation is in breach of this article.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to actions referred to above?

(b) What rights of appeal are available from the decision of the lower Courts?

8.1 Limitation periods

(a) Criminal proceedings

Information or complaints relating to offences under the CWUMPO identified in question 2 may be tried if they are laid or made at any time within three years after the commission of the offence and within 12 months after the date on which evidence sufficient in the opinion of the Secretary of Justice (as evidenced by a certificate of the Secretary of Justice) to justify the proceedings comes into his knowledge.¹⁵⁸

(b) Civil actions

(i) In relation to fraudulent trading the limitation period is generally six years from the date on which the cause of action accrued.¹⁵⁹

(ii) In relation to breaches of fiduciary duties or misfeasance by directors the limitation period is generally six years from the date on which the cause of action accrued.¹⁶⁰ No limitation period will apply if it is an action in respect of a fraudulent breach of trust or to recover trust property or the proceeds of trust property which have been retained by a director or received by him and converted to his own use.¹⁶¹ English case law (which a Hong Kong Court would consider persuasive) has interpreted this widely so as to include the use of trust proceeds by a director for the benefit of a company he indirectly controls.¹⁶²

(iii) In relation to breaches of statutory duties of skill and care by directors, the limitation period is also six years from the date on which the cause of action accrued.¹⁶³

¹⁵⁸ Section 351A of the CWUMPO.

¹⁵⁹ Section 4(1) of the Limitation Ordinance (Cap.347).

¹⁶⁰ Sections 20(2) and 4(1) of the Limitation Ordinance (Cap.347).

¹⁶¹ Section 20(1) of the Limitation Ordinance (Cap.347).

¹⁶² *Re Pantone 485 Ltd* [2002] 1 B.C.L.C. 266 (relating to section 21(1) of the Limitation Act 1980 (UK)), which is highly persuasive authority in Hong Kong. The relevant Hong Kong legislation, section 20(1) of the Limitation Ordinance (Cap.347), is substantially the same as section 21(1) of the Limitation Act 1980 (UK).

¹⁶³ Section 4(1) of the Limitation Ordinance (Cap.347) in the case of liability founded in tort. In an action based on negligence, the time limit may be extended under section 31 of the Limitation Ordinance in the event that the facts relevant to the cause of action were not known at the date on which it accrued. The extension allowed under this section is a further three-year period from the date on which the claimant had both the knowledge required to bring the claim and the right to do so. This is subject to a long stop under section 32 of the Limitation Ordinance which provides that no action shall be brought in respect of a negligence claim more than 15 years after the date on which the act of negligence relied upon occurred.

- (iv) In relation to any limitation period prescribed by the Limitation Ordinance (Cap.347) including those applicable to sub-paragraphs (b)(i) to (iii) above, if:
- (1) there has been fraud by the defendant; or
 - (2) the plaintiff's right of action has been deliberately concealed from him by the defendant, the limitation period shall not begin to run until the plaintiff has discovered the fraud or concealment or could with reasonable diligence have discovered it.¹⁶⁴
- (v) The limitation period applying to disqualification applications pursued under S 168H of the CWUMPO is four years from the date on which the winding-up of the company commenced or is deemed to have commenced, or in the case of a company that goes into receivership, the date on which the receiver vacated his office.¹⁶⁵ The Court enjoys a discretion, however, to extend this period which may be exercised in circumstances where, for example, the delay is attributable to the failure of the director to cooperate, the charges laid against the director are serious, there is a public interest in ensuring that the application is pursued or where the director would not suffer any specific prejudice as a result of the delay.¹⁶⁶ In exercising its discretion, the Court will have to balance the public interest with the legitimate interest of the director and the possible prejudice which he might suffer if an extension were granted.
- (vi) An application to the Court based on unfair preference shall only be made with regard to any act made or done by or against a company within six months, or in the case of an unfair preference made in favour of a connected person or an associate¹⁶⁷ (depending on the date of the preference) of the company, two years, before the commencement of its winding-up.¹⁶⁸ Applications to set aside transactions based on unfair preference are actions upon a specialty.¹⁶⁹ The limitation period for an action based upon a specialty is 12 years.¹⁷⁰ However, where the substance of the claim is not to set aside a transaction but “to recover a sum recoverable by virtue of” such provisions, such applications will be governed by S 4(1)(d) of the Limitation Ordinance and subject to a six year limitation period.¹⁷¹
- (vii) An application to the Court based on transaction at an undervalue shall only be made with regard to any transaction entered into within five years before the commencement of the winding-up of the company.¹⁷² Applications to set aside transactions based on this ground are actions upon a specialty, and the limitation period is 12 years. However, if the action is to recover a sum (rather than setting aside the transaction) under this provision, the limitation period will be six years.

8.2 Appeals

(a) Criminal appeals

- (i) The Magistrates' Court, the District Court¹⁷³ and the Court of First Instance¹⁷⁴ each have criminal jurisdiction with differing sentencing powers. All summary offences may be tried in the Magistrates' Court; only rarely will they be tried in the District Court.

¹⁶⁴ Section 26 of the Limitation Ordinance (Cap.347).

¹⁶⁵ Section 168I(2) of the CWUMPO.

¹⁶⁶ Section 168I(2) of the CWUMPO. See also *Re China Talent International Development Ltd (in liq)* [2002] 4 HKC 344 and *Re Tse Yu Hong Ltd & Others* [2003] 2 HKLRD 332 for a discussion of the factors to be taken into account by the Court in considering an application for leave to commence disqualification proceedings out of time.

¹⁶⁷ Defined in section 51B of the Bankruptcy Ordinance (Cap.6).

¹⁶⁸ Section 266B of the CWUMPO.

¹⁶⁹ *Joint and Several Liquidators of Faith Dee Ltd v Yip Shu Chee*, unreported, HCCW 237/2005 (5 February 2013)

¹⁷⁰ Section 4(3) of the Limitation Ordinance (Cap. 347).

¹⁷¹ Section 4(1)(d) and (2) of the Limitation Ordinance (Cap. 347). See also *Re Priory Garage (Walthamstow) Ltd* [2001] BPIR 144, applied in *Joint and Several Liquidators of Faith Dee Ltd v Yip Shu Chee*, unreported, HCCW 237/2005 (5 February 2013).

¹⁷² Section 266B CWUMPO.

¹⁷³ Section 74 of the District Court Ordinance (Cap.336).

¹⁷⁴ Section 12 of the High Court Ordinance (Cap.4).

- (ii) While a Magistrate may, upon the application of a party, or of his or her own motion, review his or her decision in a matter which he or she has power to determine in a summary way,¹⁷⁵ all appeals from a Magistrate's decision are heard in the Court of First Instance.¹⁷⁶
- (iii) If a party believes that a decision of the Magistrate in respect of a conviction, order, determination or other proceedings which the Magistrate has power to decide in a summary way is erroneous in point of law, or is in excess of the Magistrate's jurisdiction,¹⁷⁷ then that party may request the Magistrate to state and sign a case for the opinion of a judge of the Court of First Instance.¹⁷⁸ Leave of the Court is not required for this procedure to be invoked.
- (iv) An appeal against any conviction, order or determination of a Magistrate by a person who did not plead guilty or admit the truth of an information or complaint may be made to a judge in the Court of First Instance¹⁷⁹ by giving the Magistrate's clerk notice in writing.¹⁸⁰ No leave of the Court is required for such an appeal to be brought.
- (v) An appeal against a sentence passed by a Magistrate¹⁸¹ (except where the sentence is one fixed by law) may be made to a judge in the Court of First Instance by giving the Magistrate's clerk a notice in writing.¹⁸² No leave of Court is required for such an appeal to be brought.
- (vi) A defendant may appeal to the Court of Appeal against his conviction by either the District Court¹⁸³ or the Court of First Instance:¹⁸⁴
 - (1) as of right on any ground which involves a question of law; and
 - (2) with leave of the Court of Appeal, on any ground which involves a question of fact, a mixed question of law and fact or on any other ground.¹⁸⁵
- (vii) A person convicted of an offence on indictment by the District Court or the Court of First Instance may appeal to the Court of Appeal against any sentence (except where the sentence is one fixed by law) passed on him.¹⁸⁶ Where a person is not convicted on indictment, he may still appeal to the Court of Appeal if he is sentenced to imprisonment for a term of six months or more, or if the sentence is one which the Court convicting him had no power to pass.¹⁸⁷ An appeal in these cases may only be brought with the leave of the Court of Appeal.¹⁸⁸
- (viii) The Secretary of Justice may appeal to the Court of Appeal against a verdict or order of acquittal of the District Court¹⁸⁹ based only on matters of law. No leave of Court is required for such an appeal to be brought.
- (ix) The Secretary of Justice may, with leave of the Court of Appeal, apply to the Court of Appeal for the review of any sentence (except where the sentence is one fixed by law) passed by the District Court or the Court of First Instance on the grounds that the sentence is not authorised by law, is wrong in principle and/or is manifestly excessive or manifestly inadequate.¹⁹⁰

¹⁷⁵ Section 104 of the Magistrates Ordinance (Cap.227); a magistrate may review questions of fact or law.

¹⁷⁶ Sections 105, 113 and 113A of the Magistrates Ordinance (Cap.227); these provisions refer to 'appeals (or refers or states) to a judge' and although 'judge' is not defined in the Magistrates Ordinance, the definition of 'judge' in section 3 of the Interpretation and General Clauses Ordinance (Cap.1), read with section 2 of the Criminal Procedure Ordinance (Cap.221), indicates that the 'judge' is a judge of the Court of First Instance.

¹⁷⁷ Section 105 of the Magistrates Ordinance (Cap.227).

¹⁷⁸ Section 105 of the Magistrates Ordinance (Cap.227).

¹⁷⁹ Section 113 of the Magistrates Ordinance (Cap.227).

¹⁸⁰ Section 114 of the Magistrates Ordinance (Cap.227).

¹⁸¹ This appeal is only available to a person who is convicted on any offence by a magistrate after pleading guilty or admitting the truth of the information or complaint (section 113(2) of the Magistrates Ordinance (Cap.227)).

¹⁸² Section 114 of the Magistrates Ordinance (Cap.227).

¹⁸³ Section 13(3)(a) of the High Court Ordinance (Cap.4). By virtue of section 83 of the District Court Ordinance (Cap.336), sections 80 to 83Y (which include appeal procedures) of the Criminal Procedure Ordinance (Cap.221) apply to criminal proceedings in the District Court.

¹⁸⁴ Section 13(3)(a) of the High Court Ordinance (Cap.4).

¹⁸⁵ Section 82 of the Criminal Procedure Ordinance (Cap.221).

¹⁸⁶ Section 83G of the Criminal Procedure Ordinance (Cap.221); by virtue of section 83 of the District Court Ordinance (Cap.336), sections 80 to 83Y (which include appeal procedures) of the Criminal Procedure Ordinance (Cap.221) apply to criminal proceedings in the District Court.

¹⁸⁷ Section 83H of the Criminal Procedure Ordinance (Cap.221).

¹⁸⁸ Section 83I of the Criminal Procedure Ordinance (Cap.221).

¹⁸⁹ Section 84 of the District Court Ordinance (Cap.336).

¹⁹⁰ Section 81A(1) of the Criminal Procedure Ordinance (Cap.221).

- (x) There may be an appeal to the Court of Final Appeal from any final decision of the Court of Appeal or the Court of First Instance (if no appeal lies to the Court of Appeal).¹⁹¹ Leave to appeal is required from the Court of Final Appeal¹⁹² which will be granted only where a point of law of great and general importance is involved or where substantial and grave injustice has been done.¹⁹³
- (b) Civil appeals
- (i) Both the District Court¹⁹⁴ and the Court of First Instance¹⁹⁵ exercise civil jurisdiction. The jurisdiction to wind up a company is vested in the Court of First Instance.¹⁹⁶
- (ii) An appeal from a decision, judgment or order of the District Court or the Court of First Instance is heard in the Court of Appeal (subject to certain exceptions).¹⁹⁷ While an appeal from the Court of First Instance is available to the parties as of right,¹⁹⁸ an appeal from the District Court can generally only be made with leave.¹⁹⁹
- (iii) An appeal from the Court of Appeal shall lie to the Court of Final Appeal.²⁰⁰ An appeal may be permitted to be made to the Court of Final Appeal at the discretion of the Court of Appeal or the Court of First Instance if in the opinion of the Court of Appeal or the Court of First Instance (as the case may be) the question involved in the appeal is one which, by reason of its great general or public importance, or otherwise, ought to be submitted to the Court of Final Appeal for decision.²⁰¹

QUESTION 9

9. Foreign corporations

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

9.1 Introduction

Part X of the CWUMPO deals with the winding-up of unregistered companies. A 1997 amendment to S 326 of the CWUMPO clarified long-standing confusion as to the definition of “unregistered company” by stating that it includes a non-Hong Kong company that is registered under Part XI of the old Companies Ordinance (Cap 32) or Part 16 CO Cap 622.²⁰²

9.2 Winding-up unregistered companies

Section 327 of the CWUMPO provides that any unregistered company may be wound up under the CWUMPO and that all of the provisions of the CWUMPO with respect to winding-up apply to unregistered companies. The primary exception is that no unregistered company may be wound up voluntarily.²⁰³

¹⁹¹ Section 31 of the Hong Kong Court of Final Appeal Ordinance (Cap.484).

¹⁹² Section 32 of the Hong Kong Court of Final Appeal Ordinance (Cap.484).

¹⁹³ Section 32(1) of the Hong Kong Court of Final Appeal Ordinance (Cap.484).

¹⁹⁴ Section 32 of the District Court Ordinance (Cap.336) which provides that the District Court may hear cases founded on contract, quasi-contract or tort where the plaintiff's claim does not exceed HK\$1,000,000.

¹⁹⁵ Section 12 of the High Court Ordinance (Cap.4).

¹⁹⁶ Section 176 of the CWUMPO.

¹⁹⁷ See section 14(3) of the High Court Ordinance (Cap.4).

¹⁹⁸ Section 14 of the High Court Ordinance (Cap.4); subsection (3) of the provision sets out the exceptions to the rule.

¹⁹⁹ Section 63 of the District Court Ordinance (Cap.336); subsection (3) of the provision sets out the exceptions to the rule, namely where a person is found liable in contempt of Court or for rescuing goods seized in execution or under a distress for rent, or where that person is made subject to an order for arrest or imprisonment for the enforcement of a judgment.

²⁰⁰ Section 22 of the Hong Kong Court of Final Appeal Ordinance (Cap.484); an appeal to the Court of Final Appeal shall only be made with leave of the Court of Appeal or the Court of Final Appeal, provided that where an appeal lies as of right, leave to appeal shall not be refused (section 23 of the Hong Kong Court of Final Appeal Ordinance (Cap.484)).

²⁰¹ Section 22(1)(b) of the Hong Kong Court of Final Appeal Ordinance (Cap.484).

²⁰² Section 326(2) of the CWUMPO.

²⁰³ Section 327(2) of the CWUMPO.

The circumstances in which an unregistered company may be wound up are:

- (a) if the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding-up its affairs;
- (b) if the company is unable to pay its debts; and
- (c) if the Court is of the opinion that it is just and equitable that the company should be wound up.²⁰⁴

Section 327(4) of the CWUMPO sets out the circumstances in which an unregistered company will be deemed unable to pay its debts.²⁰⁵

9.3 Exercise of discretion

The Court will not assume jurisdiction to wind up foreign companies in all circumstances but has adopted the general test developed by English case law consisting of three “core” requirements. These can be summarised as follows:

- (a) there must be a sufficient connection with Hong Kong which may, but does not necessarily have to, consist of assets within the jurisdiction of the Hong Kong Court;²⁰⁶
- (b) there must be a reasonable possibility, if a winding-up order is made, of benefit to those applying for the winding-up order; and
- (c) one or more persons interested in the distribution of the assets of the company must be persons over whom the Court can exercise jurisdiction.

9.4 Application to foreign directors

As stated above, all of the provisions relating to winding-up in the CWUMPO relate to unregistered companies which are being wound up. English Courts have held that the English Court has jurisdiction in connection with an application relating to fraudulent trading being made against foreign directors.²⁰⁷ This will be the case even where the relevant foreign jurisdiction has no equivalent provision although the English Court would take into account the usual standard of care and duties expected of directors in the place of incorporation of the company before making an order. The same principle extends to other provisions relevant to directors. The approach of the English Court would be highly persuasive in Hong Kong.

Other provisions in the CWUMPO relating to directors such as those relating to the provision of information and disqualification also relate to directors of unregistered companies, subject to the considerations set out above, regardless of domicile.

²⁰⁴ Section 327(3) of the CWUMPO.

²⁰⁵ Including the classic common law provision of failure to satisfy a statutory demand.

²⁰⁶ In *Re Irish Shipping Ltd* [1985] HKLR 437, the relevant company did not have any assets in the jurisdiction at the time of presentation of the petition however it did have a boat which arrived in Hong Kong in time for the hearing. The Company was considered to have sufficient nexus with Hong Kong.

²⁰⁷ *Re Howard Holdings Inc* [1998] BCC 549.

QUESTION 10

10. Insurance

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

10.1 Nature of directors' duties

The general duties applicable to the conduct of every director and the circumstances in which personal liability may arise during the "twilight period" are considered above.

10.2 Indemnification

At common law, a director as agent or trustee of a company is entitled to indemnification for acts carried out on behalf of the company where he is acting within the powers conferred upon him.

That said, the scope of the indemnities a company can make available to a director is restricted by S 468 of the CO Cap 622. Any provision (whether contained in the company's articles or in a contract entered into by the company or otherwise) which (i) exempts a director of the company from any liability that would otherwise attach to the director, or (ii) directly or indirectly indemnifies a director of the company, or a director of an associated company of the company, against any liability attaching to the director, in each case in connection with any negligence, default, breach of duty or breach of trust in relation to the company or the associated company (as the case may be) is void (subsections (1) and (2) of S 468 CO Cap 622).

Section 468 of the CO Cap 622 applies only to Hong Kong incorporated companies. It only applies to directors and not to other officers of the company. A separate and equivalent provision for auditors is provided in S 415.

10.3 The availability of D&O liability insurance

In contrast D&O liability insurance is permitted and may be purchased and maintained by the company for any officer of the company or any person employed by the company as auditor. This may extend to negligence, default, breach of duty and breach of trust (save for fraud) and also cover the costs of defending an action.²⁰⁸

The CO Cap 622 specifically permits a company to purchase and maintain insurance for a director of the company, or a director of an associated company of the company, against liability incurred by him in defending any civil or criminal proceedings for any negligence, default, breach of duty or breach of trust (including fraud) in relation to the company or associated company (S 468(4)(b) CO Cap 622).

It also permits an indemnity against liability incurred by a director to a third party if certain requirements or conditions set out in the provision are met (also known as permitted indemnity provision as defined in S 467 of the CO Cap 622), including an indemnity if the Court grants relief to the director for breach of trust, duty, negligence and default (S 469(2)(b)(v) CO Cap 622). Section 903 of the CO Cap 622 gives a general power to a Court to relieve a specified person (which means an officer or a person employed by the company as an auditor) from liability for negligence, default, breach of duty or breach of trust if it appears to the Court that person (i) is or may be liable for the misconduct, (ii) has acted honestly and reasonably, and (iii) having regard to all the circumstances of the case he ought fairly to be excused wholly or partly from his liability.

²⁰⁸ Section 468 CO Cap 622.

10.4 Nature of D&O liability insurance

D&O liability insurance offers protection to directors and officers by covering them against civil liability to any person and their defence costs for civil and criminal claims for wrongful acts (provided, in the latter case, they are found not guilty). The insurance will indemnify the directors for liabilities arising from acts committed in their capacity as directors and the cover provided will be subject to certain terms, conditions and exclusions. Section 468 of the CO Cap 622 allows companies in Hong Kong to obtain insurance for directors and officers in respect of effectively all matters other than dishonesty, criminal penalties and claims by the company itself.

Although S 468(4) CO Cap 622 allows for an indemnity to be given to a director for the costs of defending proceedings in which it is alleged he acted fraudulently, it does not allow a director to be indemnified in relation to any personal liability the director may be found to have as a consequence of a finding of fraud. D&O insurers in practice and on grounds of public policy, always exclude, in any event, their liability to indemnify against any loss resulting from fraud.

Considering, however, that most claims for indemnity under D&O liability insurance in Hong Kong are for the provision of defence costs to assist directors to fund the cost of defending litigation against them, the ability to insure against defence costs is a significant protection for directors.

Defence costs incurred in negotiating settlements (before the outcome of a trial) may be advanced (depending on the specific terms of the policy).

10.5 Claims generally covered by D&O policies

D&O liability insurance will normally cover liabilities arising out of “wrongful” acts or omissions. This will include breaches of contract, torts, breaches of statutory duty and (in certain circumstances) breaches of fiduciary duty (although claims brought by the company itself will not be covered by insurance).

In all cases where insurance coverage exists, there will be no coverage for dishonesty or fraud. No insurance offers protection for fraudulent, dishonest or criminal acts committed by directors.

In cases of criminal liability, defence costs will be covered provided the director is not convicted of the offence. Hence, fines incurred by directors by virtue of their breaches of statutory duties will not be covered by the policy, but the costs for defending such criminal claims will be covered if the director is acquitted.

There is no legislation in Hong Kong relating to the insurability of punitive damages. It is not clear whether punitive damages are recoverable from an insurer, although there is an authority in the UK which suggests that they are recoverable.²⁰⁹ Most standard D&O policies would, however, exclude punitive damages.

Claims brought by the company will not be covered but claims by aggrieved (usually minority) shareholders and liquidators may be covered, depending on the wording of the specific policy.

Employment claims are generally excluded (but separate employment practice liability cover can be purchased).

The following is an executive summary of the types of duties generally imposed on directors, the manner in which they incur liability and whether insurance would be available in principle.

²⁰⁹ *Lancashire County Council v Municipal Mutual Insurance* [1996] 3 All ER 545.

Type of claim	Civil / criminal	Insurance available in principle?	Potential liability?
Breach of duty of skill and care	Civil	Yes	Loss suffered
Breach of fiduciary duty e.g. duty to act in best interests of company etc.	Civil	Yes, but not available to cover claims brought by company	Loss suffered
Employment claims, e.g. sexual discrimination	Civil	Generally Excluded	May be substantial. Precedents include US\$100m (for Cathay pilots) and HK\$39m (for Cap Gemini employee)
Contract claims	Civil	Yes	Loss suffered
Tort claim, e.g. misrepresentation	Civil	Yes	Loss suffered
Keeping of books/records	Criminal	No	12 months prison Fine: HK\$300,000
Misleading statements to auditors	Criminal	No	Two years prison Fine: HK\$150,000
Misleading statements in prospectus	Criminal	No	Three years prison Fine: HK\$700,000
Failure to disclose material interest in contract	Criminal	No	Fine: HK\$100,000
Granting of loan /guarantee to director	Civil	No	Loss suffered
Disposal of assets, breach of restrictions	Criminal	No	Six months prison Fine: HK\$50,000
Non-disclosure of Interests	Criminal	No	Fine: HK\$100,000
Misrepresentation	Criminal	No	Seven years prison Fine: HK\$1 million
	Civil	Yes, provided no fraud	Loss suffered
False/Misleading public communications	Civil	Yes, provided no fraud	Loss suffered
Market misconduct	Criminal	No	Ten years prison Fine: HK\$10 million
Breach of management responsibility	Civil	Yes	Loss suffered
Air pollution	Criminal	No	12 months prison Fine: HK\$500,000
Unlawful waste disposal	Criminal	No	Six months prison Fine: HK\$500,000
Water pollution	Criminal	No	Two years prison Fine: HK\$1 million
Carrying out projects without environmental Permit	Criminal	No	Two years prison Fine: HK\$5 million

Type of claim	Civil / criminal	Insurance available in principle?	Potential liability?
Noise pollution	Criminal	No	Three months prison Fine: HK\$200,000
Signing cheques without specifying “for and on behalf of CLP”	Civil	Yes	Value of cheque
Carrying on business for fraudulent purpose	Civil Criminal	No	Value of debts
Corporate manslaughter	Criminal	No	Prison - variable
Contempt of Court	Criminal	No	Fine-possibly c.HK\$20,000 but may be higher. Prison is also a possibility.
Liability under US securities laws	Civil ²¹⁰	Unlikely given nature of offence	

10.6 Coverage afforded under D&O liability insurance policies

This is normally divided into two sections:

- (a) cover for the directors and officers (note that there are a number of advantages in each individual director having a policy effected specifically for that director’s own liability: the policy is unlikely to be invalidated by the actions of other members of the board of a company (by for example, failure to disclose all material facts in the policy application form); his personal policy may not be exhausted by claims against other members of the board; the insured can ensure his own policy does not lapse and his cover extends to a period beyond his departure from the company; there are no privity of contract concerns as to whether a director can claim on the company policy which he is not a party to); and
- (b) company reimbursement. This indemnifies the company against matters for which the company is permitted to indemnify the director or officer under the articles of association and under the exception to Ss 468 and 469 CO Cap 622.

In addition, “entity coverage” may be provided in D&O liability insurance. This provides for the company to be insured in its own right for loss it may suffer. In the event of the company becoming insolvent, however, directors may face opposition from shareholders, a liquidator or trustee who consider that the limit of indemnity available under the D&O liability insurance (paid for by a company) represents a finite asset of the company which should not be eroded by the advancement of defence costs to a director.

10.7 How the D&O policy works

There are policy and practical issues which must be considered, as well as steps which must be taken to effect D&O liability insurance. These include:

²¹⁰ There may be criminal liability as well - specialist US law advice should be taken.

- (a) The objects of the company (if such exist) must permit the company to obtain such insurance. Power should be granted to the directors in the articles to effect such insurance. Because the policy is a contract of the company, the directors must disclose their interest under the CO Cap 622. The director should be authorised to vote notwithstanding this interest. The company must disclose the fact that it purchases or maintains D&O liability insurance in its annual report and accounts. Any permitted indemnity provision must be disclosed in a director's report²¹¹ and be available for inspection by a member of the company upon request.²¹²
- (b) The cover offered by the policy should be checked in advance. It is very important to compare policies to note differences in cover (particularly the scope of actions and potential liabilities covered by the policy; the conditions and exclusions (for example, US business); the definition of “wrongful acts” and “defence costs”; the financial limit on indemnities to claimants and whether, for example, defence costs are in addition; any excess payable by the insured or the company in the event of a claim (for example, whether the excess payable by each individual director, or the limit on liability per loss and/or per aggregate for policy period); the period for which the policy is operative; any pending claims in the case of a blanket policy; whether the director in the case of a company policy has the power to enforce the insurance contract himself; the conditions and exclusions; contribution conditions; and outside directorships.)
- (c) A contract of insurance is based upon the doctrine of utmost good faith. It is therefore critical that all relevant facts are disclosed to the insurer at the time the D&O liability policy is effected, that the insurer has correctly interpreted that information and that he has carried out adequate due diligence to ensure that there are no grounds on which the policy could be vitiated. Proper enquiries should be carried out of all relevant personnel (including directors) to ensure that this disclosure has been adequately made.
- (d) The position on insolvency of the company should be checked, specifically whether the policy will automatically lapse or continue until its natural expiry.

The information provided in this country chapter is correct as at 13/02/2017

²¹¹ Section 470 of the CO Cap 622.

²¹² Section 472 of the CO Cap 622.

INDIA

QUESTION 1

1. The directors and the start and duration of the relevant period

(a) How are directors identified / defined?

(b) 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

The Companies Act 1956 is in the process of being replaced with effect from 29 August 2013 when the 2013 Act received the Presidential assent. The new Act has not been published in its entirety - it is being phased in and, the provisions of the 1956 Act still apply, especially the provisions in relation to insolvency and restructuring, where new provisions have not yet been published. In the meanwhile, The Insolvency and Bankruptcy Code 2016 received the Presidential assent and was published on the 28 May 2016. However, so far only sections pertaining to the 'The Insolvency A and Bankruptcy Board of India' and the rules relevant thereof have been brought into effect. This insolvency law relates *"to reorganisation insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto."* Until this Code comes into effect, the provisions of the 1956 Act relevant to insolvency proceedings still apply.

Briefly the earlier law means and refers to:

- Chapter XIX & Chapter XX of Companies Act, 2013
- Part VIA, Part VII & Section 391 of Companies Act, 1956
- Recovery of Debts Due to Banks and Financial Institutions Act, 1993
- Securitisation and Asset Reconstruction of Financial Assets and Enforcement of Security
- Interest Act, 2002
- Sick Industrial Companies Act, 1985
- The Presidency Towns Insolvency Act, 1909
- The Provincial Insolvency Act, 1920
- Chapter XIII of the Limited Liability Partnership Act, 2008

1.2 How are directors identified / defined?

The Directors are defined as appointed as such to the Board of a company.¹ Further Directors have also been defined to mean (i) the Chief Executive Officer or the managing director or the manager; (ii) the company secretary; (iii) the whole-time director; (iv) the Chief Financial Officer; and (v) such other officer as may be prescribed.² A director is also defined as a 'manager' who occupies the position and has the management of the whole, or substantially the whole of the affairs of the company, similarly a Managing Director means a director who is entrusted with substantial powers of management of the

¹ 2013 Companies Act Section 2 (34).

² Section.2(53.)

affairs of the company. It includes any “officer”, in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act other than a person who gives advice in a professional capacity.³

1.3 Time frames that are applicable

There is no prescribed time in the 2013 or the 1956 Acts before an insolvency proceeding begins. SICA has a triggering mechanism where a director is bound to make a reference to the Board for Industrial and Financial Restructuring (BIFR) only when a company’s net worth has fallen below 50%. Though different treatments of industrial and non-industrial companies will be removed under the 2013 Companies Act, as it is yet to come into force, the previous differentiations prevail.

1.3.1 Industrial Companies

Under the incorporated provisions of SICA in the Companies Act, the board of directors of a sick industrial company is required to submit a scheme for the company’s rehabilitation to the National Company Law Tribunal (the Tribunal) (along with such particulars as may be prescribed)⁴ within 180 days from the date on which the directors become aware of the relevant facts or within 60 days of final adoption of accounts.⁵

With the winding-up order, the company ceases to be the beneficial owner of its assets and, despite continuing as the legal owner, it is the Official Liquidator who deals with the company’s property, employees and unsecured creditors.⁶

Any disposition of property after the commencement of the winding up is void unless approved by the Court. A conditional approval may be granted subject to an undertaking being given that the person with the benefit of the transfer will on demand by the Official Liquidator deposit the amounts due and payable to the workers in full or in part to which the secured creditor and the workers would be entitled.⁷

If in the course of the winding up it appears that any business of the company has been carried on with intent to defraud creditors, the directors may be held personally liable.⁸ On an application to Court by the Official Liquidator, the Court may make a declaration, at its discretion, which is not limited to the amount of the debts of those creditors who were defrauded. The Court will⁹ enquire into the conduct of an officer, promoter, director, etc. and compel him to repay or restore any money or property to the company or pay compensation. The Court is empowered to give any further directions as it deems fit for declaring a charge on any debt or obligation due from the company to the director, promoter, officer etc. liable or on any mortgage or charge of the company’s assets so held due to the fraudulent transfer. The burden of proof lies with the Official Liquidator.^{10 & 11}

The Tribunal may¹² if it is of the opinion that any direction is necessary in the interest of the company, creditors, shareholders or in the public interest, direct that the company may not, except with the prior approval of the Tribunal, dispose of any of its assets during the period of inquiry or during the period of preparation or consideration of the scheme.¹³ If in the course of scrutiny or implementation of any scheme or proposal, it appears to the Tribunal that any person who has taken part in the promotion, formation or management of the company or its undertaking, including any past or present director, manager or officer or employee of the company has: (a) misapplied or retained or become liable or accountable for, any money or property of the company; or (b) been guilty of any misfeasance, malfeasance, non-feasance or the breach of trust in relation to the company, the Tribunal may order him to repay or restore the money or property or any part thereof, with or without interest, or to contribute such sum to the assets of the company or the other person entitled by way of compensation.¹⁴

³ (S.2 (54)). S.2 (59).

⁴ Section 424A (1) Companies (Second Amendment) Act 2002.

⁵ Section 424A (4) Companies (Second Amendment) Act 2002.

⁶ Section 447 of the Companies Act 1956 read with Rule 114 of the Companies (Court) Rules 1959.

⁷ Section 536 of the Companies Act 1956.

⁸ See the Supreme Court decision in *Official Liquidator v. PA. Tendolkar* (1973)43 Com Cases 382.

⁹ Section 543 of Companies Act 1956, read with Companies (Court Rules) R. 12 (12).

¹⁰ Sections 542 & 543 of Companies Act 1956.

¹¹ See *Sandal Chit Fund and Financiers P. Ltd v. Narinder Kumar Sharma* (1994) 79 Com Cases 25 (P&H).

¹² Section 424-I.

¹³ Sections 424B or 424C respectively.

¹⁴ Section 424K (2).

Breach of the above is punishable with imprisonment for a term of up to three years or a fine not exceeding ten lakh rupees.¹⁵ Under the Companies Act 2013,¹⁶ the distinction between sick industrial and non-industrial companies has been done away with. The Tribunal may in future assess damages against delinquent directors and impose punishment for certain offences with an imprisonment for up to seven years and a fine up to ten lakh rupees.¹⁷

1.3.2 Non-industrial companies: Companies Act 1956

When a company is in the process of a winding up by the Tribunal, then any attachment or sale of any assets of the company without the leave of the Tribunal, and any sale proceeds must be handed over to the Official Liquidator. A sale or transfer of assets, payment for which is made by or against a company within six months before the commencement of its winding up (which if made within three months prior to the presentation of an insolvency petition on which an individual is adjudged insolvent, would be deemed in his insolvency a fraudulent preference of his creditors) shall be invalid.¹⁸ Where a floating charge¹⁹ has been created within twelve months prior to the commencement of the winding up proceedings, it needs to be proved beyond doubt that the company was solvent otherwise the floating charge will be invalid except to the extent of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for, the floating charge.²⁰

On an application by the Official Liquidator or creditor or contributor for such fraudulent preferences, the Tribunal may declare such persons to be personally liable, without limitation, for all or any of the debts or other liabilities of the company.²¹

The Tribunal may set aside a fraudulent preference if the Tribunal is satisfied that a transaction is fraudulent, and order as it thinks fit to restore the position to what it would have been if the company had not given the preference.²² Where any person who has taken part in the promotion or formation of the company, or any person who is or has been a director, manager, company liquidator or officer of the company has been guilty of any misfeasance or breach of trust in relation to the company, the Tribunal may order him or her to repay or restore the money or property (or any part thereof) with interest at such rates as the Tribunal considers just and proper. The application to the Tribunal must be made within five years of the date of the winding up order or of the first appointment of the company liquidator in the winding up as the case may be, whichever is longer. These penalties are in addition to any criminal liability.

¹⁵ Section 424L Roughly 11,500 GBP.

¹⁶ Ch. XIX sections 253 – 365.

¹⁷ Section 266 (1): "If, in the course of the scrutiny or implementation of any scheme or proposal including the draft scheme or proposal, it appears to the Tribunal that any person who has taken part in the promotion, formation or management of the sick company or its undertaking, including any director, manager, officer or employee of the sick company who are or have been in employment of such company: (a) has misapplied or retained, or become liable or accountable for, any money or property of the sick company; or

(b) has been guilty of any misfeasance, malfeasance, non-feasance or breach of trust in relation to the sick company, it may, by order, direct him to repay or restore the money or property, with or without interest, as it thinks just, or to contribute such sum to the assets of the sick company or the other person, entitled thereto by way of compensation in respect of the misapplication, retainer misfeasance, malfeasance, non-feasance or breach of trust as the Tribunal thinks just and proper, provided that such direction by the Tribunal shall be without prejudice to any other legal action that may be taken against the person including any punishment for fraud in the manner as provided in section 447.

If the Tribunal is satisfied on the basis of the information and evidence in its possession with respect to any person who is or was a director or an officer or other employee of the sick company, that such person by himself or along with others had diverted the funds or other property of such company for any purpose other than the purposes of the company or had managed the affairs of the company in a manner highly detrimental to the interests of the company, the Tribunal shall, by order, direct the public financial institutions, scheduled banks and State level institutions not to provide, for a maximum period of ten years from the date of the order, any financial assistance to such person or any firm of which such person is a partner or any company or other body corporate of which such person is a director, by whatever name called, or to disqualify the said director, promoter, manager from being appointed as a director in any company registered under this Act for a maximum period of six years.

(3) No order shall be made by the Tribunal under this section against any person unless such person has been given a reasonable opportunity of being heard."

Section 267: "Whoever violates the provisions of this Chapter or any scheme, or any order, of the Tribunal or the Appellate Tribunal or makes a false statement or gives false evidence before the Tribunal or the Appellate Tribunal or attempts to tamper with the records of reference or appeal filed under this Act, shall be punishable by imprisonment for a term which may extend to seven years and with fine which may extend to ten lakh rupees."

¹⁸ See section 531 of the Companies Act 1956.

¹⁹ See provisions 332 of the Companies Act 2013 and section 534 of Companies Act 1956.

²⁰ See section 534 of the Companies Act 1956.

²¹ See section 542 of the Companies Act with Rule 11(18) of the Companies (Court) Rules 1949.

²² Sections 328-341.

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 the director?

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

- (i) Is the director's liability considered to be civil, criminal or both?
- (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
- (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?
- (iv) Is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director? and
- (v) What defences, if any, will be available in relation to each offence?

Insolvency – related liability

Directors may find themselves liable for acts which take place during the “twilight” period as a consequence of specific insolvency-related offences provided for by statute or as a consequence of the general fiduciary, common law and, in some cases, statutory duties imposed on a director, which may take on particular significance if a company finds itself in financial difficulties.

2.1 Misconduct by officers of companies in liquidation²³

A past or present officer of a company commits an offence if he:

- (a) does not, to the best of his knowledge and belief, fully and truly discover to the liquidator all the property, movable and immovable, of the company, how, to whom, for what consideration and when it was disposed, except where it has been disposed of in the ordinary course of business;
- (b) does not deliver up to the liquidator, or as he directs, all movable and immovable property of the company in his custody or under his control, and which he is required by law to deliver up;
- (c) does not deliver up to the liquidator, or as he directs, all books and papers of the company in his custody or under his control and which he is required by law to deliver up;
- (d) within the 12 months before the commencement of the winding up or at any time thereafter, conceals any property of the company valued at 100 rupees or more, or conceals any debt due to or from the company;
- (e) within the 12 months before the commencement of the winding up or at any time thereafter, fraudulently removes any property of the company valued at 100 rupees or more;
- (f) makes any material omission in any statement relating to the affairs of the company;
- (g) fails to inform the liquidator that a false debt has been proved by any person under the winding up;

²³ Section 538 Companies Act 1956.

- (h) after the commencement of the winding up, prevents the production of any book or paper affecting or relating to the property or affairs of the company;
- (i) within the 12 months before the commencement of the winding up or at any time thereafter, conceals, destroys, mutilates or falsifies or is privy to the concealment, destruction, mutilation or falsification of any book or paper affecting or relating to, the property or affairs of the company;
- (j) within the 12 months before the commencement of the winding up or at any time thereafter, makes or is privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company;
- (k) within the 12 months before commencement of the winding up or at any time thereafter, fraudulently parts with, alters or makes any omission in, or is privy to the fraudulent parting with, altering or making of any omission in, any book or paper affecting or relating to the property or affairs of the company;
- (l) after the commencement of the winding up or at any meeting of the creditors of the company within the 12 months before the commencement of the winding up, attempts to account for any property of the company by fictitious losses or expenses;
- (m) within the 12 months before the commencement of the winding up or at any time thereafter, by any false representation or other fraud, obtains on credit, for or on behalf of the company, any property which the company does not subsequently pay for;
- (n) within the 12 months before the commencement of the winding up or at any time thereafter, under the pretence that the company is carrying on business, obtains on credit, for or on behalf of the company, any property which the company does not subsequently pay for;
- (o) within the 12 months before the commencement of the winding up or at any time thereafter, pawns, pledges or disposes of any property of the company which has been obtained on credit and has not been paid for unless such pawning, pledging or disposing is in the ordinary course of the business of the company; or
- (p) is guilty of any false representation or other fraud for the purpose of obtaining the consent of the creditors of the company or any of them, to an agreement with reference to the affairs of the company or to the winding up.

2.1.1 Liability

If any of the above from (a) - (p) are satisfied:

- (a) Liability under this provision is criminal.
- (b) A person guilty of this offence is liable to imprisonment or a fine or both.
- (c) The gravity of the misconduct will be reflected in the term of imprisonment or the fine imposed. In exercising its punitive jurisdiction, the Court(s) do not seek to compensate the company concerned. The offence shall be punishable, in the case of any of the acts mentioned in sub-paras (m), (n) and (o), with imprisonment for a term of up to five years and/or a fine, and, in the case of any other offence, with imprisonment for a term of up to two years and/or a fine;
- (d) The act in question must have occurred in most of the above cases either:
 - (i) after the commencement of the winding up; or
 - (ii) within the 12 months preceding the commencement of the winding up.
- (e) It shall be a good defence:
 - (i) to a charge under (b), (c), (d), (f), (n) and (o), if the accused proves that he had no intent to defraud; and

- (ii) to a charge under (a), (h), (i) and (j), if the accused proves that he had no intent to conceal the true state of affairs of the company or to defeat the law.

The above offence is incorporated under S 336 of the Companies Act 2013, which remains similar to the provisions under the 1956 Act, save for the offence of fraud which is laid down under S 337 of the Companies Act 2013. (yet to be notified).

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

- (a) has, by false pretences or by means of any other fraud, induced any person to give credit to the company;
- (b) with intent to defraud creditors of the company or any other person, has made or caused to be made any gift or transfer of, or charge on, or has caused or connived at the levying of any execution against, the property of the company; or
- (c) with intent to defraud creditors of the company, has concealed or removed any part of the property of the company since the date of any unsatisfied judgment or order for payment of money obtained against the company or within two months before that date,

The director responsible shall be punishable with imprisonment for a term which shall not be less than one year but which may extend to three years and with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees.

2.2 Defrauding creditors²⁴

An offence is committed by an officer of a company which is subsequently wound up by the Court or which subsequently passes a resolution for voluntary winding up, if he:

- (a) has, by false pretence or other fraud, induced any person to give credit to the company;
- (b) has made or caused to be made any gift or transfer of or charge on or has caused or connived at levying execution against the property of the company with intent to defraud creditors of the company; or
- (c) has, with intent to defraud creditors of the company, concealed or removed any part of the property of the company since the date of any unsatisfied judgment or order for payment of money obtained against the company, or within the two months prior to that date.

2.2.1 Liability

- (a) Liability under this provision is criminal. Hence, the answers to (b) and (c) are as set out in para 2.1.1 above, except that this offence is punishable with imprisonment for a term of up to two years and a fine.
- (b) There is no set time period. It all depends on whether it was within the knowledge of the officer that the company was bound or likely to go into liquidation.
- (c) Absence of *mens rea* (i.e. absence of intention to defraud) may be available as a defence.

The liability for fraudulent conduct of business is in S 339 of the Companies Act 2013. Where any business of a company is carried on with such intent or for such purpose, every person carrying on the fraudulent conduct shall be liable for action.²⁵ The prescribed punishment is imprisonment for a minimum term of six months extendable to ten years and/or a fine equal to the minimum amount involved in the fraud, which may be extended to three times the amount involved in the fraud. (This offence will, under the Companies Act 2013, effectively replace both the offence of defrauding creditors and the offence of fraudulent conduct of the company's business referred to in 2.5 below.)

²⁴ Section 540 Companies Act 1956.

²⁵ Section 447 of the Companies Act 2013.

2.3 Maintenance of improper accounts²⁶

In the course of winding up of a company, if it is shown that the company did not keep proper books of account, every officer of the company who is in default shall be guilty of an offence under this provision.

2.3.1 Liability

Liability under this provision is criminal. Hence, the answers to (b) and (c) are as set out in para 2.1.1 above except that this offence is punishable with imprisonment for a term of up to one year. The offence must have been committed throughout the two years immediately preceding the commencement of the winding up, or the period between the incorporation of the company and the commencement of the winding up, whichever is shorter.

It is a defence to show that the officer acted honestly and that, in the circumstances in which the business of the company was carried on, the default was excusable.

Where proper books of account were not kept by the company throughout the period of two years immediately preceding the commencement of the winding up, every officer of the company who is in default shall be punishable with an imprisonment term of not less than one year extendable to three years and with a fine of not less than one lakh rupees extendable to three lakh rupees.²⁷

2.4 Falsification of company's books²⁸

An offence is committed if any officer or contributor of a company, which is being wound up, with intent to defraud or deceive any person:

- (a) destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities; or
- (b) makes, or is privy to the making of, any false or fraudulent entry in any register, book of account or document belonging to the company.

2.4.1 Liability

Liability under this provision is criminal. Hence, the answers to (b) and (c) are as set out in para 2.1.1 above except that this offence is punishable with imprisonment for a term of up to seven years and a fine.

This offence applies when the company is being wound up.

Absence of intention to defraud or deceive any person by virtue of commission of the above acts is a defence.

The above offence applies under the Companies Act 2013 where a person destroys, mutilates or falsifies, or conceals or tampers or unauthorisedly removes, or is a party to the destruction, mutilation or falsification or concealment or tampering or unauthorised removal of, documents relating to the property, assets or affairs of the company or the body corporate.²⁹ The prescribed punishment is imprisonment for a minimum term of six months extendable to ten years and/or a fine at least equal to the amount involved in the fraud, which may be extended to three times the amount involved in the fraud.

2.5 Fraudulent conduct of company's business³⁰

If it is found that any business of the company has been carried on with intent to defraud creditors or any other person, or for any fraudulent purpose, persons engaged in the conduct of business shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company.

The elements of the concept are therefore:

²⁶ Section 541 Companies Act 1956.

²⁷ Section 338 Companies Act 2013.

²⁸ Section 539 Companies Act 1956.

²⁹ Section 447 of the Companies Act 2013.

³⁰ Section 542 Companies Act 1956.

- (a) there has to be an insolvent liquidation in progress;
- (b) there has to have been dishonesty in the running of the business;
- (c) the standard of proof is ‘beyond reasonable doubt’, even in a case of civil liability;
- (d) there is no hard and fast rule or statutory provision as to the time period within which the act or offence must have been committed. It depends on the nature and circumstances of the individual case, as scrutinised by the Courts.

2.5.1 Liability

Liability may be criminal or civil.

The Court enjoys a wide discretion to compensate for the loss caused to the company by the director’s conduct but it may include punitive damages.

There should be proportionality in terms of compensation versus punitive damages, albeit the Court’s discretion is very wide.

There is no specified period.

The main defence is that the party concerned was not dishonest. In practice, the party may be able to admit to incompetence, imprudence or even folly as long as he honestly believed that, for example, any new credit incurred would ultimately be repaid in full.

2.6 Delinquency, breach of trust & misfeasance: directors and others³¹

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, retained, become liable or accountable for any money or property of the company; or
- (b) has been guilty of any misfeasance or breach of trust in relation to the company.

2.6.1 Liability

Liability under this provision is civil.

A person guilty of this offence can be compelled by the Court to repay or restore the money or property or any part thereof, with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation for the misapplication, retainer, misfeasance or breach of trust, as the Court thinks just.

The Court has a wide discretion with respect to the orders it may make under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability.

Aside from Statute of Limitations provisions, there is no set time period within which the impugned act must have occurred in order for liability to attach. It depends on the nature and circumstances of the individual case, as scrutinised by the Courts.

No specific defences are provided for, although the Registrar of Companies, in making its report, will be required to give the person concerned an opportunity to state his case.

This liability has ceased to be purely civil under the current Act if, in the course of the scrutiny it appears to the Tribunal that any person who has taken part in the promotion, formation or management of the company or its undertaking, including any director, manager, officer or employee of the company who are or have been in employment of such company – has misapplied or retained, or become liable or accountable for, any money or property of the company or has been guilty of misfeasance, non-feasance or breach of trust in relation to the company, it may, by

³¹ Section 543 Companies Act 1956.

order direct him to repay or restore the money or property with or without interest or to contribute such sum to the assets of the company or the other person entitled thereto by way of compensation in addition to the punishment for fraud.³²

2.7 Misfeasance proceedings³³

An offence is established if, in the course of scrutiny or implementation of any revival/rehabilitation scheme or proposal, it appears to the Board for Industrial and Financial Reconstruction that any person who has taken part in the promotion, formation or management of the company or its undertaking, including any past or present director, manager or officer or employee of the company:

- (a) has misapplied or retained or become liable or accountable for any money or property of the company; or
- (b) has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust in relation to the company.

2.7.1 Liability

Liability under this provision is civil.

A person guilty of this offence can be directed by the Court to repay or restore the money or property or any part thereof, with or without interest, as it thinks just, or to contribute such sum to the assets of the company or to any person entitled to compensation in respect of the misapplication, retainer, misfeasance or breach of trust as the Tribunal thinks just. The Tribunal may also report the matter to the Central Government for any other action which the Government may deem fit. The officer or other person found guilty of this offence may also be prevented from borrowing any money for the next ten years.

The Court has a wide discretion with respect to the orders it may make under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability.

There is no time period during which the impugned act must have occurred in order for liability to attach.

There is a defence if the person has acted honestly and reasonably and the Court concludes that he ought fairly to be excused.

Under the Companies Act 2013, the Tribunal, on the application of the official / company liquidator or any creditor or contributor of the company, may declare that any persons who were knowingly parties to the carrying on of the business with intent to defraud creditors or for any fraudulent purpose shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as per the directions of the Tribunal.³⁴

(Section 339 speaks of liability for fraudulent conduct of business. Section 340 speaks of the power of tribunal to assess damages against delinquent directors etc.)

³² Provision 447 of the 2013 Act.

³³ Section 424K Companies Act 1956.

³⁴ Section 339(1): "If in the course of the winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or any other persons or for any fraudulent purpose, the Tribunal, on the application of the Official Liquidator, or the Company Liquidator or any creditor or contributory of the company, may, if it thinks it proper so to do, declare that any person, who is or has been a director, manager, or officer of the company or any persons who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Tribunal may direct: provided that on the hearing of an application under this sub-section, the Official Liquidator or the Company Liquidator, as the case may be, may himself give evidence or call witnesses.

(2) Where the Tribunal makes any such declaration, it may give such further directions as it thinks proper for the purpose of giving effect to that declaration and, in particular:

(a) make provision for making the liability of any such person under the declaration a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in any mortgage or charge on any assets of the company held by or vested in him, or any person on his behalf, or any person claiming as assignee from or through the person liable or any person acting on his behalf;

(b) make such further order as may be necessary for the purpose of enforcing any charge imposed under this sub-section.

(3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in sub-section (1), every person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be liable for action under s.447.

(4) This section shall apply, notwithstanding that the person concerned may be punishable under any other law for the time being in force in respect of the matters on the ground of which the declaration is to be made."

2.8 Directors and managers with unlimited liability³⁵

In the winding up of a limited company, any director or manager, whether past or present, whose liability is unlimited, shall, in addition, be liable to make a further contribution as if he were, at the commencement of the winding up, a member of an unlimited company.

2.8.1 Exceptions

A past director or manager shall not be liable to make a further contribution if he ceased to hold office a year or more before the commencement of the winding up.

A past director or manager shall not be liable to make a further contribution in respect of debts or liability of the company incurred or entered into after he ceased to hold office.

Subject to the articles of the company, a director or manager shall not be liable to make such further contribution unless the Court deems it necessary to require the contribution in order to satisfy the debts and liabilities of the company, and the costs, charges and expenses of the winding up.

2.9 Offences under Part VIA of the Companies Act 1956³⁶

Any person who violates any provision of Part VIA of the Companies Act or any scheme or order of the Tribunal or the Appellate Tribunal or who furnishes a false statement and/or evidence to the Tribunal or attempts to tamper with the records of reference or appeal filed under the Companies Act, shall be punished with imprisonment for a term of up to three years and a fine.

The directors and other officers of every company shall ensure that books of account of the company are completed and audited up to the date of winding up order by the Tribunal and submitted to it, failing which such directors and officers shall be liable for punishment for a term not exceeding one year and a fine.

2.10 General Liability

2.10.1 Removal of managerial personnel³⁷

If any person concerned in the conduct and management of the affairs of a company is or has been guilty of fraud, misfeasance, persistent negligence or default in carrying out his obligations or breach of trust, or if the business has been conducted and managed in a manner which is likely to cause, or has caused, serious injury or damage to the interests of the trade, industry or business of the company, or with intent to defraud creditors, members or other persons, or otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to the public interest, the Central Government may, in conjunction with the Company Law Board, by order, remove from office any director or other person concerned.

This power of removal is now vested with the Tribunal on a complaint by any member of a company or central government about the conduct of the company being prejudicial to its interests or its members or any class of members. The Tribunal may seek the removal of the managing director, manager or any of the directors of the company and ask for recovery of undue gains made by any such person.³⁸

2.10.2 Reduction in membership³⁹

If at any time the number of members of a company is reduced in the case of a public company, below seven or, in the case of a private company, below two and the company carries on business for more than six months while the number is so reduced, every person who is a member of the company and knows of the fact shall be severally liable for all the debts of the company contracted during that time.

³⁵ Section 427 Companies Act 1956.

³⁶ Section 424L Companies Act 1956.

³⁷ Sections 388B, 388D & 388E Companies Act 1956.

³⁸ Section 244.

³⁹ Section 45 Companies Act 1956 – while this provision was diluted under the 2013 Act, a recent amendment through the Companies Bill 2016 through provision 3A seeks to introduce the same provision in toto.

The Companies Act 2013 introduces the concept of single-member companies as One Person Companies (OPC). If a company limited by guarantee or a single-member company enters into a contract, the terms of the contract or offer will need to be recorded in the minutes of the first meeting with the board of directors.

2.10.3 Misdescription of name⁴⁰

In any contract of a company, if its name is not properly indicated, those responsible shall be personally liable.

2.10.4 Fiduciary and common law duties owed to the company

Directors owe a number of fiduciary and common law duties to the company. These include:

- (a) duty to ensure that the corporate capital is used only for the legitimate business of the company. If any part of it has been diverted to purposes foreign to the company's memorandum, the directors will be personally liable to replace it;
- (b) a duty to act with honesty;
- (c) a duty to account for any profits made;
- (d) a duty not to exploit corporate opportunities to their own advantage;
- (e) a duty not to use the company's assets (including business connections, goodwill, trade assets and the list of customers) for the benefit of a rival concern;
- (f) a duty to repay to the company any profit they make on shares in the company; and
- (g) a duty not to use or exploit unpublished and confidential information of the company. The company can ask the director to make good any loss arising as a result of a breach of this duty.

Once the company becomes insolvent, however, the interests of the creditors take priority. Thereafter, the directors' duties are subject to an overriding duty to have regard to the interests of the general body of creditors of the company.

2.10.5 Disqualification of a director⁴¹

A person shall not be appointed as a director of a company if he has been found to be of unsound mind; he is an undischarged insolvent; he has applied to be adjudicated as an insolvent and his application is pending; he has been convicted of an offence involving moral turpitude and sentenced to imprisonment for not less than six months and a period of five years has not elapsed since the expiry of the sentence; he has not paid any call in respect of shares of the company and six months have elapsed from the last day fixed for the payment of the call; or an order disqualifying him from appointment as director has been passed by the Court.

If in the course of the scrutiny or implementation of any scheme or proposal⁴² it appears to the Tribunal that any person who has taken part in the promotion, formation or management of the company or its undertaking - including any director, manager, officer or employee – has misapplied or retained, or become liable or accountable for, any money or property of the sick company or has been guilty of any misfeasance, malfeasance, non-feasance or breach of trust, he would be punished with both the monetary penalty and punishment.⁴³ The liability for fraudulent conduct of business is set down in S 339.

⁴⁰ Section 147 Companies Act 1956.

⁴¹ Section 274 Companies Act 1956.

⁴² Companies Act 2013 section 266.

⁴³ Section 447.

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period
- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 Overview

Most of the offences listed above, for which personal liability may be incurred, apply not only to directors but also to 'officers' of the company (sometimes both past and present officers) and, in some cases, to 'managers' of the company. The 2013 Companies Act includes 'key managerial personnel'⁴⁴ meaning (i) the Chief Executive Officer or the managing director or the manager; (ii) the company secretary; (iii) the whole-time director; (iv) the Chief Financial Officer; and (v) such other officer as may be prescribed. An officer of the company who is in default liable to any penalty or punishment by way of imprisonment, fine or otherwise, means any of (i) whole-time director; (ii) key managerial personnel; (iii) where there is no key managerial personnel, such director or directors as specified by the Board in this behalf and who has or have given his or their consent in writing to the Board to such specification, or all the directors, if no director is so specified; (iv) any person who, under the immediate authority of the Board or any key managerial personnel, is charged with any responsibility including maintenance, filing or distribution of accounts or records, authorises, actively participates in, knowingly permits, or knowingly fails to take active steps to prevent, any default; (v) any person in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act, other than a person who gives advice to the Board in a professional capacity; (vi) every director, in respect of a contravention of any of the provisions of this Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the Board or participation in such proceedings without objecting to the same, or where such contravention had taken place with his consent or connivance; (vii) in respect of the issue or transfer of any shares of a company, the share transfer agents, registrars and merchant bankers to the issue or transfer

3.2 Managers and officers

A "manager" of a company means an individual (not being the managing agent) who, subject to the superintendence, control and direction of the board of directors, is responsible for the management of the whole or substantially the whole of the affairs of the company and includes a director or any other person occupying the position of a manager, by whatever name called, and whether under a contract of service or not⁴⁵.

An "officer" includes any director, manager or secretary or any person in accordance with whose directions or instructions the board of directors or any one or more of the directors is or are accustomed to act.⁴⁶ "Secretary" means the person, if any, who is appointed to perform the duties, which may be performed by a secretary.⁴⁷

An officer of the company (regardless of whether he is a director or not) who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine or otherwise. The expression "officer who is in default" means any officer of the company who is knowingly guilty of the default, non-compliance, failure, refusal or contravention mentioned or who knowingly and wilfully authorises or permits such default, non-compliance, failure, refusal or contravention.⁴⁸

⁴⁴ Section 2(51).

⁴⁵ Section 2(24) Companies Act 1956.

⁴⁶ Section 2(30) Companies Act 1956.

⁴⁷ Section 2(45) Companies Act 1956.

⁴⁸ Section 5 Companies Act 1956.

3.3 Nominee and *de facto* directors

A nominee director is not supposed to be in charge of a company's affairs. He is not liable for failures by the company to comply with the 1956 Act or other regulatory laws. Nominee directors are mainly appointed by secured creditors pursuant to the right to appoint a member on the board of funded companies. Such a nominee may be an executive of the secured creditor bank or financial institution or may sometimes be a professional. He becomes an officially appointed director and has voting rights. His main obligation is to ensure fair utilisation and application of the financial assistance lent. He also keeps an eye on the company's affairs though is neither responsible for nor involved in the day-to-day affairs of the company. Since he is not involved in management, there has been a debate over the liabilities he may incur in case of fraud or wrongful action by the company. There are conflicting views of the Court on this issue.

A nominee director suffers from an essential conflict of duty and interest. He owes his duty to the person who nominated him but sits on the board of the company. Problems never arise as long as the interests of the relevant companies are in harmony. But when the interests are in conflict, nominees are placed in a precarious situation.

A person who has acted as a director may be regarded as a director even though not validly appointed as one (for example, an executive director). To hold a person as a *de facto* director, there must be conclusive evidence that he was the sole person directing the affairs of the company or that he acted on an equal footing with other directors in managing the affairs of the company. A *de facto* director may be held liable for his actions during the twilight period.

Every company shall maintain a register containing such particulars of its directors and key managerial personnel which shall include details of securities held by each of them in the company or its holding, subsidiary, subsidiary of the company's holding company or associate companies. There is a prohibition on forward dealings in securities of company by director or key managerial personnel. Any such contravention will be punishable with imprisonment for a term which may extend to two years or a fine which shall not be less than one lakh rupees and which may extend to five lakh rupees or both (S 194).

Provisions have been introduced with regard to the selection of independent directors, their duties and responsibilities and an ethical code for conduct. However, their duties and responsibilities have been 'liability proofed' in that an independent director shall not during the period of three years be appointed in or be associated with the company in any other capacity either directly or indirectly and shall be held liable only in respect of acts of omission or commission by the company which occur with his knowledge attributable through Board processes and with his consent or connivance or where he has not acted diligently.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Introduction

The legal position in India is such that it seeks to undo transactions prejudicial to a company and / or which are unfairly beneficial to a counterparty, particularly when they are entered into during the twilight period. The Insolvency and Bankruptcy Code 2016 (yet to be notified) makes provisions for the Interim resolution professional who shall make every endeavour to protect and preserve the value of the property of the corporate debtor and manage the operations of the corporate debtor as a going concern.⁴⁹

4.2 Summary of heads of challenge

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

- (a) which are at an undervalue;
- (b) which are preferences;
- (c) defrauding creditors;
- (d) which constitute extortionate credit bargains;
- (e) comprising floating charges given for past value;
- (f) involving onerous property;
- (g) dispositions of the company's property made after the commencement of winding up;
- (h) unregistered charges;
- (i) avoidance of a voluntary transfer.

4.3 Transactions at an undervalue

A transaction at an undervalue is not defined anywhere. In ordinary parlance, it could be stated to be one that is entered into at a time when the company is insolvent at an apparently lesser price than it could have attracted otherwise. There is no direct provision dealing with this aspect though it could be stated to fall under fraudulent preference.

4.3.1 Conditions for setting aside a transaction at undervalue

There are no conditions laid down in the 1956 Act, but the disposal must have been made during the year prior to the company's insolvency.

⁴⁹ For the purposes of sub-section (1) of S.20, the interim resolution professional shall have the authority— (a) to appoint accountants, legal or other professionals as may be necessary; (b) to enter into contracts on behalf of the corporate debtor or to amend or modify the contracts or transactions which were entered into before the commencement of corporate insolvency resolution process; (c) to raise interim finance provided that no security interest shall be created over any encumbered property of the corporate debtor without the prior consent of the creditors whose debt is secured over such encumbered property: Provided that no prior consent of the creditor shall be required where the value of such property is not less than the amount equivalent to twice the amount of the debt. (d) to issue instructions to personnel of the corporate debtor as may be necessary for keeping the corporate debtor as a going concern; and (e) to take all such actions as are necessary to keep the corporate debtor as a going concern.

The Court may not make an order to set aside a transaction at a undervalue if it is satisfied that the company entered into the transaction in good faith and for the purpose of carrying out its business and that at the time, it did so there were reasonable grounds for believing that the transaction would benefit the company and that all possible efforts were made to get the best possible price. The Court may not make an order which would prejudice purchasers in good faith and for value.

If the Tribunal is satisfied that there has been a preferential transfer of property, movable or immovable, or any delivery of goods, payment, execution made, taken or done by or against a company within six months before making winding up application, the Tribunal may declare such transaction invalid and restore the position.⁵⁰

4.4 Preferences

A transaction will be a preference if it puts a creditor in a better position than he would have been in if the company had instead gone into liquidation. It is not a term defined by the 1956 Act and is not necessarily a preference made with fraudulent intent as with a fraudulent preference. The preference must have been made in the one-year period prior to the company's insolvency. The Court has a range of options to restore the position to what it would have been if the transaction had not been entered into.

4.4.1 Conditions for setting aside a preference

There is no specific test for what constitutes a preference. The Court can, if it is satisfied on the basis of facts brought before it that a person has been preferred, make an order restoring the status quo to what it was prior to the preference having been made or direct that the person preferred shall be subject to the same liabilities and have the same rights as if he had undertaken to be personally liable as surety for the debt (if the property was mortgaged or charged to secure company's debt).

4.4.2 Defences

There are few reported examples of a preference. However, a Court will not make an order in respect of a preference unless the company which gave the preference was influenced by a desire to prefer the person to whom the preference was given, as is the case under English law. This will be a question of fact.

Any transfer of property, movable or immovable, or any delivery of goods, by a company not being in the ordinary course of business, if made within a period of one year before the presentation of a petition for winding up by the Tribunal or the passing of a resolution for voluntary winding up of the company, will be void. Similarly, any transfer or assignment by a company of all its property or assets to trustees for the benefit of all its creditors will be void.⁵¹

4.5 Transactions defrauding creditors

4.5.1 Conditions

If an asset is sold with intent to put the asset beyond the reach of a person who has or may at some time make a claim against the company in respect of that asset or to otherwise prejudice the interests of that person in relation to his claim, the Court can restore and protect the interests of the persons affected by the transaction.

4.5.2 Defences

The same defences as for transactions at an undervalue and preferences apply.

Any transfers or assignments by the company of all of its property or assets to trustees for the benefit of all its creditors will be void.⁵² Similarly in the case of voluntary winding up, any transfer of shares in the company and any alteration in the status of the members of the company, made after the commencement of the winding up, will be void.

⁵⁰ Section 328.

⁵¹ Sections 329-330 Companies Act 2013.

⁵² 330 & 334 of the Companies Act 2013.

4.6 Extortionate credit transactions

4.6.1 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.

4.6.2 Defences

There are no statutory defences (other than successfully disproving the allegation).

4.7 Avoidance of floating charges for past value⁵³

Where a company is being wound up, a floating charge on the undertaking or property of the company created within the 12 months immediately preceding the commencement of the winding up, shall, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, except to (i) the amount of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for the charge and (ii) interest on that amount at 5% (or such other rate as may be notified by central Government in the official Gazette). This remains unchanged.

4.7.1 Defences

It will be a defence that the company was not or did not become insolvent as a result of granting the floating charge.

4.8 Disclaimer of onerous property

The liquidator may abandon onerous property belonging to the company. The following are regarded as onerous:⁵⁴

- (a) land burdened with covenants;
- (b) shares or stock in companies;
- (c) any other property which is unsaleable or is not readily saleable due to the fact that it requires the possessor to perform certain acts or pay a sum of money; and
- (d) unprofitable contracts.

The liquidator may, with leave of the Court, disclaim any such property and it is the duty of the Court to help the liquidator disclaim onerous contracts whenever this is necessary to safeguard the interests of the creditors and the shareholders of the company.

The disclaimer must be made in writing within 12 months of the commencement of the winding up or such extended period as the Court may allow. The disclaimer determines, in respect of the property disclaimed, the rights, liabilities and interests of the company; it releases the company and property from liability.

The company liquidator may notwithstanding that he has endeavoured to sell or has taken possession of the property or exercised any act of ownership in relation thereto, with the leave of the Tribunal at any time within twelve months after the commencement of the winding up or such extended period as may be allowed by the Tribunal disclaim the property:⁵⁵

Provided that the company liquidator was not aware of the existence of any such property within one month from the commencement of the winding up, the power of disclaimer may be exercised at any time within 12 months after the liquidator becomes aware of such property, such extended period as is allowed by the Tribunal.

⁵³ Section 534 Companies Act 1956.

⁵⁴ Section 535 Companies Act 1956.

⁵⁵ Section 333 of the Companies Act 2013.

The disclaimer shall operate to determine as from the date of disclaimer the rights and interest and liabilities of the company in or in respect of the property disclaimed.

In case of leasehold property, the Tribunal shall not make a vesting order in favour of any person claiming under the company unless that person is subject to the same liabilities and obligations as the company was subject to under the lease at the commencement of the winding up or, if the Tribunal thinks fit, subject only to the same liabilities and obligations as if the lease had been assigned to that person at that date.

4.9 Disposition of the company's property made after the commencement of winding up

Where any company is being wound up by or subject to the supervision of the Court –⁵⁶

- (a) any attachment, distress or execution put in force, without leave of the Court, against the estate or effects of the company after the commencement of winding up; or
- (b) any sale held, without the leave of the Court, of any of the property or effects of the company after the commencement of the winding up will be void.

Any transfer without the sanction of the company liquidator and any alteration in the status of the members of the company, made after the commencement of the winding up, will be void.⁵⁷

4.10 Failure to register a charge

The power to borrow includes the power to mortgage or charge the company's assets. Any charge created on any of the following assets of a company must be registered with the Registrar of Companies:⁵⁸

- (a) charge for the purpose of securing any issue of debentures;
- (b) charge on uncalled share capital of the company;
- (c) charge on any immovable property, wherever situate, or any interest therein;
- (d) charge on any book debts of the company;
- (e) charge, not being a pledge, on any moveable property of the company;
- (f) floating charge on the undertaking or any property of the company including stock in trade;
- (g) charge on calls made but not paid;
- (h) charge on a ship or any share in a ship; and
- (i) 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.

A certificate is issued by the Registrar of Companies which is conclusive evidence that the requirements as to registration have been complied with. Registration must be effected within 30 days of the creation of the charge.

Upon registration, the charge becomes binding on the company even in the event of its winding up and on every subsequent purchaser or encumbrancer of the property covered by the charge. The effect of non-registration is that the charge will be void against the liquidator and any creditor of the company in the event of a winding up.

⁵⁶ Section 537 Companies Act 1956.

⁵⁷ Section 334.

⁵⁸ Section 125 of the 1956 Act.

It is the duty of every company creating a charge within or outside India on its property, assets or any of its undertakings, whether tangible or otherwise and situated within or outside India, to register it with the Registrar of Companies within 30 days of its creation.⁵⁹ If any company contravenes any provision of this chapter the company shall be punishable with a fine of not less than one lakh rupees extendable to ten lakh rupees. Every officer of the company who is in default shall be punishable with imprisonment for a term up to six months or a fine which shall not be less than 25,000 rupees extendable to six months, or both (S 86).

4.11 Avoidance of voluntary transfer

Any transfer of property, movable or immovable, or any delivery of goods made by a company, which is not a transfer or delivery made in the ordinary course of its business or in favour of a purchaser or encumbrancer in good faith, even though made for valuable consideration, shall, if made within the period of one year before the presentation of a petition for winding up by or subject to the supervision of the Court or the passing of a resolution for voluntary winding up of the company, be void against the liquidator.

Any transfer of property, movable or immovable or any delivery of goods, made by a company not being made in the ordinary course of its business if made within a period of one year before the presentation of a petition for winding up by the Tribunal or the passing of a resolution for voluntary winding up of the company, will be void. Similarly any transfer or assignment by a company of all its property or assets to trustees for the benefit of all its creditors will be void.⁶⁰

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Introduction

When a company goes into liquidation, the authority and powers of the directors are taken over by the Official Liquidator or the Provisional Liquidator. They review actions taken by the directors and other personnel during the twilight period and if there has been any loss to the company, they try to initiate proceedings for the benefit of creditors. The Official Liquidator is in essence empowered to bring actions against the directors and others where there has been a breach of either legal or fiduciary duties owed to the company subject to the authority of the Court, without whose sanction these proceedings would have no effect.

Within three weeks from the date of passing of a winding up order, the company liquidator⁶¹ shall make an application to the Tribunal for the constitution of a winding up committee to assist and monitor the progress of the liquidation proceedings. This committee will consist of the Official Liquidator,⁶² a nominee of the secured creditors and a professional nominated by the Tribunal. The company liquidator will be the convenor of the meetings and monitor the proceedings relating to the following:

- ii) taking over assets;
- (ii) examination of the statement of affairs;

⁵⁹ Ch.VI of the Companies Act 2013 section 77.

⁶⁰ Sections 329-330 Companies Act 2013.

⁶¹ "Company Liquidator", in so far as it relates to the winding up of a company, means a person appointed by:

(a) the Tribunal in case of winding up by the Tribunal; or

(b) the company or creditors in case of voluntary winding up, as a Company Liquidator from a panel of professionals maintained by the Central Government under sub-section (2) of section 275.

⁶² "Official Liquidator" means an Official Liquidator appointed under sub-section (1) of section 359 Companies Act 2013.

- (iii) recovery of property, cash or any other assets of the company including benefits derived therefrom;
- (iv) review of audit reports and accounts of the company;
- (v) sale of assets;
- (vi) finalisation of list of creditors and contributories;
- (vii) compromise, abandonment and settlement of claims;
- (viii) payment of dividends, if any; and
- (ix) any other function, as the Tribunal may direct from time to time.⁶³

This makes the Tribunal the custodian of the company's property and, when a report is received from the company liquidator or Central Government, an investigation under S 210 is ordered by the Tribunal with a direction to the company liquidator to file a criminal complaint against persons who were involved in the commission of the fraud.

5.2 Criminal proceedings

The following acts are criminal offences which the Official Liquidator is duty bound to bring to the Court's notice.

5.2.1 Offences

Fraudulent removal or concealment of property to prevent distribution among creditors and falsification of accounts are punishable under the Indian Penal Code. The offences have to be brought to the notice of the Court in order for the Court to take appropriate legal action.

- (a) Falsification of company's books - S 539; (S 336 (e) of the Companies Act 2016)
- (b) Fraud by officers - S 540; (S 340(1)(d)(3))
- (c) Offences by officers - S 538; (S 336 (1))
- (d) Fraudulent conduct of business - S 542; (S 339(1))
- (e) Wrongful withholding of property - S 630; (S 452(1))
- (f) False representations to creditors - S 538 (m); (S 336 (1)(i))
- (g) Disqualification of a director - S 274 (S 164).

Destruction, mutilation or falsification or concealing or tampering or being a party to the destruction of documents relating to property, assets or affairs of the company or body corporate (S 229(a)).

After the notification of the Second Amendment and the Sick Industrial Companies (Special Provision) Repeal Act 2002, the following offences will be added (specifically in respect of industrial companies):

Violation of provisions of Part VIA or any scheme of the Tribunal – S 424L:

- (ii) Non-submission of audited books and accounts – S 446A;
- (iii) Wilful refusal to furnish information relating to affairs of producer companies – S 581ZM.

⁶³ See Section 277 Companies Act 2013.

5.3 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, provisions exist to provide access for a range of people to bring action to recover funds for the benefit of the company's creditors. The overall recovery made is distributed evenly amongst the creditors in accordance with the rules relating to priority. The table below sets out those people who may bring an action against the directors and others in connection with certain transactions entered into by the Company.

Activity / transaction	Person able to bring proceedings
Misfeasance	Liquidator, a creditor or a contributory
Fraudulent trading	Liquidator only
Transaction at undervalue	Liquidator/creditors
Performance	Liquidator
Extortionate credit transactions	Liquidator
Transactions defrauding creditors	Liquidator/creditor

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

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

Offences	Remedy available
Transactions in fraud of creditors	Up to five years imprisonment and / or a fine in case of falsely representing / pledging / pawning / disposing of the company's property to obtain credit for himself. Otherwise, two years imprisonment and / or a fine. Now punishable with an imprisonment term of not less than three years extendable to five years and with a fine of not less than three lakh rupees extendable to five lakh rupees.
Misconduct in winding up	Imprisonment or a fine or both.
Falsification of company books	Up to seven years imprisonment and / or a fine. Imprisonment of not less than six months extendable to ten years and a fine of not less than the amount involved. Where public interest is involved, the term of imprisonment is a minimum of three years.
Material omissions from statement relating to the company's affairs	Imprisonment which may extend to two years or a fine or both. Prison term not less than three years extendable to five years with fine of not less than one lakh rupees but which may extend to three lakh rupees.
False representations to creditors	Imprisonment for a term, which may extend to two years and a fine. Prison term of not less than three years extendable to five years and a fine of not less than one lakh rupees extendable to three lakh rupees.

Offences	Remedy available
Misfeasance	<p>A person guilty of this offence can be compelled by the court to repay or restore the money or property or any part thereof, with interest at such rate as the court thinks just, or to contribute to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust, as the court thinks just.</p> <p>Remains the same with the Tribunal replacing the court.</p>
Fiduciary duties	<p>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 his fiduciary duty.</p> <p>Directors' duties are laid out in detail in S 166; any contravention is punishable with a fine of not less than one lakh rupees which may extend to five lakh rupees (S 166(7)). Under S 172, if a company contravenes any of the provisions for which no specific punishment is provided, then the company and every officer of the company who is in default shall be punishable with a fine which is not less than 50,000 rupees but which may extend to five lakh rupees.</p>
Duties of skill and care	<p>Liability is civil. The director may be ordered to compensate the company for all damage caused by breach of his fiduciary duty.</p> <p>Directors' duties are laid out in detail in S 166 any contravention is punishable with a fine of not less than one lakh rupees which may extend to five lakh rupees (S 166(7)).</p> <p>Under S 172 if a company contravenes any of the provisions for which no specific punishment is provided, then the company and every officer of the company who is in default shall be punishable with a fine which is not less than 50,0000 rupees but which may extend to five lakh rupees.</p>
Fraudulent conduct of business	<p>Up to two years' imprisonment and/or a fine.</p> <p>Section 339: where in the course of the winding up of a company it appears that any business of the company has been carried on with the intent to defraud creditors of the company or any other persons or for any fraudulent purpose, the Tribunal may declare such persons to be personally liable without limitation of liability for all or any of the debts or other liabilities of the company as the Tribunal may direct.</p>
Fraud by officers	<p>Up to two years imprisonment and/or a fine.</p> <p>Imprisonment term of not less than one year extendable to three years and a fine of not less than one lakh rupees extendable to three lakh rupees.</p>
Destroying, mutilating company documents including making an omission in a document	<p>Liability is criminal. Imprisonment for a term which may extend to two years and/or a fine.</p> <p>Under S 229 such a person shall be punishable as per the provisions of S 447 – imprisonment for a term of not less than six months extendable to ten years and also shall be liable to a fine of not less than the amount involved in the fraud extendable to three times the amount involved.</p>
Conduct rendering a director unfit to be a director	<p>Liability is civil. The liability is as provided under S 447 above, and the grounds of disability are laid down under S 164 of the Companies Act 2012.</p>

Offences	Remedy available
Transactions at an undervalue and preferences	<p>There is no specific remedy provided under the 1956 Act and/or SICA unless the transaction at an undervalue or preference is treated as an offence (delinquency, breach of trust and misfeasance) under S 24 of SICA and S 543 of 1956 Act (as detailed in the reply to Question 2), in which case an order may be made to contribute to the assets of the company by way of compensation. Such a direction can be made by BIFR/AAIFR on an application moved before it or by the company court as well as in a suit brought before a civil court. Once the Second Amendment comes into force, the law will be as follows:</p> <p>There is no specific remedy provided for unless the transaction at an undervalue or preference is treated as an offence under S 424K and S 543 of the 1956 Act (as amended by the Second Amendment), in which case an order may be made to contribute to the assets of the company by way of compensation. Such a direction can be made by the Tribunal on an application moved before it.</p> <p>Under S 328 where the Tribunal is satisfied that there is a preference transfer of property taken or done by or against the company within six months before making winding up application, the Tribunal may declare such transaction invalid and restore position.</p>
Transactions defrauding creditors	<p>Liability is criminal as well as civil. An action for criminal breach of trust can be brought if the transaction involved property charged to creditors. A civil action can also be brought: for example, if a dividend is paid to shareholders but creditors are not paid despite an agreement to this effect; the creditors can bring an action.</p> <p>When it is an auditor who has contravened with the intention to deceive the creditors, he shall be punishable with an imprisonment term extendable to one year and with a fine of not less than one lakh rupees extendable to 25 lakh rupees. The persons in charge of management of the company shall, when found responsible with intention of deception or defraud, even after the company has been reported dissolved, be held jointly and severally liable to any person or persons who incurred loss or damage and be punishable for fraud as provided under S 447 of the Companies Act 2013.</p>
Extortionate credit transactions	<p>Liability is civil. A civil action for setting aside such transactions can be brought.</p> <p>Where any contract or arrangement is entered into by a director or any other employee, without obtaining the consent of the Board or approval by a special resolution within three months from the date on which such contract or arrangement was entered into, the contract or arrangement will be voidable at the option of the Board and if such contract or arrangement is with a party related to any director or is authorised by any other director, the directors concerned shall indemnify the company against any loss incurred by it.</p> <p>Any director or any other employee of a company who has entered into or authorised the contract or arrangement in violation of the provisions of this section shall – in the case of a listed company be punishable with imprisonment for a term which is extendable to one year or a fine of not less than 25,000 rupees extendable to five lakh rupees, or both; in the case of any other company, a fine of not less than 25,000 rupees extendable to five lakh rupees.</p>

Offences	Remedy available
Avoidance of a floating charge	<p>Liability is civil. The court can declare that the floating charge is invalid in whole or in part.</p> <p>Except for the amount of cash paid to the company at the time of, or subsequent to the creation of and in consideration for the charge, together with interest at the rate of 5% per annum or such other rate as may be notified by Central Government.</p>
Non-submission of audited books and accounts	<p>Liability is criminal. Imprisonment is for a term which may extend to one year and a fine.</p> <p>The company is punishable with a fine of not less than 25,000 rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or a fine which shall not be less than 10,000 rupees extendable to one lakh rupees or both.</p> <p>Where an auditor contravenes he shall be punishable a fine of not less than 25,000 rupees extendable to five lakh rupees.</p>

QUESTION 7

7. Duty to co-operate

- (a) **To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

7.1 Obligation to co-operate with investigation into company’s affairs

7.1.1 General duty to co-operate

Under the 1956 Act and SICA, officers and agents, past and present, of the company are required to co-operate with an investigation into the company’s affairs. The nature and extent of the duty to cooperate is implicit but it applies in the circumstances and is imposed on the persons set out below. Under SICA, the BIFR / AAIFR are empowered to seek information. Under the 1956 Act, the liquidator can call for information. The duty is to give such information concerning the company and its promotion, formation, business dealings, affairs or property as may, at any time after the effective date, be reasonably required; and to attend on the BIFR / AAIFR or the Official Liquidator at such times as they may reasonably require.

After implementation of the Second Amendment, the duty to co-operate will be as before but it will be the Central Government or the Tribunal⁶⁴ or the Official Liquidator⁶⁵ who can call for information.

Under S 284 the promoters, directors, officers and employees, who are or have been in employment of the company or acting or associated with the company shall extend full cooperation to the company liquidator in discharge of his functions and duties. Where any person fails to discharge his obligations, he shall be punishable with imprisonment extendable to six months or with fine extendable to 50,000 rupees, or both.

⁶⁴ Sections 424J, 439A and 441E Companies Act 1956.

⁶⁵ Section 454 and 457(2D) Companies Act 1956.

The general duty to co-operate applies where:

- (a) proceedings are pending before the BIFR / AAIFR under SICA, even though this is an investigation prior to the recommendation to wind up the company;
- (b) a winding-up petition has been presented;
- (c) a Provisional or Official Liquidator has been appointed;
- (d) the company goes into liquidation; or
- (e) a winding-up order has been made by the Court.

The duty is imposed on:

- (a) those who are or have at any time been officers of the company - this will include a director, manager or secretary of a company;
- (b) those who have taken part in the formation of the company at any time during the one year before the effective date;
- (c) those who are employed by the company, or have been in its employment including employment under a contract for services which includes those who have provided professional services to the company, within the one year and are, in the Official Liquidator's opinion, capable of giving information which he requires;
- (d) those who are, or have within that one year been, officers, or in the employment (including employment under a contract for services) of another company which is, or within that year was, an officer of the company in question; and
- (e) in the case of a company being wound up by the Tribunal, any person who has acted as the Official Liquidator or Provisional Liquidator of the company.

7.1.2 Sanction

If any person without reasonable excuse defaults in complying with any of the requirements under S 454 of SICA, he shall be punished with imprisonment for a period of up to two years and fined.

7.2 **Obligation to assist with getting in the company's property⁶⁶**

This obligation applies where:

- (a) a winding-up order has been made; or
- (b) a Provisional Liquidator or Official Liquidator has been appointed.

The liquidator or the Provisional Liquidator is required to take into his custody or under his control, all the property, effects and actionable claims to which the company is or appears to be entitled. The directors and officers are required to hand over such property to the liquidator and assist the liquidator in obtaining possession of any property and assets not in their possession.

7.2.1 Sanction

The Court has the power to summon any person suspected of having property of the company in their possession and may require them to produce to the Court any books and papers in their custody relating to the company.⁶⁷ Failure to appear before the Court may lead to their apprehension and being brought before the Court for further examination.

⁶⁶ Section 456 Companies Act 1956.

⁶⁷ Section 477 Companies Act 1956.

7.3 Obligation to provide information⁶⁸

The Court may summon to appear before it:

- (a) any officer of the company;
- (b) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; or
- (c) any person whom the Court thinks is capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company.

This power has very wide application. Such persons may be required (i) to submit an affidavit to the Court containing an account of their dealings with the company; or (ii) to produce any books and papers in their custody or under their control relating to the company (but subject to and without prejudice to any lien that they may claim on the books or papers and the Court shall have jurisdiction in the winding up to determine all questions relating to the lien).

7.3.1 Sanction

If any officer or person so summoned, after being paid or tendered a reasonable sum for his expenses, fails to appear before the Court at the appointed time, the Court may cause him to be apprehended and brought before the Court for examination.

7.4 Company's statement of affairs⁶⁹

Where the Court has made a winding up order or appointed a Provisional Liquidator, the Official Liquidator or the Provisional Liquidator may require certain persons to make out and submit to him a statement of the affairs of the company.

The persons who may be required to provide such a statement are:

- (a) those who are or have been officers of the company;
- (b) those who have taken part in the formation of the company at any time during one year before the relevant date;
- (c) those who are in the company's employment, or have been in its employment within that year, and are, in the Official Liquidator's opinion, capable of giving the information required; or
- (d) those who are or have been within that year officers of, or in the employment of, a company which is, or within that year was, an officer of the company.

7.4.1 Sanction

Past and present officers of the company may commit an offence if they make material omissions from the statement of affairs.

If any person without reasonable excuse makes default in complying with any of the requirements under S 454 of SICA, he shall be punished with imprisonment for a period of up to two years and fined.

7.5 Public examination of officers⁷⁰

Where a company is being wound up by the Court and the Official Liquidator has made a report to the Court stating that in his opinion a fraud has been committed (a) by any person in the promotion or formation of the company or (b) by any officer of the company, the Court may direct the person or officer to appear before the Court and be publicly examined.

⁶⁸ Section 477 Companies Act 1956.

⁶⁹ Section 454 Companies Act 1956.

⁷⁰ Section 478 Companies Act 1956.

7.5.1 Sanction

The Court may, on proof of probable cause that a contributor is about to quit India or abscond, or avoid examination, have the contributor arrested and his books and papers and movable property seized and kept safe until such time as the Court may order.⁷¹

7.6 Human rights

In India, human rights are protected under the Protection of Human Rights Act 1993. This Act was enacted to take into account gross violation of human rights, meaning rights related to life, liberty, equality and dignity of an individual guaranteed by the Constitution of India or embodied in the international covenants and so enforceable in the Indian Courts.

The Act provides for a Commission on a National and State Level, which inquires into complaints *suo moto* or on a petition presented to it by a victim or any person on his behalf. Complaints are in the nature of violation of human rights or abetment and negligence in the prevention of such a violation by a public servant.

7.6.1 Powers of the Commission

The Commission has powers akin to the civil Courts and can therefore:

- (a) summon and enforce the attendance of witnesses and examine them on oath;
- (b) discover and ask for the production of any document;
- (c) receive evidence on affidavit;
- (d) requisition any public record or a copy from any Court or office;
- (e) issue commissions for the examination of witnesses or documents; and
- (f) handle any other matter which may be prescribed.

The Commission can conduct any investigation pertaining to an inquiry; it can also call for information from the Government or any other authority.

7.6.2 Opportunity

It gives reasonable opportunity to people who are likely to be adversely or prejudicially affected.

7.6.3 Incriminating statement

Statements made by persons to the Commission cannot be used against them in civil or criminal proceedings except on a prosecution for giving false evidence by such statement.

7.6.4 Action taken

If the inquiry discloses a human rights violation or negligence on the part of a public servant, appropriate steps are taken in the Court of law for punishing the accused, as permitted by the law.

Proceedings in the human rights Court are deemed to be judicial proceedings.

⁷¹ Section 479 Companies Act 1956.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 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 limitation applies to the offences attracting criminal liability, identified above. Disqualification proceedings can be initiated in civil proceedings.

8.2 Limitation period for civil actions

8.2.1 Delinquency, breach of trust & misfeasance: Directors and others⁷²

An application under S 543 1956 Act, which is similar to S 24 SICA, has to be made within five years from the date of the winding up order or from the first appointment of the liquidator or the date of the alleged offence. However, no limitation has been provided under SICA.

Following implementation of the Second Amendment, S 24 of SICA will be repealed. However a similar provision will be added to the 1956 Act, S 424K. As under S 24 of SICA, no limitation has been provided under S 424K of the 1956 Act.

8.3 Other offences⁷³

For the other offences, no specific limitation has been provided. In this event, the limitation period provided under the Limitation Act 1963 will usually apply. In relation to any suit / application for which no period of limitation is provided elsewhere under the Limitation Act 1963, the limitation period is three years and the time from which the period begins to run is when the right to sue / apply accrues.

8.4 Appeals

An appeal against an order passed by the BIFR under S 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 15 days or less.

Most complaints for offences committed under the 1956 Act are made to the Company Law Board. An appeal against an order of the Company Law Board lies to the Company Judge of the High Court within whose jurisdiction the company is located. The Company Law Board has the same power as a civil Court; it has no power to review its order. Orders passed by the Company Law Board are also subject to judicial review by the High Court. Any person aggrieved by any decision or order of the Company Law Board may file an appeal to the High Court on any question of law arising out of the order. There can be no appeal on a question of fact and hence the Company Law Board is the final authority so far as questions of fact are concerned. Any appeal must be filed within 60 days of the communication of the order or decision to the appellant, unless extended by the High Court for a further period of 60 days. The appeal lies before the High Court where the registered office of the company is situated and not at the place where the Company Law Board arrives at a decision.

Actions before a Civil Judge / Magistrate are appealable before a District Judge. A revision also lies against the order of a Civil Judge to the High Court if the order is questioned for want of jurisdiction. The order of the District Judge can be challenged before the High Court. Orders of the High Court are final and only if leave is granted can an appeal be made to the Supreme Court of India.

⁷² Section 543 Companies Act 1956.

⁷³ Under the Companies Act 1956 & SICA.

8.5 Pending reforms relating to appeals

After the implementation of the Second Amendment and the Repeal Act, the law relating to appeals will change. The new position will be as follows:

- (i) After the commencement of the Second Amendment, complaints for offences committed under the 1956 Act will lie to the Tribunal. Any person aggrieved by any decision or order of the Tribunal may file an appeal with the Appellate Tribunal provided the order or decision was not made with the consent of the parties. Any appeal must be filed within 45 days of the communication of the order or decision to the appellant, unless extended by the Appellate Tribunal. The Tribunal and the Appellate Tribunal shall have the same powers as the Civil Court. Any person aggrieved by the decision or order of the Appellate Tribunal may file an appeal to the Supreme Court within 60 days of the date of communication of the decision or order of the Appellate Tribunal to him on any question of law.
- (ii) Appeals from orders made or decisions given before the commencement of the Second Amendment in the matter of winding up by the Court shall lie to the same Court, in the same manner, and subject to the same conditions for an appeal from any order or decision of the Court in cases within its ordinary jurisdiction.⁷⁴

QUESTION 9

9. Foreign corporations

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

Foreign Company means any company or body corporate incorporated outside India which has a place of business in India, whether by itself or through an agent, physically or through electronic mode; and conducts any business activity in India in any other manner.

9.1 Introduction

A foreign corporation may be wound up in India as an unregistered company, provided it has established a place of business within India.⁷⁵ Where a body corporate incorporated outside India is carrying on business in India ceases to carry on business in India, it may be wound up as an unregistered company.⁷⁶

An unregistered company includes any partnership, association or company consisting of more than seven members which is not a railway company incorporated by any Act of Parliament or other India law or any Act of Parliament of the United Kingdom, a company incorporated in India or a company registered under any previous companies' law and not being a company whose registered office was in Burma, Aden or Pakistan immediately before the separation of that country from India.

9.2 Winding up of unregistered companies⁷⁷

All the provisions (including those set out in Question 2 above) with respect to winding up of a domestic company apply to an unregistered company.

No unregistered company shall be wound up voluntarily by the Court.

⁷⁴ Section 483 Companies Act 1956.

⁷⁵ Section 591 Companies Act 1956.

⁷⁶ Section 376.

⁷⁷ Section 583 Companies Act 1956.

9.3 Criteria of winding up⁷⁸

An unregistered company may be wound up if:

- (a) the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs;
- (b) the company is unable to pay its debts;
- (c) the Court is of the opinion that it is just and equitable that the company be wound up.

9.4 Record of information

Foreign companies which establish a place of business within India shall, within one month of establishment, deliver to the Registrar of Companies for registration:⁷⁹

- (a) a certified copy of the charter, statutes, or memorandum and articles of the company or other instrument constituting or defining the constitution of the company; and if the instrument is not in English, a certified translation;
- (b) the full address of the registered or principal office of the company;
- (c) a list and details of the directors and secretary containing certain particulars;
- (d) details of one or more persons authorised to accept service of documents in India on behalf of the company; and
- (e) details of its principal place of business in India.

Every foreign company is required to:⁸⁰

- (a) prepare an annual balance-sheet and profit and loss account as if it were a domestic company; and
- (b) deliver copies to the Registrar of Companies.

9.5 Penalties⁸¹

If a foreign company fails to comply with any of the foregoing provisions, every officer or agent of the company who is in default shall be punishable by a fine of up to 1000 rupees, and in the case of a continuing offence, by an additional fine of up to 100 rupees for every day the default continues.

9.6 Effect of offence⁸²

Any failure by a foreign company to comply with any of the foregoing provisions shall not affect the validity of any contract, dealing or transaction entered into by the company or its liability to be sued in respect thereof.

But the company shall not be entitled to bring any suit, claim any set-off, make any counter-claim or institute any legal proceeding in respect of the contract dealing or transaction until the foregoing provisions have been complied with.

9.7 Miscellaneous provisions

Apart from the above, the provisions pertaining to the registration of charges, appointment of receiver and books of account as applicable to the domestic companies shall apply mutatis mutandis to foreign companies.

⁷⁸ Section 583 Companies Act 1956.

⁷⁹ Section 592 Companies Act 1956.

⁸⁰ Section 594 Companies Act 1956.

⁸¹ Section 598 Companies Act 1956.

⁸² Section 599 Companies Act 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 Indian Law, statutory or otherwise providing for this and hence directors' and officers' insurance is not available in India.

The information provided in this country chapter is correct as at 01/01/2017

INDONESIA

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Defining the directors

1.1.1 The Company Law¹ provides a two-tier board structure namely a board of commissioners and a board of directors.

1.1.2 The role of the board of directors is “to manage” and “to represent” the company.² The board of commissioners supervises and advises the board of directors in the management of the company.³ The board of commissioners may temporarily assume the management of the company, for example, if membership of the board of directors is vacant or temporarily suspended by the board of commissioners, subject to the company’s articles of association.⁴ Whilst the position of Chief Executive Officer (CEO) and the like is common in Indonesia, it is not necessary equivalent to the role of director. Unlike the board of directors, the CEO’s role is generally governed by contractual terms between the company and the CEO. By default, a director’s role is subject to and governed by the company’s articles of association and the Company Law.

1.2 Insolvency proceeding

1.2.1 The state of insolvency is determined by the Court. Under the Bankruptcy Law,⁵ a debtor with more than one creditor and who has failed to pay in full one of its debts that is due and payable, can be declared bankrupt by the Commercial Court upon petition of either the debtor or any of its domestic or foreign creditors. But the bankruptcy requirements must be simply proven.⁶

1.2.2 There is no requirement for the default debt to exceed a certain amount. There is also no cash flow test or balance sheet test to determine the bankruptcy of a company. Consequently, a solvent company can be declared bankrupt so long as the requirements to bankrupt the debtor have been proven. In 2012, PT Telkomsel - Indonesia’s biggest telecommunications company - was declared bankrupt for a disputed debt of approximately US\$520,000. The Supreme Court later overturned the bankruptcy judgment. It is interesting to note that the Supreme Court relied on article 8 paragraph (4) of the Bankruptcy Law. The fact that PT Telkomsel was a solvent company and that the amount of the disputed debt was insignificant was not the Supreme Court’s consideration in overturning the Commercial Court’s bankruptcy judgment, rather it was the complexity of the case that required it to be heard by the general judiciary or arbitration as appropriate.

1.2.3 The Company Law does not specify at what point the directors should take the decision to commence voluntary bankruptcy proceedings, even if the company can no longer sustain its business financially. By contrast, the Company Law provides that the directors cannot commence voluntary bankruptcy proceedings without obtaining approval from the General Meeting of Shareholders.⁷

¹ Law No. 40 of 2007 on Limited Liability Companies (Company Law).

² Articles 1 (5), 92 and 98 of the Company Law.

³ Articles 1 (6) and 108(1) of the Company Law.

⁴ Article 118 of the Company Law.

⁵ Law No. 37 of 2004 on Bankruptcy and Suspension of Payment (Bankruptcy Law).

⁶ Article 8 paragraph (4) of the Bankruptcy Law.

⁷ Article 104 (1) of the Company Law.

1.3 Start and duration of the twilight period

- 1.3.1 As a general rule, Indonesian law does not impose a strict twilight period. The Company Law only looks into the causality of the insolvency. In the event a company's insolvency is caused by the fault or negligence of directors, and the assets of the company are not sufficient to pay its debts, the directors may be liable to pay the shortfall in bankruptcy.⁸
- 1.3.2 However, upon the declaration of bankruptcy by the Court, to protect against the dissipation of the company's assets or any other acts that may be detrimental to the creditors' interests, the company's acts are subject to a "clawback" provision, when certain conditions are fulfilled. If these conditions are fulfilled, those acts may be annulled by the Court.
- 1.3.3 One such condition is that the debtor and the counterparty had knowledge that the act would prejudice the interests of the creditors as a whole. As it is difficult to establish the parties' knowledge at the relevant time prior to bankruptcy, the Bankruptcy Law provides a statutory presumption of deemed knowledge of prejudice to other creditors, if the bankrupt debtor's action was performed within one year prior to the bankruptcy declaration, provided that the act falls under one of the following categories:⁹
- (a) an agreement under which the obligations of the debtor were more onerous than the obligations of the counterparty;
 - (b) the payment of or granting of security for debts which were not due and payable; or
 - (c) the transaction was performed with related parties (which is described extensively in the Bankruptcy Law).

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 the director?
- (b) In relation to each act identified in (a) above:-
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?
 - (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 Liability of the directors in bankruptcy of the company

- 2.1.1 As discussed above, there is no a strict twilight period under Indonesian law.

⁸ Article 104 (2) of the Company Law.

⁹ Article 42 of Law No. 37 of 2004 on Bankruptcy and Suspension of Payment Obligation (Bankruptcy Law).

2.1.2 According to the Company Law, if a company goes bankrupt due to the fault or negligence of the directors, and the company's assets are not sufficient to discharge all creditors' claims, the directors shall be jointly and severally liable for the shortfall in bankruptcy. As a general rule, the liability is divided between the directors: see the defences available below. It should be noted that "fault" and "negligence" are not defined by the Company Law. A finding of fault or negligence on the part of a director depends on the circumstances of the specific case. Given the formulation of directors' liability under the Company Law, the twilight period of insolvency is less relevant in Indonesia than in other jurisdictions. Directors' liability is potentially extended to throughout their tenure.

2.1.3 There are defences available to the directors under the Company Law as follows:¹⁰

- (a) the bankruptcy did not result from his fault or negligence;
- (b) the director has discharged his obligations with good faith, prudence and full responsibility for the company's best interests in line with the purposes and objectives of the company (which suggests that the directors must always act within the scope of their authorisation as mandated by the company's articles of association);
- (c) there was no conflict of interest, either directly or indirectly, during the course of his management of the company; and
- (d) the director has taken precautionary measures to avoid the bankruptcy.

The defences are available to the board of directors collectively and each member of the board of directors individually. So whilst certain directors may be held liable for the shortfall in bankruptcy, another director may be excluded from that liability should he establish one of the defences referred to above.

2.1.4 Acting in good faith is one of the safe harbours for the directors. The directors cannot be held liable for their decisions as long as they have acted in good faith and have no personal vested interest in decisions directly or indirectly (no conflict of interest). As a general rule, the duty to act in good faith does not impose an obligation for directors to create a positive outcome for the company, but how far the directors must go to reach a business decision in order to qualify as having acted in good faith is an "unsettled" legal issue in Indonesia.

2.1.5 The Indonesian Criminal Code may impose criminal liability on the directors. Under the Criminal Code, the directors of a bankrupt company may be subject to criminal liability for the following acts:¹¹

- (a) assisting in or allowing the conduct of activities contradictory to the articles of association of the company which caused substantial losses;
- (b) borrowing money on onerous terms and conditions to delay the bankruptcy knowing that even with these funds the bankruptcy will not be avoided;
- (c) failing to prepare and maintain proper records as required under the law;
- (d) recording non-existent liabilities, failing to record assets or revenues or embezzling assets which are part of the bankruptcy estate;
- (e) transferring assets without consideration or at an under value; or
- (f) attempting to benefit only certain of the company's creditors in the event of its bankruptcy or composition with creditors.

¹⁰ Article 104 (4) of the Company Law.

¹¹ Articles 398, 399 of the Criminal Code.

QUESTION 3

3. **Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period**
- (a) **In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?**
 - (b) **In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?**
 - (c) **Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?**

3.1 Liability of commissioners

- 3.1.1 The same liability also extends to the commissioners. The liability arises when the commissioners are at fault or are negligent in their supervision of and advice to the directors, which results in the bankruptcy of the company. The liability is jointly shared by all of the members of the board of commissioners and only extends to the deficit to the creditors. In the same way as for directors, the commissioners are not liable if they can prove that:¹²
- (a) the bankruptcy did not result from their fault or negligence;
 - (b) they performed their supervisory and advisory role in good faith, with prudence and full responsibility for the interests of the company and in accordance with the company's purpose and objectives;
 - (c) they did not have any direct or indirect conflict of interest over the actions of management performed; and
 - (d) they have given advice to the directors to avoid bankruptcy.

3.2 Liability of former directors and commissioners

- 3.2.1 The same liability also extends to former directors and commissioners who are at fault or are negligent and who served as directors or commissioners within five years prior to the bankruptcy declaration.¹³

¹² Article 115 (1, 3) of the Company Law.

¹³ Article 104 (3), Article 115 (2) of the Company Law.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?**
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?**
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?**

The Bankruptcy Law recognises the principle of fraudulent conveyance, in which certain transactions may be annulled if the transactions prejudice the creditors' interests. Such actions may be commenced if the following requirements are met:¹⁴

- (a) the transaction was performed by the debtor prior to the bankruptcy declaration;
- (b) that debtor was not required to perform the transaction by contract or by law;
- (c) the transaction prejudices the creditors' interests; and
- (d) the debtor and the party which benefited from the transaction (or the counterparty) knew or should have known that such transaction would prejudice creditors.

The Bankruptcy Law does not provide a strict twilight period where the debtor is prohibited from entering into the transaction prior to the bankruptcy declaration. Likewise, there is no cash flow test or balance sheet test to determine if the transaction prejudices the creditors' interests. Generally, to assess whether the transaction prejudices the interests of other creditors, it is necessary to make a comparison between the value of the debtor's assets upon bankruptcy and the value that would have existed had this transaction not been entered into.

Nevertheless, as discussed above, the Bankruptcy Law provides a statutory presumption of deemed knowledge of prejudice to other creditors' interests in the bankruptcy estate if the bankrupt debtor's action was performed within one year prior to the bankruptcy declaration, provided the acts fall under one of the following categories:¹⁵

- (a) an agreement under which the obligations of the debtor were more onerous than the obligations of the counterparty;
- (b) the payment of or granting of security for debts which were not due and payable; or
- (c) the transaction was performed with related parties (who are described extensively in the Bankruptcy Law - see below).

In addition to paragraph (b) above, the payment of a due and payable debt by the debtor may also be annulled if it can be proven that: (i) the counterparty who received the payment was aware that a petition for a bankruptcy declaration had been filed against the debtor; or (ii) the payment was made pursuant to a collaboration between the debtor and the counterparty with the intention to pay the counterparty ahead of the other creditors.¹⁶

With regard to transactions with related parties, the Bankruptcy Law provides a wide range of related parties including:¹⁷

- (a) the directors and members of the management of the company;

¹⁴ Article 41 of the Bankruptcy Law.

¹⁵ Article 42 of the Bankruptcy Law.

¹⁶ Article 45 of the Bankruptcy Law.

¹⁷ Article 42 of the Bankruptcy Law.

- (b) relatives of the directors and members of the management;
- (c) a legal entity in which the directors and members of management may exercise control;
- (d) a legal entity in which the relatives of directors and members of management may exercise control; and
- (e) legal entities belonging to a group (for example, transactions between subsidiaries or between a holding company and a subsidiary).

In circumstances where a debtor makes a gift prior to the bankruptcy declaration, such an act can also be annulled provided that the receiver can establish that the debtor knew or should have known that the act would prejudice his creditors. The Bankruptcy Law prescribes a statutory presumption of knowledge on the part of the debtor should the gifts be made within one year prior to the bankruptcy declaration.¹⁸

Upon successful annulment of the suspect transaction, the assets removed from the bankrupt debtor must be returned by the person against whom the annulment has been invoked. This is because there is no longer a valid title for the transfer. If this person is not able to return the assets in the same condition, he must compensate the bankruptcy estate for the damage that it suffers as a result. On the other hand, the receiver should return to him the consideration received by the bankrupt debtor or the value thereof, to the extent that the bankruptcy estate has benefited therefrom. He may file a claim for the deficit as an unsecured creditor. However, if the assets have been transferred to a third party, the receiver may not be able to reclaim the assets from this third party. There are two requirements. First, the third party must have acted in good faith (e.g. he did not know and could not have known that the acquisition of the assets between the bankrupt seller and the first hand purchaser was prejudicial to the creditors of the bankrupt debtor). Second, he will only be protected if he buys the assets from the first-hand purchaser (i.e., there will be no protection if he obtains the assets as gift).

It is interesting to note that the annulment of the transaction may serve as a defence for the directors. As explained above, the directors may be jointly and severally liable for the shortfall in bankruptcy if a company goes bankrupt due to their fault or negligence. The annulment of the transaction may potentially maximise the bankruptcy estate, and thus may improve the creditors' recovery and reduce the directors' exposure.

The Bankruptcy Law does not restrict the company from incurring further credit during the twilight period. However, the directors should be cautious of personal liability if the company's assets are not sufficient to repay the debt upon the bankruptcy declaration, and therefore should take steps to assess whether:

- (a) the credit obtained may result in the company's bankruptcy, and they have taken measures to mitigate this risk (or at least the credit may improve the company's chances of survival);
- (b) the credit is obtained on an arm-length basis and in good faith for the company's best interests; and
- (c) there is no conflict of interest, either directly or indirectly, in performing the transaction.

¹⁸ Articles 43, 44 of the Bankruptcy Law.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

In the author’s opinion, given that the Company Law arguably seeks to protect the creditors’ interests, the action should be brought by the creditors. It is not clear whether the shareholders, the receivers or other stakeholders can take action against the directors for a shortfall in the bankruptcy of the company.¹⁹

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, the following remedies are available:

Offence	Remedy Available
Fault and negligence on the part of directors’, commissioners’ or former directors’ or commissioners’ causing the bankruptcy	The Court may order the directors, commissioners or former directors or commissioners to pay the shortfall in bankruptcy
Fraudulent conveyance prior to the declaration of bankruptcy.	The Court may annul the transaction, or issue an order compensating the bankruptcy estate, should the relevant party be unable to return the asset to the company
Certain restrictions under the Criminal Code.	The directors, commissioners and other wrongdoers may be imprisoned

¹⁹ To the author’s knowledge, there have been no such actions and, unlike in other jurisdictions, law reports are not available in Indonesia.

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder's investigation into the company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

The Bankruptcy Law requires the directors and commissioners to co-operate with the receiver including providing access to documents and information relating to the company's affairs as required by the receiver or the supervisory judge.²⁰ The Bankruptcy Law goes even further, restraining directors from leaving their domicile during the bankruptcy process to ensure their co-operation in the bankruptcy process, unless there is consent to leave their domicile from the supervisory judge.²¹ Furthermore, under the Bankruptcy Law, upon a proposal from the supervisory judge or a request from one or more creditors after obtaining an opinion from the supervisory judge, the Court may order the director to be remanded in custody, either in prison or in his own house, under supervision of the public prosecutor appointed by the supervisory judge. The custody shall be not more than 30 days, but it can be extended for not more than another 30 days by the supervisory judge. The purpose of this custody is to ensure the directors' co-operation during the bankruptcy process.²² Under the Criminal Code, the directors and commissioners of the bankrupt company may be subject to criminal liability if they refuse to provide information or provide false information relating to the company's affairs, after being duly requested to do so in accordance with Indonesian law.²³

QUESTION 8

8. Appeals and limitation periods

- (a) What limitation period, if any, applies to the actions referred to above?
- (b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Statute of limitation

- 8.1.1 As explained above, in relation to a claim setting aside a transaction which prejudices the interests of the creditors in the bankruptcy estate, the claimant needs to establish that the debtor and the party that benefited from the transaction (or the counterparty), knew or should have known that such transaction would prejudice creditors. In respect of the statute of limitation for commencing this action, the Civil Code provides a statute of limitation of five years from the date upon which the claimant has knowledge of the parties' intention to prejudice the creditors' interest.²⁴
- 8.1.2 In relation to a claim against the directors, commissioners, former directors and commissioners to compensate for a shortfall in the bankruptcy of a company, the statute of limitation is 30 years from the date of the bankruptcy declaration.²⁵

²⁰ See for example Articles 98, 110 of the Bankruptcy Law.

²¹ Article 97 of the Bankruptcy Law.

²² Article 93 of the Bankruptcy Law.

²³ Article 226 of the Criminal Code.

²⁴ Article 1454 of the Civil Code.

²⁵ Article 1967 of the Civil Code.

8.2 Appeals

- 8.2.1 The decisions of the lower Courts are generally subject to appeal to the High Court, and subsequently to the Supreme Court (through the cassation process or civil review process). Generally, there is an automatic stay during the appeal process so that the decision of the lower Court cannot be enforced pending the appeal process. In relation to claims setting aside transactions that prejudice the interests of the creditors in the bankruptcy estate, an appeal against the decision of the lower Court may be made directly to the Supreme Court through the cassation process. The cassation decision is subject to the civil review process. The civil review process is a judicial appeal, which will also be heard and decided by the Supreme Court. There are only limited reasons to pursue a civil review process.
- 8.2.2 In relation to claims against the directors, commissioners, former directors and commissioners to compensate for a shortfall in the bankruptcy estate, appeals against the decisions of the lower Courts may be made to the High Court. The decision of the High Court is subsequently subject to appeal to the Supreme Court. The cassation decision is also subject to a civil review process.

QUESTION 9

9. Foreign corporations

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

In relation to claims setting aside transactions that prejudice the creditors' interests in bankruptcy proceedings, the point of dispute is about the validity of transactions regardless of the nationality of the parties. Thus, the provisions apply equally to both domestic and foreign corporations.

In regard to claims against the directors, commissioners, former directors and commissioners to compensate for a shortfall in bankruptcy, the provisions will apply only to the directors, commissioners and former directors and commissioners of domestic corporations. However, a foreign corporation as creditor can rely on the Company Law as legal basis to claim for their losses.

QUESTION 10

10. Insurance

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

Directors' and officers' insurance is permissible in Indonesia. There is no judicial precedent suggesting such insurance is unenforceable to protect the directors and officers from personal liability for any shortfall in bankruptcy.

The information provided in this country chapter is correct as at 06/07/2016

ITALY

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Twilight period

1.1.1 Companies¹ in the twilight period are governed both by insolvency law rules and by company law rules.

1.1.2 Legal framework – overview

In 2003, the Italian Government enacted a sweeping company law reform which came into force on 1 January 2004.² Royal Decree No. 267 of 16 March 1942, (as amended, Bankruptcy Law), was also substantially amended – in an effort to render insolvency proceedings more flexible and expeditious – through a long series of legislative measures adopted between 2005 and 2015. The first part of the Bankruptcy Law reform, enacted by the Italian Government in March 2005,³ introduced a set of new rules mainly relating to claw-back actions, compositions with creditors and out-of-Court restructuring procedures. The second part of the Bankruptcy Law reform, adopted in January 2006,⁴ primarily dealt with the ordinary bankruptcy proceeding (*fallimento*) with the intention of simplifying and shortening the applicable procedures.⁵ In September 2007,⁶ a so-called corrective decree introduced amendments intended, in particular, to narrow the scope of business enterprises subject to bankruptcy and to address certain issues arisen during the initial implementation of the reformed Bankruptcy Law. The third generation of legislative interventions took place between 2009⁷ (introducing certain amendments and adjustments to compositions with creditors) and 2010⁸ (giving, among other things, super-priority status to certain financing granted by banks and shareholders in the context of restructuring procedures, provided that certain conditions are met). In 2012,⁹ the Italian Government introduced important amendments to the Bankruptcy Law intended to facilitate the restructuring of distressed companies, mainly through quicker access to judicial composition with creditors, interim financing, and a new special form of composition aimed at ensuring the continuity of the debtor's business (*concordato con continuità aziendale*). Finally, in 2015,¹⁰ with a view to addressing certain issues arising from the application of the 2012 reform, a further round of amendments to the Bankruptcy Law was approved, primarily in order to (i) allow creditors to file competing plans in the context of a *concordato*, (ii) regulate the sale of assets by a debtor in a *concordato* and offers by so-called “stalking horses”, (iii) facilitate urgent financing supporting the business during a *concordato* and (iv) introduce a variant somehow similar to English law schemes of arrangement permitting the out-of-Court restructuring of financial claims with the consent of creditors holding at least 75% of the relevant claims.

¹ For the purposes of this chapter, any reference to a “company” or “business undertaking” includes any undertaking (whether as proprietorship (*imprenditore individuale*), partnership (*società di persone*) or corporation (*società di capitali*)) operating a business activity, other than an undertaking that can prove that each of the following requirements is met: (i) its assets over the three years preceding the bankruptcy order do not exceed €300,000, (ii) its gross revenues over the three years preceding the bankruptcy order do not exceed €300,000 and (iii) its liabilities, including those not yet come to maturity, do not exceed €500,000. Undertakings that satisfy all the requirements above are not subject to bankruptcy or other insolvency proceedings under the Bankruptcy Law (as identified below).

² Legislative Decree No. 6 of 17 January 2003.

³ Decree-law No. 35 of 14 March 2005, ratified into Law No. 80 of 14 May 2005.

⁴ Legislative Decree No. 5 of 9 January 2006, which came into effect on 16 July 2006.

⁵ The main areas affected by the second part of the reform were: (a) the scope of business enterprises subject to bankruptcy; (b) the roles of the bankruptcy Court, trustee and creditors' committee; (c) the consequences of bankruptcy on executory contracts; (d) continuation of the debtor's business operations; (e) the conversion of liquidation proceedings into reorganisations; and (e) the discharge from unpaid debt.

⁶ Legislative Decree No. 169 of 12 September 2007, which came into effect on 1 January 2008.

⁷ Law No. 69 of 17 June 2009.

⁸ Decree-law No. 78 of 31 May 2010 ratified into law, with amendments, by the Italian Parliament on 30 July 2010.

⁹ Decree-law No. 83 of 15 June 2012, ratified into law, with amendments, by the Italian Parliament on 3 August 2012.

¹⁰ Decree-Law No. 83 of 27 June 2015, ratified into law, with amendments, by the Italian Parliament on 6 August 2015.

1.1.3 Given the size and stratification of several legislative interventions and the absence of a sufficiently settled body of case law on some of the most recently introduced rules, certain legal issues involving corporations in the twilight period are still the subject of debate among legal scholars. In dealing with both company and bankruptcy law issues, therefore, this chapter will provide an account of the prevailing interpretations of the new rules and, where applicable, of the case law developed under the previous regime where the new rules are identical or similar to the old ones. It is uncertain whether the courts will confirm their prior findings under the new laws or follow the prevailing scholarly interpretations.

1.1.4 Moreover, the legal framework outlined above may soon be overhauled. On February 11, 2016, the Italian Government approved a bill for a comprehensive reform of the existing bankruptcy and related corporate legislation (hereinafter referred to as the “Reform Bill”). The Reform Bill has been submitted to, and is currently being reviewed by, the Italian Parliament and, once approved by both houses of Parliament, will grant Government the power to adopt a Legislative Decree reforming the Italian bankruptcy laws in accordance with the principles set forth therein.

1.1.5 To the extent relevant (and subject to any amendment to the Reform Bill that Parliament may approve), this chapter will also provide a general account of certain key changes that the envisaged reform might introduce and how those changes could have an impact on the matters discussed herein.

1.1.6 Types of corporate organizations and related governance

Unless otherwise specified, the description of relevant Italian law provisions below applies to all companies, whether joint-stock corporations (*società per azioni*, hereinafter “SpA”) or limited liability companies (*società a responsabilità limitata*, hereinafter “SRL”).¹¹

1.1.6.1 Under Italian company law, SpA may opt for one of three corporate governance systems:

- (i) the so-called traditional system, in which alongside the board of directors (or a single director) there exists a separate board of statutory auditors (*collegio sindacale*) with audit and monitoring functions;
- (ii) the two-tier system, whereby the members of the management board are appointed by a supervisory board, which also performs audit and monitoring functions;
- (iii) the one-tier system, whereby audit and monitoring functions are exercised by an audit committee composed by independent members of the board of directors.

1.1.6.2 Except as noted in paragraph 1.2 below or otherwise specified, any reference herein to “directors” relates exclusively to members of the board of directors (in the traditional and one-tier governance systems) or the management board (in the two-tier system). The liability of members of the board of statutory auditors and of the supervisory board will be addressed in paragraphs 1.2, 3.3 and 3.4 below.

1.1.6.3 A SRL must appoint an internal control body – i.e. a single statutory auditor (*sindaco unico*), a board of statutory auditors (*collegio sindacale*) or an external auditing firm or – only when the company’s size exceeds certain thresholds – a professional auditor (*revisore*).¹² The specific functions of the internal control body and of the external auditor in a SRL are debated. According to certain views, if the SRL appoints a control body, such body may only exercise the same powers and duties as boards of statutory auditors in SpA (i.e. verify compliance with law and by-laws); according to others, instead, the company’s shareholders may also resolve to entrust the control body with the additional duty to audit the company’s financial statements (under SpA default rules, instead, the board of statutory auditors does not audit the financial statements¹³ and in SpA with shares listed on an Italian or other EU stock exchange, the company’s accounts must be audited by an independent audit company). Finally, other views maintain that if the SRL appoints an external auditor instead of an internal control body, such external auditor may only be entrusted with the audit of the company’s accounts and should not also perform the typical control functions of the board of statutory auditors.

¹¹ Under Italian law there are two types limited liability companies: (i) standard limited liability companies (which may be established with a share capital of no less than € 10,000) and (ii) simplified limited liability companies (which may be established, by individuals only, with a minimum share capital of € 1). For the purposes of this chapter the reference to SRL will include both such types.

¹² The thresholds under Art. 2477, Civil Code consider, among other things, total net assets, revenues and the number of employees.

¹³ By-laws of closely held SpAs not required to prepare consolidated accounts may empower the board of statutory auditors to audit their financial statements.

1.1.7 Bankruptcy liquidation and other restructuring proceedings

The Bankruptcy Law is the main piece of legislation dealing with ordinary bankruptcy proceedings (*fallimento*) in Italy, as well as various proceedings aimed at avoiding bankruptcy through (a) a Court-supervised composition with creditors (*concordato preventivo*),¹⁴ (b) an out-of-Court restructuring agreement ratified by the Court (*accordo di ristrutturazione*)¹⁵ or (c) a recovery plan assessed by an independent expert (*piano attestato di risanamento*).¹⁶ By contrast, banks and investment services companies are subject to special rules¹⁷ implementing the EU directive on banks' recovery and resolution.¹⁸

- 1.1.7.1 By way of background, until the recent reforms, the Bankruptcy Law did not provide for effective reorganisation procedures, which over time became increasingly necessary in the Italian economic environment, in particular for large industrial companies. For this reason, in 1979 the Italian Parliament enacted a law,¹⁹ subsequently amended in 1999²⁰ (the so-called "Prodi Law"), which introduced a new insolvency procedure aimed at the reorganisation of certain large insolvent companies (*amministrazione straordinaria*). In December 2003, in the wake of the Parmalat crisis, the Prodi Law was further amended and supplemented in order to make a new specific procedure of *amministrazione straordinaria* available to particularly large and indebted companies, providing for a two-year restructuring plan and a special composition with creditors.²¹
- 1.1.7.2 The special composition with creditors available to large insolvent companies since December 2003 was significantly more flexible than the ordinary regime generally available to all business enterprises (*concordato preventivo*). The 2005 Bankruptcy Law reform amended the general regime to make it substantially similar to the special *concordato* of large insolvent companies. Further significant improvements were made in 2012 and 2015. As a result, *concordato preventivo* proceedings have become the main in-Court restructuring procedure available to Italian debtors. Accordingly, the following paragraphs will provide an outline of the key features of *concordato preventivo* proceedings as resulting from the various reforms approved over the last decade.
- 1.1.7.3 A *concordato preventivo* is a Court-supervised composition procedure available to debtors facing a distress situation (*crisi*), generally considered as a financial, economic or industrial imbalance which may result (or has resulted) in insolvency (i.e. the inability of the debtor to meet its obligations as they fall due). A *concordato* may provide for: (a) the division of creditors into different classes; (b) the differential treatment of creditors belonging to different classes; (c) the restructuring of debts in any form, including a debt-for-equity exchange; (d) the transfer of the insolvent company's assets to an assignee (*assuntore*); (e) the authorisation to suspend or terminate executory contracts (with indemnification to the other party); (f) the authorisation of interim financing (with super priority) necessary to fund the ongoing operations of the company during the proceedings; and (g) the authorisation to pay for goods or services received prior to filing the *concordato* application.
- 1.1.7.4 *Concordato preventivo* proceedings may only be started by the debtor (i.e. creditors may not request the admission of the debtor to the proceedings) by filing a *concordato* application. Such filing triggers an automatic stay upon all pending and new enforcement or interim actions against the debtor's assets. Prior to the 2012 reform, the debtor had to file such application along with a proposal to its creditors, a feasibility assessment by an independent expert, and other documentation. The preparation of this package (and, often, informal negotiations with the main creditors) typically took a long time and, meanwhile, the operations of the debtor and relationships with its creditors were not protected. Only after the complete filing could the debtor (and third parties) benefit from the *concordato preventivo* protections, including the mentioned automatic stay.

¹⁴ Article 160, Bankruptcy Law.

¹⁵ Article 182-bis and Art. 182-septies, Bankruptcy Law.

¹⁶ Article 67, para. 3, lett. d), Bankruptcy Law. The 2006 Bankruptcy Law reform abolished the two-year judicial moratorium proceeding (*amministrazione controllata*) – previously available to companies in temporary financial distress – since it proved substantially ineffective.

¹⁷ Legislative Decree No. 181 of 16 November 2015.

¹⁸ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014.

¹⁹ Law No. 95 of 3 April 1979.

²⁰ Legislative Decree No. 270 of 8 July 1999.

²¹ Decree-law No. 347 of 23 December 2003, ratified and amended by the Italian Parliament with Law No. 39 of 18 February 2004, and further amended by Decree-law No. 119 of 3 May 2004, ratified and amended by the Italian Parliament with Law No. 166 of 5 July 2004. In connection with insolvency of the Italian flagship carrier, Alitalia SpA and the Ilva SpA steel manufacturing group, the Italian Government, through Decree-law No. 134 of 28 August 2008, ratified and amended by the Italian Parliament with Law No. 166 of 27 October 2008, and Decree-Law No. 1 of 5 January 2015, ratified and amended by the Italian Parliament with Law No. 20 of 4 March 2015, extended the availability of this proceeding to reorganisations made through the divestiture of debtor's assets to third party purchasers, whether as a whole or as one or more lines of business.

- 1.1.7.5 The 2012 reform sought to incentivize a timely access to *concordato* and thereby avoid that debtors unduly delay a suitable attempt to address their situation of financial distress. In particular, as a result of the 2012 reform, a distressed debtor may file a “blank” application for admission to *concordato preventivo*, i.e. an application not yet coupled with the proper restructuring plan, proposal to creditors and expert opinion. The debtor may file the remaining documentation within a subsequent term set by the Court, between 60 and 120 days (with a possible further extension of up to 60 days). Alternatively, within the same term, the debtor may apply for Court ratification of a restructuring agreement (*accordo di ristrutturazione*; see paragraph 1.1.4.11 below). In the event that the debtor does not file either a *concordato* proposal or an application for the Court ratification of a restructuring agreement within the prescribed term, any creditor or the Public Prosecutor may request the Court to verify that the debtor is insolvent and issue a bankruptcy order.
- 1.1.7.6 A *concordato* plan may seek to address the situation of financial distress in two different ways. The first traditional option is a piecemeal liquidation of the debtor’s assets, the application of the resulting proceeds to satisfy the creditors’ claims and eventually the winding-down of the debtor’s business and cancellation from the Companies’ Register. In such case, as a result of the 2015 reform, the debtor is required to ensure at least a 20% recovery for unsecured creditors.
- 1.1.7.7 Alternatively, the *concordato* plan may envisage the debtor’s business continuity (the so-called *concordato con continuità aziendale*). Such latter form of *concordato*, which was introduced as a result of the 2012 reform, is available if the proposal to creditors provides for (a) the continuation of the business by the debtor, (b) the sale of the business as a going concern, or (c) the contribution-in-kind of the business as a going concern to one or more companies (even if newly incorporated). In these cases, the *concordato* application must include a certification from an independent expert that the continuation of the business would enhance creditors’ recovery. Under this special *concordato*, the payment of secured creditors may be deferred up to one year²² after final Court ratification of the *concordato* proposal, executory contracts may not be terminated because of the *concordato* proceedings (despite any provisions in the contracts to the contrary) and the Court may authorize the debtor, based on a certification from an independent expert, to pay for goods or services received prior to filing.
- 1.1.7.8 The *concordato preventivo* must be approved by creditors holding a majority of the debt;²³ thereafter, it is submitted to the Court for ratification together with a third-party expert report on the accuracy of the financial data and feasibility of the plan and, once ratified by the Court, is binding on all creditors. Financing granted by third parties and, up to certain thresholds, by shareholders in the context of a *concordato preventivo* are given super-priority status. Moreover, transactions, security interests and payments entered into, granted or made pursuant to a *concordato preventivo* are exempted from claw-back.
- 1.1.7.9 With a view to enhancing the creditors’ recovery in a *concordato*, the 2015 reform sought to limit the debtor’s leverage typically resulting from the circumstance that the *concordato* plan and the proposal to creditors are exclusively and unilaterally prepared by the debtor. Creditors could therefore only reject or approve the debtor’s plan. Faced with such alternative, creditors were often forced to approve suboptimal plans to avoid bankruptcy liquidation. As a result of the 2015 reform, creditors holding at least 10% of the overall debt are entitled to file a competing plan (unless the debtor’s plan ensures payment of at least 40% of unsecured claims, in which case no competing plan is allowed). Creditors proposing a competing plan may vote on their plan only if they are included in a separate class. Competing plans are submitted to the creditors’ vote along with the debtor’s plan and the most voted²⁴ plan is then presented to the Court for ratification. In case the Court ratifies a competing plan, should the debtor not co-operate in the implementation of the plan, the Court may assign the necessary powers to the judicial commissioner or an administrator. In the event that the plan envisages a capital increase, the judicial appointee may adopt the necessary corporate resolutions, thus effectively replacing the debtor’s shareholders or board of directors.

²² Certain judgments of the Italian Supreme Court have also held that recovery of secured creditors may be deferred beyond the one-year moratorium expressly envisaged by the law, provided that such secured creditors are admitted to voting (generally they are not, because they are to be satisfied in full).

²³ In addition, if the creditors are divided into different classes, majority approval must be obtained in the majority of the existing classes. Intra-group creditors are not entitled to vote.

²⁴ More specifically, if one of the competing plans is approved by the majorities required by the law, such plan is directly submitted to the Court for its ratification; by contrast, if none of the competing plans meets the required majorities, the Court requests the creditors to vote on the plan which received the larger approval. If such plan is approved by the required majorities, it is submitted to the Court for its ratification.

- 1.1.7.10 Moreover, the 2015 reform amended the *concordato* rules by introducing a proper competitive process in the sale of the debtor's assets. In *concordato preventivo* proceedings, the debtor's restructuring plan is indeed often based on a third party's offer to purchase the debtor's business. In such cases, there is no guarantee that the offer maximizes the value of the business and creditors' recovery. To address this issue, the 2015 reform provided that the Court – upon request of the judicial commissioner – may order the launch of a competitive bid process, allowing interested third parties to conduct due diligence on the relevant assets. Moreover, the initial offer (similarly to what happens with so-called “stalking horse” offers in U.S. Chapter 11 proceedings) may provide for reimbursement of the expenses incurred to prepare the offer in case a competing bidder prevails. Such reimbursement may not exceed 3% of the offer price.
- 1.1.7.11 An alternative instrument available to debtors to address their situation of financial distress is a Court-ratified restructuring agreement (*accordo di ristrutturazione*). This type of agreement was introduced by the 2005 reform and revisited on several occasions. These agreements determine certain protections for the parties thereto,²⁵ as well as a moratorium against enforcement actions brought by third parties pending the negotiations and completion of the ratification process. Such protections depend on certain substantive and procedural requirements that the agreement and the debtor must meet. In particular, the agreement must be filed with the Court for ratification and the relevant petition may be filed only if (a) a majority of creditors holding at least 60% of the debt have entered into the restructuring agreement, and (b) a third-party expert has certified the truthfulness of the underlying data and the feasibility of the proposed restructuring (in particular with respect to the full payment of creditors who are not party to the agreement). The restructuring agreement is not binding on creditors who are not party to it; however, any such creditor must be paid in full within 120 days of the Court's ratification of the restructuring agreement or, if later, of the relevant debts' original maturity.
- 1.1.7.12 Because the restructuring agreements outlined in paragraph [1.1.4.11] above are purely consensual arrangements, individual creditors may often exercise a *de facto* veto on the restructuring, even when a large majority of creditors holding claims of the same nature have already accepted the terms of the restructuring. Inspired by English law schemes of arrangement, the 2015 reform introduced a special form of restructuring agreements in order to address this issue with respect to the restructuring of financial liabilities (i.e. claims held by banks or financial intermediaries). Under the new rules, a debtor whose financial debt amounts to at least 50% of its overall liabilities may ask the Court to extend the effects of a restructuring agreement to dissenting financial creditors, provided that consenting creditors hold at least 75% of the debt included in the relevant class.²⁶
- 1.1.7.13 Finally, a further instrument offered by the law to address a situation of financial distress is the so-called certified recovery plan (*piano di risanamento attestato*). This restructuring device is entirely out-of-Court but extends the claw-back exemption to transactions, security interests and payments entered into, granted or made pursuant thereto, provided that an independent expert appointed by the debtor certifies the truthfulness of the underlying data and the feasibility of the plan as well as that the actions envisaged by the plan are suitable to permit restructuring of the debt and to ensure the recovery of debtor's financial condition. Certified recovery plans are in principle unilateral instruments, i.e. do not require per se any agreement by a creditor or third parties, but almost invariably constitute the framework of a consensual arrangement with at least the key creditors. Accordingly, because such recovery plans are not subject to any Court approval, non-participating creditors are not bound by the terms thereof.

²⁵ Transactions, security interests and payments entered into, granted or made pursuant to the agreement are not subject to claw-back.

²⁶ To such end, the debtor must show that the economic interest and legal position of the dissenting creditors that would be crammed down have the same nature as those of the consenting creditors included in the same class. In addition, the debtor must show that dissenting creditors (a) were effectively given a chance to participate in the restructuring negotiations, (b) were adequately informed of the financial condition of the debtor and (c) are treated no worse than under any effectively available alternative. Dissenting creditors must be notified of the debtor's application to the Court and, on grounds that any of the above conditions are not met, may request that the agreement be not binding on them. The Court decides on the opposition in the context of the ratification hearing.

1.2 Definition and identification of directors

- 1.2.1 As a general rule, directors of a SpA or SRL are identified on the basis of their formal appointment by the shareholders' meeting and subsequent filing with the Companies' Register. The duties and obligations of directors therefore are attached to the office they formally hold.²⁷ Under default rules, only individuals can be appointed as directors of a SpA or SRL. However, according to the prevailing interpretation, bylaws of SpA and SRL may provide for the appointment of a legal entity as director (*amministratore persona giuridica*): in such cases the company-director will act through a designated representative (an individual) who will be subject to the ordinary rules applicable to directors and will be liable in case of breach of its duties and obligations jointly and severally with the company-director.
- 1.2.2 However, as mentioned in paragraph [1.1.3.3] above, in certain circumstances the Italian courts have extended the scope of directors' liability to persons who *de facto* have acted as if they had been entrusted with management powers. Notably, scholars and Court precedents define a *de facto* director as the person or entity who actually and systematically exercises the powers of a director, even though such person or entity does not formally hold such office. A *de facto* director may be held liable for the damages caused to the company, its shareholders and third parties (including creditors of the company) in connection with the mismanagement of the company.
- 1.2.3 In addition, the peculiar structure of an SRL may result in the shareholders being granted management powers which would typically lie with directors, to the effect that such shareholders could be held liable for mismanagement.

More specifically, in principle, the management of the business of an SRL lies with the directors only. Therefore, only the directors could be liable for actions or omissions relating to the management of the company. However, the by-laws of an SRL may provide that the powers of the shareholders be extended to matters relating to the management of the company. In addition, shareholders representing at least one-third of the capital – as well as one or more directors – may request that a decision on a specific matter relating to the management of the company be submitted to the shareholders. Further, shareholders of an SRL may be held jointly and severally liable (*vis-à-vis* the company, the other shareholders, and third parties as well) with the directors for any damage caused by actions that such shareholders “intentionally” decided, authorized or carried out.²⁸

1.3 The start and duration of the twilight period with respect to directors' liability

- 1.3.1 The law does not specifically determine the duration of the period during which directors' actions or omissions are liable to give rise to personal liability. In other words, there is no precisely defined twilight period with respect to directors' liability.
- 1.3.2 However, when a company is insolvent, directors have a duty to petition the Court for an insolvency ruling.²⁹ If they fail to do so and consequently aggravate the company's deficit, then they are criminally liable³⁰ (see paragraph [2.4.3] below) and may hence be held liable for up to the difference between the net assets at the time the company has become insolvent and the net assets as determined by the bankruptcy trustee under the bankruptcy proceedings.
- 1.3.3 With regard to directors' liability, the twilight period ends when the bankruptcy trustee takes charge of the company's operations.
- 1.3.4 The Reform Bill may have a material impact in this respect. A system somewhat inspired by the so-called “alert measures” would be introduced for the first time in Italy and impose a structured obligation upon the directors to take the necessary actions to address the situation of distress at a time when insolvency could still be avoided. Accordingly, a defined point in time from which directors are formally required to address the situation of distress will need to be identified, thus determining for several (though not all)³¹ purposes the official beginning of the twilight period.

²⁷ If two or more directors are appointed, they form a board of directors, which may entrust executive powers to one (or more) of its members (so-called *amministratore delegato*) and / or to a committee (so-called *comitato esecutivo*). However, in an SRL the by-laws may entrust executive powers to each director acting severally.

²⁸ Article 2476, para. 7, of the Italian Civil Code.

²⁹ When the company is in a situation of recoverable distress (and not insolvency), directors can take those steps necessary to access the alternative procedures mentioned above, such as a composition with creditors or a restructuring agreement.

³⁰ Article 217, Bankruptcy Law.

³¹ For instance, the term from which transactions may become subject to a claw-back action would still depend on the date of the bankruptcy declaration and not on the commencement of the “alert measure” period envisaged by the Reform Bill.

1.3.5 In particular, according to the general principles set forth in the Reform Bill, if the control bodies of a company (i.e. the board of statutory auditors, the supervisory board and / or the company auditing the company's accounts) believe that the company is in a situation of distress, they would have to promptly inform the directors. Should the directors not provide a suitable reaction, the control bodies of the company may directly inform the so-called "crisis composition organizations."³²

In addition, qualified creditors (such as the tax administration, the tax collection agencies and the social security organisations) would be required to inform the control bodies of the enduring failure by the debtor to meet material obligations. Failure to provide such information could result in any security interest securing the claims of such qualified creditors being set aside in the case of bankruptcy.

1.3.6 Pursuant to the Reform Bill, the crisis composition organization involved in the process would have to convene the debtor and the company's control bodies in order to identify an effective solution to the situation of distress. Upon request of the debtor, the crisis composition organization may also entrust a turn-around expert within its organization to work out a consensual arrangement between the debtor and its creditors within a certain term (not exceeding six months). Pending the restructuring discussions, the debtor may also apply to the Court for the adoption of such protection measures (e.g. a moratorium), which appear appropriate to enable the successful conclusion of the negotiations.

1.3.7 The debtor's directors would play a crucial role in the context outlined above. The Reform Bill provides for the introduction of various sanctions (including a new bankruptcy crime) to punish the debtor who does not request the start of the restructuring process, notwithstanding the circumstances would require a prompt initiative, or hinders the process. Moreover, if the crisis composition organization finds that the debtor has not taken the required actions to address the situation of distress, it must inform the Court, which in turn may appoint an independent expert to verify the financial conditions of the debtor and grant a term within which the debtor must act. Failure to act would result in the expert's report being published on the Companies' Register.

1.4 The start and duration of the twilight period under bankruptcy laws: the notion of insolvency and claw-back provisions

1.4.1 For purposes of assessing the vulnerability of transactions to challenge (as opposed to the personal liability of directors), the twilight period is the preference period (*periodo sospetto*) prior to the opening of the ordinary bankruptcy proceeding (*fallimento*),³³ during which certain transactions entered into by the debtor may be voided by a judgment of the bankruptcy Court upon request of the trustee in a so-called bankruptcy claw-back action (*revocatoria fallimentare*).³⁴

1.4.2 A company (or any other business enterprise) shall enter into bankruptcy proceedings when it becomes insolvent. The concept of "insolvency" under Italian law is defined as the inability of the company to regularly pay its obligations as they become due. Failing to meet payments is usually considered prima facie evidence of insolvency, even though obligations regularly honoured may also conceal the company's insolvency, if such payments are made by fraudulent or detrimental means (e.g. the sale of all or part of the debtor's assets or estate on favourable terms).³⁵ In an insolvency, the company's directors, any of the company's creditors or the Public Prosecutor may file a petition for a formal declaration of insolvency by the competent Court thereby starting a formal bankruptcy procedure.

³² The "crisis composition organizations" are public entities or private organizations registered with the Ministry of Justice established pursuant to Law No. 3 of January 27, 2012 to introduce a set of provisions governing the composition or orderly liquidation of over-indebted consumers and undertakings not meeting the minimum requirements to become subject to insolvency proceedings under the Bankruptcy Law (these provisions were subsequently extended to so-called "innovative start-ups"). Their role in the existing framework is both of assistance to the debtor in preparing the restructuring plan and liaising with the courts for the purposes of co-ordinating the process.

³³ The same rules basically apply in the case of *liquidazione coatta amministrativa* and *amministrazione straordinaria*.

³⁴ Or by the extraordinary commissioner in the *amministrazione straordinaria*.

³⁵ Article 5, para. 2, Bankruptcy Law. According to case law, a company is insolvent, *inter alia*, if it faces unfavourable conditions of liquidity, irrespective of the ratio of assets to liabilities, or if it has insufficient cashflow to meet its current obligations in spite of positive net assets (e.g. due to illiquid investments). Likewise, a company may be insolvent, despite having large inventories, if its goods are not saleable under standard conditions without resorting to selling below cost, or if the company faces unfavourable terms of access to credit due to its particular situation or general market conditions.

- 1.4.3 The date on which the preference period is deemed to begin depends upon the different types of transactions carried out by the company prior to the opening of formal bankruptcy proceedings (or, in the case of *amministrazione straordinaria*, prior to the declaration of insolvency). Generally, such period does not exceed one year prior to that date (see question 4). Certain transactions, however, may be voided even before the preference period commences and irrespective of whether the company is insolvent, if specific requirements are satisfied (see paragraph 4.1.2).
- 1.4.4 The preference period ends on the date on which the competent Court orders the opening of formal bankruptcy proceedings (or, in case of *amministrazione straordinaria*, when the Court declares the insolvency).³⁶

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 the director?
- (b) In relation to each act identified in (a) above:
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or 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

- 2.1.1 In the case of an insolvency proceeding, directors may be held liable for any action or omission in violation of their duties, as defined by the law and by the corporate by-laws, whenever such action or omission causes damage to the company and / or its creditors, and may also be held liable towards individual shareholders or third parties, to the extent that such action or omission causes a direct damage to them.
- 2.1.2 Some actions and omissions, as identified in paragraph 2.4, give rise to both civil and criminal liabilities.
- 2.1.3 The liability attaches jointly and severally to all directors who are held to have violated their duties. Under general principles of Italian law, a director who has refunded the damage has recourse against each of the other directors who are also at fault in proportion to the degree of fault of each and to the harmful consequences arising therefrom.

As explained under paragraph 1.3.1 above, there is no specified period before commencement of an insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director (see also paragraph 8.1).

³⁶ Pursuant to Art. 69-bis of the Bankruptcy Law (which was introduced with the 2012 reform), if the bankruptcy declaration occurs at the end (or during) a *concordato* procedure, the reference date to determine the preference period is moved back to the date of publication of the *concordato* application with the Companies' Register (which is to occur within one day of filing with the Court).

2.1.5 As a general rule, there must be a causal link between a directors' violation and the loss incurred by the company, the creditor and / or the shareholders. Both the damage and the causal link have to be proven by the plaintiff.

2.2 Directors' duties

2.2.1 Directors owe the corporation a general duty of due care and diligence, based on the nature of their office and on their expertise. In general, SpA non-executive directors carry no liability for damages following actions or omissions relating to the exercise of powers formally or *de facto* delegated to the executive committee or to one or more executive directors.³⁷

2.2.2 However, no matter whether executive or non-executive, directors of SpA must act in an informed way³⁸ and are jointly and severally liable *vis-à-vis* the corporation if, being aware of actions damaging the corporation, they fail to do what is in their power to avoid or reduce the harmful consequences of such actions or omissions.³⁹

2.2.3 Liability for such actions does not apply to the directors who, being without fault, promptly express in the minutes their dissent and give immediate written notice to the chairman of the board of statutory auditors.

2.2.4 Specific duties attach to members of the audit committee under the one-tier corporate governance system for SpA. The audit committee must verify the adequacy of the company's organisational structure, internal control system and management and accounting system. It must also perform the additional tasks assigned to it by the board of directors, with special reference to relations with the company's independent auditor.⁴⁰

2.2.4.1 Audit committees under the one-tier corporate governance system also have the power to file a complaint with the Court alleging that other directors have violated their duties and that the company may suffer damage therefrom. The Court may then order an inspection and, if any irregularities are found, it may order provisional measures and call a general meeting to facilitate a resolution or, in the most serious cases, remove the directors and appoint a judicial administrator.⁴¹

2.2.4.2 Listed companies' audit committees under the one-tier corporate governance system have a similar duty to report to CONSOB (the Italian Securities and Exchange Commission) any irregularities in the management of the company.⁴²

2.2.4.3 Therefore, audit committee members who, being aware of actions damaging the corporations taken by executive directors in violation of their duties, omit to file the complaint mentioned under paragraph 2.2.4.2 above or (if the corporation is listed) to report irregularities to CONSOB will probably be held liable for breach of their duty to do what is in their power to avoid or reduce the damage following the harmful action.

2.2.5 Directors of SpA are also jointly and severally liable *vis-à-vis* the corporate creditors if they fail to comply with their duties concerning the preservation of the company's assets⁴³ (i.e. the duties which are likely to have an impact on the company's solvency, such as rules on distributions to shareholders, formation of capital, drawing up of financial statements, issuance of bonds).

2.2.6 Since the rule described under paragraph 2.2.5 above is not replicated by the corresponding provisions applicable to SRL, corporate law scholars debate whether the liability towards creditors may be applied by analogy to SRL directors who fail to comply with the preservation duties applicable to SRL – the interpretation favoured by the prevailing case law – or whether their liability should otherwise be derived from general tort law or company law principles. The Reform Bill envisages a clarification in such respect, by providing expressly that directors of a SRL are liable to the company's creditors under the same circumstances applicable to SpA.

³⁷ Article 2392, Civil Code.

³⁸ Article 2381, Civil Code.

³⁹ Article 2392, Civil Code.

⁴⁰ Article 2409-*octiesdecies*, Civil Code.

⁴¹ Article 2409, Civil Code.

⁴² Article 149, para. 4-*ter*, Legislative Decree No. 58 of 25 February 1998.

⁴³ Article 2394, Civil Code.

- 2.2.7 Directors having an interest – on their own behalf or on behalf of third parties – in a transaction carried out by the company may incur liability if they do not comply with certain rules. In particular: (a) directors must disclose their interest to the board of directors, even if such interest is not conflicting with the interest of the company; and (b) an executive director having any interest in a proposed transaction within the scope of his powers must solicit prior board approval for such transaction. The interested director is not required to abstain from voting on the resolution approving the transaction, but the resolution must state explicitly the reasons for, and the benefit to the company of, the transaction. In the event that these provisions are not complied with, or that the transaction would not have been approved without the vote of the interested director, the resolution approving the detrimental transaction may be challenged and the interested director may be held liable for damages incurred by the company as a result of the transaction.⁴⁴
- 2.2.8 Moreover, directors having an interest conflicting with the company's interest may incur criminal liability (punished by imprisonment for six months to three years) if they carry out or resolve the transfer of corporate assets for the purpose of procuring an unjustified profit or other advantage to themselves or third parties and thereby intentionally cause damage to the company.⁴⁵
- 2.2.9 In application of general tort law principles, directors are also liable – together with the corporation – for those damages suffered by individual shareholders and/or third parties as a direct result of their negligence or wilful misconduct.⁴⁶ So, for instance, directors issuing false financial statements may be held liable to shareholders who acquired shares relying upon such statements.

2.3 Directors' duties in the event of a company's dissolution

- 2.3.1 Specific liability provisions apply in the case of a company's dissolution. Such provisions are worth discussing, because one of the events of dissolution as indicated by the law frequently occurs before or at the time a company becomes insolvent: the event connected with the so-called "recapitalise or liquidate rule".
- 2.3.2 When an event of dissolution occurs,⁴⁷ directors have a duty to inform the general public without delay that the company is dissolved by way of a notice deposited at the Companies' Register. If they fail to do so, they are liable to the company, its shareholders, creditors and other third parties for damages.⁴⁸
- 2.3.3 Upon the occurrence of an event of dissolution and until liquidators are appointed,⁴⁹ directors may manage the company for the sole purpose of preserving the integrity and value of corporate assets. Directors are personally and jointly liable for the damages caused to the company, its shareholders, creditors and third parties for breach of such provision (i.e. entering into transactions with a purpose other than the preservation of the integrity and value of corporate assets).⁵⁰ There is no settled case law as to which transactions may fall under this provision. It has been held that the performance of existing contracts, the purchase of new raw materials or the employment of new employees required to comply with pending orders is consistent with the duty to preserve the integrity and value of the company's assets; by contrast, transactions entailing a material increase of the company's total exposure may trigger directors' liability. The Reform Bill, if approved, would require the Government to legislate on a set of criteria to quantify the directors' liability in case of breach of this rule.

⁴⁴ Article 2391, Civil Code.

⁴⁵ Article 2634, Civil Code.

⁴⁶ Article 2395, Civil Code.

⁴⁷ Relevant events of dissolution are the following (Art. 2484, Civil Code): (i) impossibility to function or protracted inactivity of the shareholders meeting; (ii) reduction of capital below the minimum required by law, unless the company is recapitalised or converted into another company (see text below, para. 2.3.4); (iii) voluntary dissolution resolved upon by the shareholders meeting; (iv) other events identified in the by-laws.

⁴⁸ Article 2484, Civil Code.

⁴⁹ See para. 3.2.1.

⁵⁰ Article 2485, Civil Code.

- 2.3.4 According to the “recapitalise or liquidate” rule, if, as a result of losses exceeding one-third of the share capital, the share capital itself falls below the statutory minimum prescribed by the law (i.e. €50,000 for SpA and €10,000 for standard SRL),⁵¹ the directors must call the general meeting without delay. The shareholders will resolve whether to reconstitute the capital to an amount not less than the statutory minimum or whether to convert the company into an SRL (provided that the SpA still has net assets, or shareholders contribute assets, worth at least €10,000) or into a partnership (which has no minimum capital). Unless either measure is taken, the company must be dissolved.⁵² The 2012 reform of the Bankruptcy Law introduced an important exception⁵³ to the application of these rules to companies seeking access to *concordato preventivo* or the Court ratification of a restructuring agreement: the obligation to recapitalise or liquidate is not applicable between the date of filing of a *concordato preventivo* application (or a Court-ratified restructuring agreement) and Court ratification at the end of the proceeding. The purpose of this moratorium is two-fold: on the one hand it avoids interference between corporate law rules and restructuring proceedings, on the other hand it avoids automatic exposures of directors to liability for failure to activate the appropriate corporate remedies upon occurrence of a material loss of share capital, provided that the application to the relevant restructuring procedure is duly made.
- 2.3.5 According to case law developed under the previous regime and confirmed after the 2003 company law reform, directors have an ongoing duty to monitor the company’s accounts to determine whether net assets fall below the thresholds prescribed by the law. This implies that directors breach the “recapitalise or liquidate” rule if, during the fiscal year, they wilfully or negligently fail to acknowledge that net assets have fallen below the specified thresholds and hence do not call the shareholders meeting.
- 2.3.6 Failure to act by the general meeting when net assets have fallen below these thresholds is an event of dissolution. In practice, it often happens that companies are declared insolvent well after such an event of dissolution has occurred. When this is the case, the directors’ actions and omissions subsequent to the time when a diligent director would have taken the steps required by the recapitalise or liquidate rule, will be reviewed by the Court in light of the requirement that directors act with the sole purpose of maintaining the integrity and the value of the corporate assets.

2.4 Facts giving rise to both criminal and civil liability

- 2.4.1 Italian law provides for specific felonies resulting from actions carried out by the company’s representatives in the period immediately preceding the declaration of bankruptcy or during the bankruptcy proceedings.
- 2.4.2 The most relevant felonies punished by the Bankruptcy Law are criminal bankruptcy (*bancarotta semplice*) and fraudulent bankruptcy (*bancarotta fraudolenta*).⁵⁴ The prerequisite for both of these offences is that the company is declared bankrupt.⁵⁵
- 2.4.3 Criminal bankruptcy (*bancarotta semplice*)⁵⁶

This criminal offence is committed when a director, with wilful misconduct or gross negligence:

- (a) has wasted or contributed to waste a significant part of the company’s assets in hazardous or openly irresponsible transactions;
- (b) has carried out or contributed to carry out highly imprudent operations, with the intention of delaying bankruptcy proceedings;

⁵¹ As regards “simplified” SRLs with a corporate capital of €1, the “recapitalize or liquidate” rule would be triggered, in practice, on the basis of the company’s assets only.

⁵² Articles 2447, 2482-ter, and 2484, No. 4), Civil Code.

⁵³ Article 182-sexies of the Bankruptcy Law.

⁵⁴ For the criminal punishment of directors in case of incurrence in further debt by an insolvent enterprise, see para. 11.1.1.

⁵⁵ Similar rules apply in the case of the so-called *concordato preventivo* (composition with creditors) as well as, upon declaration of insolvency, in the case of *liquidazione coatta amministrativa* (forced administrative dissolution) and in the case of *amministrazione straordinaria* (extraordinary administration). The Bankruptcy Law also punishes with imprisonment from one to five years the debtor who, for the sole purpose of acceding to *concordato preventivo* or obtaining the Court ratification of a special restructuring agreement with financial creditors (see para. 1.1.4.12 above) reports non-existent assets or non-existent receivables.

⁵⁶ Articles 217 and 224, Bankruptcy Law.

- (c) has worsened or contributed to worsen the financial distress of the company, by delaying to file the request of declaration of bankruptcy, or by committing another act of gross negligence;
- (d) has not fulfilled the obligations undertaken pursuant to a composition with creditors carried out in order to avoid bankruptcy (*concordato preventivo*) or to end the bankruptcy proceedings (*concordato fallimentare*); or
- (e) in the three years preceding the bankruptcy declaration, has kept (or has contributed to keeping) manifestly incomplete accounting books and other accounting records or has kept accounting books and other accounting records that do not comply with the applicable legal requirements; and
- (f) by committing any of the actions under (a) to (e) above, has contributed to worsened the financial condition of the company by disregarding the duties specifically imposed on him by the law.

2.4.3.2 A person found liable of *bancarotta semplice* is sanctioned with imprisonment for six months to two years and disqualification from carrying on business activities and from holding executive office in any business enterprise for a period of up to two years. Further ancillary sanctions may apply, based on general criminal law rules.

2.4.3.3 As mentioned at paragraph 1.3.7, the Reform Bill would extend the scope of criminal bankruptcy to directors who fail to promptly act to address the situation of distress by applying to the crisis composition organization or hinder the successful completion of the resulting procedure.

2.4.4 Fraudulent bankruptcy (*bancarotta fraudolenta*)⁵⁷

2.4.4.1 This criminal offence is committed when a director, with wilful misconduct or gross negligence:

- (a) before the declaration of bankruptcy or during the bankruptcy proceedings, has fraudulently misappropriated, concealed, destroyed or dissipated the company's assets, in whole or in part, or has fraudulently acknowledged and accepted non-existent debts in order to damage the company's creditors;
- (b) before the declaration of bankruptcy, has concealed, destroyed or falsified, in whole or in part, the company's accounting books or other accounting records, in order to gain an unlawful profit (also in the interest of a third party) or in order to damage the company's creditors, or has kept the company's books and accounting records in a manner that makes it impossible to reconstruct the company's assets or business operations;
- (c) during the bankruptcy proceedings, has destroyed, concealed, or falsified the company's books and other accounting records;
- (d) before the declaration of bankruptcy or during the bankruptcy proceedings, has effected payments or simulated priority rights, in order to favour certain creditors of the company;
- (e) before the declaration of bankruptcy, has worsened or contributed to worsening the financial conditions of the company by committing one of the following crimes: (i) false corporate declarations;⁵⁸ (ii) false corporate declarations causing damages to the company's shareholders or creditors;⁵⁹ (iii) unlawful refunds of capital contributions to shareholders;⁶⁰ (iv) unlawful distribution of profits and corporate reserves;⁶¹ (v) transactions detrimental to the company's creditors;⁶² (vi) formation of a fictitious share capital;⁶³ (vii) unlawful disposal of corporate assets;⁶⁴ or

⁵⁷ Articles 216 and 223, Bankruptcy Law.

⁵⁸ Article 2621, Civil Code.

⁵⁹ Article 2622, Civil Code.

⁶⁰ Article 2626, Civil Code.

⁶¹ Article 2627, Civil Code.

⁶² Article 2628, Civil Code.

⁶³ Article 2632, Civil Code.

⁶⁴ Article 2634, Civil Code.

(f) has caused with wilful misconduct, or as a result of transactions carried out with wilful misconduct, the bankruptcy of the company.

2.4.4.2 A person found liable for *bancarotta fraudolenta* is punished by imprisonment for three to 10 years – except for (d) above, as to which the term is one to five years – and disqualification from carrying on business activities and from holding executive office in any business enterprise for a period of 10 years. Further ancillary sanctions may apply, based on general criminal law rules.

2.5 Extent of directors' liability for damages

2.5.1 In principle, no provision either in company or insolvency law makes directors liable to creditors in respect of the whole deficit and no such rule can be derived from general principles on breach of contract, torts or directors' duties toward creditors.

2.5.2 However, the Supreme Court (*Corte di Cassazione*) has repeatedly held that, when a causal link can be found between the violation of directors' duties, primarily their duties under the recapitalise or liquidate rule or those arising once an event of dissolution occurs (see paragraph 2.3 above), and the deficit to creditors (or in one Court's ruling, the company's insolvency), the directors are liable for the entire deficit.

2.5.3 Prior to the 2003 company law reform, in light of a now-repealed rule under which directors were forbidden to "engage in new transactions" once an event of dissolution occurred, some courts held directors liable for any deficit accumulated after the occurrence of the event. Under the new regime (see paragraphs 2.3.2 and 2.3.3 above), directors will possibly be held liable for the whole deficit accumulated in connection with actions or omissions taken with purposes other than the preservation of the integrity and value of corporate assets. Based on existing case law, it is not possible to assess whether judges may construe this formula broadly and hold that, after an event of dissolution, the continuation of the company's business is per se inconsistent with those purposes.

2.5.4 Courts have consistently held that the deficit to creditors is no cap to directors' liability (i.e. that they may be held liable for further damages, if the plaintiff provides evidence thereof). This is because in an insolvency proceeding the trustee may also bring suit against directors for damages suffered by the corporation (i.e. by shareholders qua shareholders).

2.5.6 Courts have also held directors liable to creditors in respect of the whole deficit in cases in which directors had completely omitted to keep the company's books.

2.5.7 See also paragraph 1.3 above for the extent of directors' liability in the event of violation of the duty to petition the Court for an insolvency ruling.

2.6 Defences

2.6.1 The following are the most common defences to which directors resort in liability suits brought by the insolvency trustee:

(a) Non-executive directors may argue that harmful actions were taken by executive directors within the scope of their delegated power (see paragraph 2.2.1 above). Once this is proven, the issue becomes whether non-executive directors knew or should have known, in light of their general duty of due care and diligence, that harmful actions had occurred and whether they failed to do what was in their power to avoid or reduce the consequences.

(b) Statute of limitations (see paragraph 8.1).

(c) Absence of causal link between the violation and the damage suffered by the corporation and / or its creditors.

(d) Prompt expression of dissent to the harmful act (reported in the board minutes) and immediate written notice to the chairman of the board of statutory auditors.⁶⁵

⁶⁵ Article 2392, Civil Code for SpA and, with minor differences, Art. 2476, Civil Code for SRL.

- 2.6.2 The courts have consistently held that, for the purpose of determining whether the directors are liable towards the company for certain harmful transactions, it is generally irrelevant whether such transactions have been previously authorised by the shareholders.
- 2.6.3 Neither criminal nor fraudulent bankruptcy felony is applicable to payments made and other transactions carried-out to implement a composition with creditors (*concordato preventivo*), a Court-ratified restructuring agreement (*accordo di ristrutturazione*) or a certified recovery plan (*piano attestato di risanamento*), or to payments and financing authorised by the Court in the context of a *concordato con continuità aziendale*.⁶⁶

QUESTION 3

- 3. Other persons involved with the company's affairs who may become liable in relation to their actions during the twilight period:**
- (a) In addition to those persons referred to in 1(a), can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 General manager

- 3.1.1 Italian companies usually appoint a general manager / chief operating officer (*direttore generale*), who may or may not also be a member of the board of directors. General managers are liable to the corporation, its creditors and third parties under the same rules applicable to directors. Liability, however, only covers violations relating to the general manager's tasks as defined in the appointment resolution or in the by-laws.
- 3.1.2 Like directors (see paragraph 2.2.9 above), general managers may be held liable to shareholders and third parties according to general tort law principles.
- 3.1.3 Like directors (see paragraph 2.4 above), general managers may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.
- 3.1.4 It is debatable whether other top officers shall be deemed subject to the liability regime applicable to general managers. However, in listed companies, the officer in charge of preparing the company's financial reports (*dirigente preposto alla redazione dei documenti contabili societari*) in relation to the duties and responsibilities entrusted to his office – essentially corresponding to those typically assigned to chief financial officers – is expressly subject to the same liability regime applicable to the members of the board of directors.⁶⁷

3.2 Company liquidators

- 3.2.1 When a company is dissolved, the shareholders' meeting, or the Court in case of inertia by the shareholders, appoints one or more liquidators whose task it is to sell the company's assets (whether as a going concern or piecemeal), pay creditors, and distribute any further proceeds to shareholders. A company may of course enter insolvency proceedings after liquidators have been appointed, in which case the bankruptcy trustee may also sue the liquidators for damages.
- 3.2.2 Liquidators must perform their duties with the degree of care and diligence required by the nature of their office. Rules on directors' liability equally apply to liquidators who have acted in breach of their duties.⁶⁸

⁶⁶ Articles 217-*bis*, Bankruptcy Law.

⁶⁷ Article 154-*bis*, Legislative Decree No. 58 of 25 February 1998.

⁶⁸ Article 2489, Civil Code.

3.2.3 Like directors (see paragraph 2.4 above), liquidators may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.⁶⁹

3.3 Members of the internal control body

3.3.1 The board of statutory auditors in companies who opted for the traditional corporate governance (or single statutory auditor, in the specific case of SRL) system has a duty to verify: (a) directors' and managers' compliance with the law, the by-laws and principles of correct management; and (b) the adequacy of the organisational, administrative and accounting arrangements adopted by the company and the actual operation thereof.

3.3.1.1 In closely-held SpA, which are not under an obligation to prepare consolidated financial statements, the by-laws may also entrust to the board of statutory auditors the auditing of the company's financial statements. In those SRL where a control body is mandatory (and a board of statutory auditor or a single statutory auditor is appointed), the board (or the single statutory auditor) audits the company's financial statements, unless the by-laws provide otherwise.

3.3.2 Should the board of statutory auditors (or single statutory auditor, in SRL) become aware or have reason to suspect misbehaviour by directors or managers it must act in order to reduce or remove the harmful consequences thereof.⁷⁰ It may call a shareholders' meeting and / or file a complaint with the Court for material irregularities and / or – provided that two-thirds of the members approve the proposal – bring a derivative suit against the directors.⁷¹ Listed companies' boards of auditors may also call a meeting of the board of directors or the executive committee (such powers can also be exercised by at least two members of the board of statutory auditors) and must report to CONSOB any irregularities of which they become aware.⁷²

3.3.3 The members of the board of statutory auditors (or the single statutory auditor, in SRL) must perform their duties with the degree of care and diligence required by the nature of their office. They are jointly and severally liable – together with the directors – *vis-à-vis* the company and / or its creditors for the directors' actions and omissions, if the damage would not have occurred had they complied with their duties.

3.3.4 Bankruptcy trustees often sue members of the board of statutory auditors for damages according to the provisions described under paragraphs 3.3.1 to 3.3.3 above alleging that:

- (a) they failed to exercise their powers to avoid or reduce the damage brought to the corporation and / or its creditors by directors' or managers' actions and omissions;
- (b) the corporation and its creditors would have suffered no damage (or less damage) if the members of the board of statutory auditors had complied with their duties.

3.3.5 Although the law clearly requires the existence of a link between the statutory auditors' failure to comply with their duties and the damage incurred by the corporation and / or its creditors, courts tend to shift upon the defendants the burden of proving that the damage would not have been avoided or reduced if the statutory auditors had complied with their duties. Further, courts are usually strict in evaluating statutory auditors' conduct when directors continue running the company in violation of their duties under the "recapitalise or liquidate" rule or of provisions concerning the management of dissolved companies.

3.3.6 Like directors, the statutory auditors may be held liable to shareholders and third parties according to general tort law principles.

3.3.7 Like directors, statutory auditors may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.

⁶⁹ Article 2633, Civil Code specifically sanctions as *bancarotta fraudolenta* the unlawful distribution of corporate assets by liquidators.

⁷⁰ The members of the board of statutory auditors are under a duty to attend the board of directors and executive committees meetings (Art. 2405, Civil Code) and they may at any time carry out inspections, also individually, and request information from the directors regarding the company's management (Art. 2403-bis, Civil Code).

⁷¹ Article 2393, para. 3, Civil Code.

⁷² Articles 149, paras. 3, and 151, para. 2, Legislative Decree No. 58 of 25 February 1998.

3.4 Members of the supervisory board

- 3.4.1 In companies with a two-tier governance system, the supervisory board performs auditing functions which are very similar, in terms of powers and duties, to those pertaining to the board of statutory auditors in the traditional governance system. There are, however, at least two relevant differences. On the one hand, the company's by-laws may not entrust the supervisory board with the audit of the company's financial statements, a task which always has to be performed by an external auditor, even in closely held corporations. On the other hand, the supervisory board appoints and removes the members of the management board.
- 3.4.2 According to the Civil Code, the members of the supervisory board must perform their duties with the degree of care and diligence required by the nature of their office and are jointly and severally liable – together with the members of the management board – *vis-à-vis* the company and / or its creditors for the damages caused by actions or omissions of the management board, if such damages would not have occurred if they had complied with their duties.⁷³
- 3.4.3 If the by-laws also entrust the supervisory board with the power to determine strategic transactions and industrial and financial plans drafted by the management board,⁷⁴ the members of the supervisory board, according to the prevailing interpretation, may be held directly liable *vis-à-vis* the company, its creditors and / or third parties for the damages resulting from such transactions. However, the members of the management board will remain in any case liable for actions they carry out for the implementation of such resolutions.
- 3.4.4 Liability to shareholders and third parties according to general tort law principles also applies to supervisory board members.
- 3.4.5 Like directors, supervisory board members may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta*.

3.5 External auditors

- 3.5.1 SpA are generally required to have their financial statements reviewed by external auditors; however, the by-laws of closely-held SpAs may entrust such review to the board of statutory auditors.
- 3.5.2 External auditors are required by law to verify:
- (a) during the fiscal year, that companies' accounts are kept properly and their transactions reported correctly in the accounting records;
 - (b) that companies' annual and consolidated financial statements correspond to the results of the accounting records and tests performed and that they comply with the relevant statutory and regulatory provisions.⁷⁵
- 3.5.3 External auditors may obtain documents and information from the company's directors and may carry out examinations, inspections and controls; with respect to listed companies, they must report any irregularities to the board of statutory auditors and to CONSOB without delay.⁷⁶
- 3.5.4 External auditors are liable *vis-à-vis* the corporation, its creditors and / or third parties for the damages occurred as a result of a breach of their duties.⁷⁷
- 3.5.6 If the external auditor is a legal entity (as required in the case of listed corporations), liability extends to the persons who have audited the company's accounts on its behalf.

⁷³ Article 2409-*terdecies*, para. 3, Civil Code.

⁷⁴ Article 2409-*terdecies*, para. 1, Civil Code.

⁷⁵ Article 2409-*ter*, Civil Code, and Art. 155, Legislative Decree No. 58 of 25 February 1998.

⁷⁶ Article 155, Legislative Decree No. 58 of 25 February 1998.

⁷⁷ Article 2409-*sexies*, Civil Code, and Art. 164, Legislative Decree No. 58 of 25 February 1998.

3.6 Independent expert certifying the *concordato* plan, restructuring agreement or recovery plan

- 3.6.1 A debtor intending to address the situation of distress or insolvency by means of a statutory restructuring instrument needs the assistance of an independent expert who certifies that the restructuring envisaged by the debtor is feasible.
- 3.6.2 In particular, as discussed in paragraph 1.1.4, a debtor who intends to apply for a *concordato preventivo* proceeding must, among other things, file a report issued by an independent expert who certifies the feasibility of the *concordato* plan and the accuracy of the underlying corporate and economic data. A similar report is also required in connection with Court-ratified restructuring agreements, with respect to which the expert must also certify that the agreement ensures that non-participating creditors can be satisfied within 120 days of maturity of their claims. Finally, an expert opinion is required for a recovery plan to produce its protective effects (e.g. exemption from claw-back actions against the transaction carried out pursuant to the plan).
- 3.6.3 Because of the relevance of expert opinions in this context and the reliance made by creditors on the contents of such opinions, experts are exposed to criminal liability in case of failure to duly perform their duties. In particular, an expert who reports false information or fails to report relevant information is punished by imprisonment between two and five years and a fine of up to € 100,000. The penalties are increased if the expert commits the crime for the purpose of causing an unjust profit for himself or third parties, or if creditors suffer prejudice as a result.⁷⁸

3.7 *De facto* directors

- 3.7.1 As discussed in paragraph 1.2.2 above, Italian courts hold that the directors' liability regime equally applies to anyone, whether a shareholder or an outsider, who acts as a director on a regular basis, even in the absence of any kind of formal or informal appointment.
- 3.7.2 *De facto* directors may be held criminally liable for *bancarotta semplice* or *bancarotta fraudolenta* (see paragraph 2.4 above).

3.8 Sole shareholder

- 3.8.1 After the 2003 company law reform, the Civil Code provides that, in the event of insolvency, for obligations incurred during the period in which the capital of a SpA or SRL was held by a sole shareholder, such shareholder will be unlimitedly liable for the company's obligations if:⁷⁹
- (a) it has not fully paid its capital contributions upon subscription; or
 - (b) the directors or the sole shareholder omit to file with the Companies' Register a declaration identifying the sole shareholder.
- 3.8.2 According to decisions rendered by Italian courts prior to the 2003 company law reform, shares were deemed to be owned by a single shareholder only when it formally held all the outstanding shares or when the other shareholders were mere nominees. So, for instance, courts have consistently held that no sole shareholder existed when most of the shares were held by one company and the remaining shares were held by one of its wholly owned subsidiaries. Some commentators doubt whether such a formalistic interpretation can be confirmed under the new regime, meaning that a company with a "quasi-sole shareholder" who has not fully paid up its shares, or who has omitted to declare that it is the sole shareholder, may be held liable for its company's obligations.
- 3.8.3 Pursuant to Article 147 of the Bankruptcy Law, in the event that a company becomes subject to bankruptcy liquidation proceedings (*fallimento*), such proceedings extend to the unlimited shareholders thereof. According to the prevailing case law, this provision is devised to cover exclusively shareholders of unlimited liability companies (such as a *società in nome collettivo*) and not also shareholders of limited liability companies (such as a SpA or a SRL), even when – by operation of law – the latter are held liable for all liabilities of the company. Accordingly, even when the sole shareholder is unlimitedly liable for the company's obligations (for the reasons explained in paragraphs 3.8.1 and 3.8.2, above), the circumstance that the company is declared bankrupt does not result per se in the bankruptcy proceedings extending to such sole shareholder.

⁷⁸ Article 236-bis of the Bankruptcy Law.

⁷⁹ Article 2325, Civil Code.

3.9 Shareholders exercising a back-up business (*impresa fiancheggiatrice*)

- 3.9.1 As previously mentioned, shareholders may be held liable if they are found to have acted as *de facto* directors or, in the case of a parent company, abusing its “direction and co-ordination” powers (see paragraph 3.10.3 below) or, finally, under general tort law principles (see paragraph 3.11 below). If none of these situations occurs, shareholders will not be held liable for the company’s obligations.
- 3.9.2 Italian courts have, however, developed a doctrine under which individuals controlling a group of companies and co-ordinating and directing such companies’ activities may be held to carry-out a back-up commercial business (*impresa fiancheggiatrice*) and hence may be declared insolvent as such.⁸⁰ However, such individuals will only be liable for debts incurred personally and in the exercise of such back-up business, as opposed to liabilities incurred by their controlled companies. As a matter of practice, only controlled companies’ creditors having obtained a personal guarantee from such shareholders will have a claim against them.
- 3.9.3 This doctrine also implies that such shareholders may be held criminally liable for the actions described above (see paragraph 2.4), even in the absence of evidence that they were *de facto* directors of the insolvent company.

3.10 SRL shareholders resolving upon or authorising harmful transactions

- 3.10.1 As mentioned in paragraph 1.2.3 above, shareholders of a SRL who wilfully resolved upon or authorised harmful transactions to the detriment of the company, its creditors and / or third parties may be held jointly and severally liable – together with the directors – for the damages resulting from such transactions.⁸¹

3.11 Groups of companies and the liability of parent companies and their directors

- 3.11.1 According to one of the most problematic provisions in the 2003 company law reform,⁸² under certain circumstances parent companies and their directors may be held liable for the damages caused to the subsidiaries’ shareholders or creditors.
- 3.11.1.1 This liability regime applies to legal entities⁸³ with so-called “direction and co-ordination” powers over an Italian company.⁸⁴ The law does not set forth specific criteria for determining when an entity exercises *de facto* “direction and co-ordination” powers over a given company. However, according to the prevailing interpretation of the rule by commentators and by the fairly limited published case-law on this subject, an entity may be found to have “direction and co-ordination” powers over a given company where a significant part of the management decisions at the company (a Directed Company), although formally implemented by the Directed Company’s managers, is continuously and substantively taken by management at another entity (a Directing Entity).⁸⁵ This legal framework also applies when an entity exercises direction and co-ordination powers over a company pursuant to ad hoc agreements or by-laws provisions.⁸⁶
- 3.11.2 Although the concept of control is not per se equivalent to the exercise of “direction and co-ordination” powers,⁸⁷ a parent entity is presumed to exercise “direction and co-ordination” powers with respect to (a) any subsidiaries for which consolidation is compulsory,⁸⁸ and (b) any subsidiaries under its sole control.⁸⁹ Such presumption may be rebutted by providing convincing evidence of the subsidiary’s appropriate management independence. If management decisions at the subsidiary’s level are effectively independent from the parent entity’s influence, this regime should arguably not apply.

⁸⁰ Under Italian law, only companies and individuals exercising an unincorporated commercial (i.e. non-agricultural or professional) business may be declared insolvent.

⁸¹ Article 2476, para. 7, Civil Code. As noted by certain commentators, although this provision expressly applies only to limited liability companies, it cannot be entirely excluded that this rule may somehow be extended by the courts to corporations.

⁸² Article 2497, Civil Code.

⁸³ The terms used by the law (*le società o gli enti*) are broad enough to encompass any person other than individuals.

⁸⁴ Article 2497, Civil Code.

⁸⁵ A single act of interference in management decisions should arguably be irrelevant, as the new regime is intended to apply only when direction and co-ordination powers are exercised as an “activity.”

⁸⁶ Article 2497-*septies*, Civil Code.

⁸⁷ Art. 2497-*sexies*, Civil Code.

⁸⁸ Whether consolidation is mandatory should be determined by the law of the parent entity. If Italian law applies, the instances of mandatory consolidation are set forth in Arts. 25 through 28 of Legislative Decree No. 127 of 9 April 1991, implementing the 7th EC Company Law Directive. Consolidation of a jointly-controlled company is possible but not mandatory (see Art. 37).

⁸⁹ For these purposes, control is defined as (a) holding (directly or indirectly) more than 50% of the votes at a company’s ordinary shareholders’ meeting, (b) exercising a dominant influence at the company’s ordinary shareholders’ meeting through the (direct or indirect) exercise of voting rights, or (c) exercising a dominant influence on the company through contractual arrangements. See Art. 2359, Civil Code.

- 3.11.3 A Directing Entity may be liable to minority shareholders and creditors of a Directed Company for abuse of “direction and co-ordination” powers.⁹⁰ In particular, a Directing Entity that, acting in its own interest or in the interest of third parties, mismanages a Directed Company, is liable:
- (a) to the Directed Company’s other shareholders for any ensuing damage affecting returns on, or the value of, their shareholdings; and
 - (b) to the Directed Company’s creditors for any impairment caused to the Directed Company’s assets that may affect the creditors’ ability to collect on their claims.
- 3.11.4 Any person concurring in the mismanagement (e.g. the Directing Entity’s directors), or benefiting from it (e.g. another subsidiary of the Directing Entity), is jointly and severally liable with the Directing Entity.⁹¹
- 3.11.5 Liability is excluded when damages resulting from the mismanagement are (a) fully reversed, including through subsequent transactions specifically effected for this purpose, or (b) offset by the overall effect of the “direction and co-ordination” activities over the Directed Company.
- 3.11.6 Creditors or minority shareholders may bring action only if they have been unable to collect damages from the Directed Company. Therefore, liability of a Directing Entity may in practice be limited to those cases in which the Directed Company itself has become insolvent.
- 3.11.7 Further, under the Prodi Law, in the case of a group of companies, the directors of the parent company may be held jointly liable with the subsidiary’s directors for the damages caused to the insolvent subsidiary by means of an abuse of direction powers within the group.⁹²

3.12 Other third parties under general tort law principles

- 3.12.1 Third parties involved with the business of a company that enters into bankruptcy proceedings may be subject to liability if all or part of the loss suffered by the insolvent company is caused by their wrongful action. The plaintiff must establish the existence of (a) a wilful misconduct or gross negligence by the third party; (b) the damage caused to the company; and (c) a causal link between the two.
- 3.12.2 The loss may either be (a) general (i.e. suffered by the company, and therefore by all the creditors) in which case the bankruptcy trustee must bring the action or (b) specific to one creditor, in which case the action must be brought by the individual creditor.
- 3.12.3 The action is a civil action which results in the payment of damages (either to the company, in the event of an action brought by the bankruptcy trustee, or to the single creditor, in the event of an action brought by an individual creditor).

3.13 Banks

- 3.13.1 Most suits against third parties as in paragraph 3.12 above are brought against banks or financial institutions that dealt with the insolvent company. The claim is generally based on an abusive grant of financing or an unjustified interruption of financing.
- 3.13.2 Banks that financed a company in an insolvency situation, thereby delaying the opening of a formal insolvency procedure in order to gain certain advantages (e.g. in order to avoid claw-back actions, or to obtain specific guarantees), may be held liable against the company’s creditors once the company is declared bankrupt. The rationale is that the creditors would not have started or continued a business relationship with the company if the insolvency situation were apparent and not hidden by the bank’s grant of financing. The loss is specific to the injured creditors and the action against the bank is brought by such creditors and not by the bankruptcy trustee.

⁹⁰ Article 2497, Civil Code.

⁹¹ The liability of persons benefiting from the mismanagement is limited to the benefits actually received by such persons (see Art. 2497, para. 2, Civil Code).

⁹² Article 90, Legislative Decree No. 270 of 8 July 1999. Some commentators doubt whether this provision is still in force under the new regime of corporate groups, claiming that it should be regarded as implicitly repealed.

- 3.13.3 An unjustified interruption of financing occurs when a bank, without any legitimate reason, stops granting financing to a company, thereby causing its insolvency and the opening of a formal bankruptcy proceeding. In this case, the damage is suffered by the company and therefore the action needs to be brought by the bankruptcy trustee.
- 3.13.4 The framework outlined above has generated uncertainty in the banking sector, as it is not entirely clear whether and in which circumstances banks are allowed to provide funds to a distressed debtor and when they should refrain from it, particularly where funds could be lent under existing facilities. Such uncertainty often results in the banks' reluctance to continue lending even when such funds are vital to preserve the value of debtor's assets and, therefore, to protect creditor claims. With a view to addressing such concerns, various reforms between 2009 and 2012 have sought to establish a revised framework within which lenders may safely lend to a debtor intending to apply for, or already subject to, *concordato preventivo* or a Court ratification of a restructuring agreement. However, these reforms have not proved particularly successful, partly because of courts' reluctance to authorize new debt without proper evidence that it would enhance the financial conditions of the debtor.
- 3.13.5 More recently, the 2015 reform of the Bankruptcy Law sought once more to address the need for certainty by expressly providing that a debtor subject to *concordato* who requests Court authorization to borrow interim financing may extend such request to drawing funds under an existing revolving line secured by receivables assigned from time to time to the lender (so-called *linea autoliquidante*). This clarification is intended to provide banks with the required certainty to continue lending under credit facilities existing at the time of the debtor's application to the Court, although its practical effectiveness remains to be verified.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect a transaction from being attacked?
- (c) On what basis may directors and other person involved with the company's affairs properly incur further credit during the twilight period?

4.1 Transactions potentially subject to a claw-back action

- 4.1.1 According to Italian Bankruptcy Law, under certain circumstances, the bankruptcy trustee may bring an action for the avoidance of certain payments and transactions carried out by the company during the so-called preference period (*revocatoria fallimentare*). The purpose of such action is to reconstitute the company's assets in the interest of all creditors by unwinding certain transactions which (a) have been carried out to the detriment of the company or the creditors as a whole, or (b) are unfairly beneficial to a specific creditor, and thus violate the general principle of equal treatment of creditors (*par condicio creditorum*).
- 4.1.2 The Civil Code provides for a similar remedy, called ordinary claw-back procedure (*revocatoria ordinaria*), whereby a creditor may challenge the transactions undertaken by its debtor – irrespective of its actual insolvency – which defraud the creditor's rights, even if such transactions are carried out before the preference period and subject only to the applicable statute of limitations (see the answers to question 8 below).
- 4.1.3 In light of the foregoing, a third party contracting with a company runs the risk that transactions entered into with the company during the preference period (or even before) may be voided on the basis of the actions described hereof.

4.2 Summary of heads of challenge

4.2.1 Bankruptcy claw-back procedure (*revocatoria fallimentare*)

4.2.1.1 The purpose of the bankruptcy claw-back action – which was significantly amended by the 2005 Bankruptcy Law reform – is to unwind certain transactions carried out by a company to the detriment of the generality of its creditors.

4.2.1.2 Compared to other jurisdictions, until the 2005 reform of the Bankruptcy Law, Italian claw-back rules were considered extremely favourable to bankruptcy trustees. Particularly, payments and transactions, including those at arm's length, could be voided by the Court upon request of the bankruptcy trustee, if made within one or two years prior to the bankruptcy declaration, depending on the circumstances. As a result of the 2005 reform, (a) the statutory preference periods have been shortened to six months and one year, respectively; (b) additional criteria to establish when transactions may be voided as transactions outside the ordinary course of business have been introduced; and (c) certain material exemptions from the claw-back action have been established. Consequently, the effectiveness of claw-back actions, in practice, has been significantly reduced.

4.2.1.3 The relevant preference period varies based on the specific transaction:

- (a) certain actions which fall within the ordinary course of business (i.e. conveyances for adequate consideration, payments of due and payable debts, and granting of security interests upon contracting a debt)⁹³ may be voided if (i) they have been carried out within six months prior to the opening of the bankruptcy proceeding, and (ii) the bankruptcy trustee proves that the company's counterparty had actual knowledge of the company's insolvency at the time of the transaction⁹⁴ (but see paragraph 4.2.1.4 below for possible exemptions);
- (b) certain actions which are outside the ordinary course of business (i.e. transactions for inadequate consideration, discharge of due and payable debts not made with cash or other normal means of payment, and pledges and mortgages granted for pre-existing debts not yet due and payable)⁹⁵ may be voided if they have been carried out within one year prior to the opening of the bankruptcy proceeding; the company's counterparty may avoid the claw-back by proving that it was not aware of the debtor's insolvency at the time of the transaction;
- (c) pledges and mortgages granted as security for due and payable debts may be voided if they have been granted within six months prior to the opening of the bankruptcy proceeding.⁹⁶ The company's counterparty may avoid the claw-back by proving that it did not have actual knowledge of the debtor's insolvency at the time the security was granted.

4.2.1.4 One of the most important innovations of the Bankruptcy Law reforms of the past few years has been the introduction of certain exemptions from bankruptcy claw-back.⁹⁷ Exempted transactions include the following:

- (a) payment of goods and services made in the ordinary course of business on customary market terms and conditions;
- (b) payment of salaries to employees;
- (c) transactions, payments, guarantees and security in the context of a Court-supervised composition with creditors (*concordato preventivo*), a restructuring agreement ratified by the Court (*accordo di ristrutturazione*) or a recovery plan assessed by the debtor's auditors (*piano attestato di risanamento*) and other transactions, payments, guarantees and security interests lawfully carried out or given after the filing of the application to access a *concordato preventivo*;
- (d) bank remittances to the extent that they did not materially and durably decrease the debtor's exposure towards the bank; and

⁹³ Article 67, para. 2, Bankruptcy Law.

⁹⁴ In the case of a legal entity (such as a corporation), knowledge is determined by reference to the knowledge of the directors or the officers who contracted with the counterparty. Knowledge may be proved by showing, through circumstantial evidence, that a person using normal diligence would have become aware of the insolvency, (e.g. through public notices of default on promissory notes or executive actions).

⁹⁵ Article 67, para. 1, Bankruptcy Law.

⁹⁶ Article 67, para. 1, Bankruptcy Law.

⁹⁷ Article 67, para. 3, Bankruptcy Law.

(e) sale agreements (or preliminary agreements) of real estate properties used by the purchaser (or its close relatives) for residential purposes, provided that the agreed consideration was fair and the agreement was registered at the Land Registry.

4.2.1.5 Transactions without consideration and early repayments of debts with a maturity date falling on or after the date of the bankruptcy declaration have no effect *vis-à-vis* the creditors, if made within two years prior to the opening of the bankruptcy proceeding.⁹⁸

4.2.1.6 As a general rule, the bankruptcy claw-back action is also available in the case of *amministrazione straordinaria*, but only if the procedure involves a sale of corporate assets (liquidation purpose).⁹⁹ In principle in the special form of *amministrazione straordinaria* (applicable to very large debtors),¹⁰⁰ the claw-back could be exercised even if the *amministrazione straordinaria* involves the implementation of a restructuring plan (recovery purpose); in practice, however, the actual availability of this extension is debated and the case-law is not entirely settled in favour of either interpretation.

4.2.2 Factoring claw-back

4.2.2.1 Law No. 93 of 21 February 1991 (the Factoring Law) sets forth the rules applicable to factoring transactions, i.e. the assignment to a financial institution of commercial receivables for a cash consideration.

4.2.2.2 Pursuant to Article 6 of the Factoring Law, the payment made by the assigned debtor to the assignee may not be subject to a bankruptcy claw-back under the Bankruptcy Law, unless the bankruptcy trustee proves that the assignor was aware that the assigned debtor was insolvent at the time the assignee made the payment of the assignment consideration.

4.2.2.3 Moreover, the Factoring Law provides for a special claw-back action. In particular, in case of bankruptcy of the assignor, the effectiveness of the assignment *vis-à-vis* the bankruptcy estate may be challenged by the bankruptcy trustee if he proves that the assignee was aware that the assignor was insolvent at the time the assignee paid for the assignment, provided however that such payment was made (i) no earlier than one year before the bankruptcy declaration of the assignor and (ii) before the maturity of the assigned receivable.

4.2.3 Ordinary claw-back procedure (*revocatoria ordinaria*)

4.2.3.1 Besides the specific bankruptcy claw-back action available *vis-à-vis* bankrupt debtors, the Civil Code¹⁰¹ grants creditors a general right to challenge transactions that defraud their rights. This remedy is available to any creditor, regardless of the actual status of insolvency of the debtor. However, once the bankruptcy proceeding has been opened, only the bankruptcy trustee is entitled to bring this type of action on behalf of all creditors.

4.2.3.2 The requirements for the *revocatoria ordinaria* are (a) the existence of a damage to the creditor and (b) actual knowledge by the debtor and by the third party of the damage caused to the creditor. If the detrimental transaction occurred before the creditor's right arose, the plaintiff must provide evidence that such transaction was intentionally performed by the debtor – with the participation of the third party – to harm the creditor's rights. However, the *revocatoria ordinaria* can be quite a lengthy procedure and the burden of proof upon the plaintiff is difficult to meet.

4.3 Credit in the twilight period

4.3.1 Italian law does not preclude directors or other officers from incurring further credit during the twilight period, but rather punishes their conduct when specific circumstances show that the reasons for a particular transaction are not in the interest of the company or may otherwise be considered as an act of mismanagement. Accordingly, one should not conclude that incurring further credit during the twilight period is per se likely to be sanctioned by the Italian courts.

⁹⁸ Articles 64 and 65, Bankruptcy Law. Strictly speaking, these transactions and payments, rather than being subject to claw-back, are ineffective by operation of law.

⁹⁹ Article 49, Legislative Decree No. 270 of 8 July 1999.

¹⁰⁰ Namely the special extraordinary administration introduced in 2003 in the wake of the Parmalat crisis and then applied to other large insolvencies, including Alitalia and ILVA (see para. 1.1.4.1 above).

¹⁰¹ Article 2901, Civil Code.

- 4.3.2 However, strict scrutiny will normally be adopted in considering transactions entered into when a company faces financial difficulties. Moreover, from a criminal law perspective, any directors, general managers and liquidators who incur or continue to incur further credit, concealing the status of insolvency of the company, will be punished by imprisonment from six months up to three years.¹⁰²
- 4.3.3 In light of the foregoing, directors and other officers must take an extremely prudent approach when considering whether to incur further debt in the twilight period (in particular in circumstances where a Court may deem the company already insolvent, as opposed to simply having financial troubles).
- 4.3.4 However, experience has shown that new credit for a distressed debtor is not necessarily against the interests of the company's creditors, to the extent new finance helps preserve the value of the debtor's assets, or the continuity of its operations.
- 4.3.5 The recent reforms have therefore sought to clarify the legal framework within which new credit could legitimately and effectively be incurred by distressed debtors. After a first attempt in 2009 to legislate on the circumstances in which, outside any insolvency procedure, a debtor could borrow funds,¹⁰³ in 2012 the Italian legislator introduced incentives in favour of new credit in the context of *concordato preventivo* or in the process leading to the Court ratification of a restructuring agreement. In both circumstances, the need for the prior authorization of the Court has been regarded as a sufficient protection for lenders and creditors as to the suitability and appropriateness of new debt being incurred by the debtor.
- 4.3.6 More particularly, immediately upon filing for a *concordato preventivo* (including in the case of a "blank" application)¹⁰⁴ or later on up until filing of the plan and admission to the proceedings, the debtor may seek Court authorization to obtain interim financing and grant any necessary collateral. The application must be accompanied by a certification from an independent expert that the relevant financing would enhance the creditors' recovery prospects. Any such loans will benefit from "priority" ranking in a subsequent bankruptcy of the debtor.¹⁰⁵ However, based on initial case law (this provision was introduced in 2012), it appears that a number of courts are reluctant to grant such authorization if the *concordato* application, in the context of a "blank filing" application, fails to provide sufficient details on the terms of the *concordato* proposal and the plan which the debtor intends to file.
- 4.3.7 With a view to overcoming such reluctance and thereby increasing the chances of success of *concordato* proceedings, the 2015 reform added (without repealing the interim financing rules discussed above, which continue to be an option) new provisions on "urgent" financing. Under the new rules, a debtor may request the Court to authorize financing to fund urgent business needs of the debtor during the preparatory phase. Unlike interim financing (see paragraph 4.3.6), the new rules for urgent financing do not require any certification from an independent expert. The debtor, however, needs to show that (i) it is otherwise unable to obtain the funds and (ii) without the financing during the preparatory phase, its business would suffer "serious and irreparable harm". Because of the urgency of the debtor's needs, the Court must decide on the request within 10 days and, to such end, it may hear the judicial commissioner, if already appointed, and the main creditors. As for interim financing, claims of providers of authorized urgent financing benefit from "priority" ranking in case of subsequent bankruptcy of the debtor.

¹⁰² Articles 218 and 225, Bankruptcy Law.

¹⁰³ Article 182-*quater* of the Bankruptcy Law provides that funds provided to the debtor prior to filing for *concordato* or applying to the Court for ratification of a restructuring agreement, to the extent such funds are instrumental to the above filing or application, rank as super-priority claims in case of subsequent bankruptcy of the debtor, provided that the Court, upon ruling on the debtor's application, confirms the super-priority status. In other words, lenders would be lending to a debtor in the twilight period without any formal protection until the (possible) confirmation from the Court. The resulting uncertainty has therefore undermined the success of this provision.

¹⁰⁴ See para. 1.1.7.5, above.

¹⁰⁵ Similar rules apply in case the debtor applies to the Court to obtain the ratification of a restructuring agreement.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

- 5.1 In the case of an insolvency proceeding, the action for damages against directors, members of the board of statutory auditors and of the supervisory board, general managers, *de facto* directors, external auditors and liquidators may only be brought by the bankruptcy trustee¹⁰⁶ (or by the extraordinary commissioner in the *amministrazione straordinaria*). The same rule applies to actions against parent companies and their directors for damages suffered by the subsidiary's creditors.¹⁰⁷
- 5.2 Actions against the sole shareholders (see paragraph 3.7) or to shareholders exercising a backup business (see paragraph 3.8) pertain to individual creditors of the insolvent company or of the business respectively: the trustee may not exercise them collectively. In the latter case, however, the insolvent company might also be a creditor of the backup business, whereupon the action will pertain to the bankruptcy trustee.
- 5.3 In the event of bankruptcy of a Directed Company, the action inuring to the creditors as described above (see paragraph 3.10.3) can only be exercised by the bankruptcy trustee.¹⁰⁸
- 5.4 The Reform Bill would repeal Article 2394-*bis* of the Civil Code, pursuant to which the actions against the company's directors in case of bankruptcy or extraordinary administration proceedings may only be brought by the bankruptcy trustee or extraordinary commissioner.
- 5.5 With the exception of the action referred to under paragraph 5.3 above, even during insolvency proceedings, nothing prevents individual creditors and other third parties from suing directors and other persons (see question 3 above) for damages personally and directly received as a consequence of the latter's actions or omissions, when the action is based upon general tort law principles (see paragraph 3.11.2).

QUESTION 6

6. Remedies available

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

- 6.1 For causes of action outlined under paragraphs 2.1, 2.2, 2.3, 3.1, 3.2, 3.3, 3.4, 3.5, 3.6, 3.9, 3.10, 3.11 and 3.12, liability is civil and extends only to actual damages with a causal link to the defendant's actions or omission, subject to the qualifications provided above. For causes of action described above under paragraphs 3.7 and 3.8, the shareholders are personally liable for the company's or the business's debt.
- 6.2 As mentioned at paragraphs 4.2.1 and 4.2.3 above, the *revocatoria fallimentare* and the *revocatoria ordinaria* are aimed at obtaining avoidance of the transaction under challenge. As a consequence of such avoidance, the goods that have been transferred from the company to third parties or their proceeds must be returned and creditors are admitted, as unsecured creditors, to the bankruptcy proceedings for a corresponding amount.

¹⁰⁶ Article 146, Bankruptcy Law.

¹⁰⁷ Article 2497, Civil Code.

¹⁰⁸ *Ibid*, para. 4.

- 6.3 Penalties for criminal bankruptcy and fraudulent bankruptcy have been described under paragraph 2.4 above. According to general principles, a person found liable for a criminal offence may also be held liable for civil damages caused to third parties by his conduct; the final decision of a criminal Court is binding on a civil Court adjudicating a civil liability case if such decision is rendered after a full trial.
- 6.4 No disgorgement of profit remedy is available under Italian civil law. By contrast, under criminal law, the Court may order the forfeiture of the profits resulting from the crime.

QUESTION 7

7. Duty to co-operate

- (a) **To what extent are directors and others identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

7.1 Obligation to commence insolvency proceedings

- 7.1.1 When a company faces an insolvency situation, the directors or liquidators must file a petition for a bankruptcy declaration, or commence another insolvency procedure. Failure to do so could result in criminal liability (see paragraphs 1.2.2 and 2.4).
- 7.1.2 As discussed at paragraph 1.3, the Reform Bill may have a material impact on the existing rules, by introducing active and express obligations for the directors to take action as soon as they are aware of a situation of distress and extending a reporting obligation to auditors and certain qualified creditors.

7.2 Participation in the initial steps of the proceedings

Before the bankruptcy declaration, the bankruptcy Court shall carry out a preliminary investigation in order to assess the insolvency situation. As part of such preliminary investigation, the Court must summon the company’s directors.

7.3 Personal duties after the bankruptcy declaration

Once the company has been declared bankrupt, the directors and liquidators are subject to certain obligations. In particular, they must inform the bankruptcy trustee of any change to their residence or domicile. If information or clarifications are needed in connection with the bankruptcy procedure, the directors and liquidators, if so requested, must appear before the judge in charge of the bankruptcy proceeding, the bankruptcy trustee or the creditors’ committee. In case of impediment or other justified reason, the judge in charge of the bankruptcy proceeding may authorise the director and liquidators to appoint an attorney-in-fact to appear on their behalf.¹⁰⁹

7.4 Obligation to co-operate during the bankruptcy proceeding

- 7.4.1 Given that the directors of a bankrupt company are often best placed to know and understand the company and its activities, their collaboration with the bankruptcy Court and with the officers appointed to conduct the bankruptcy proceedings is invaluable. Italian law thus provides for the close involvement of the company’s directors in the proceedings.
- 7.4.2 Beside the general duties described under paragraph 7.3 above, the directors have certain specific obligations such as the following:

¹⁰⁹ Articles 146 and 49, Bankruptcy Law.

- 7.4.2.1 Immediately after the bankruptcy declaration, the bankruptcy trustee shall draw up a report of the assets of the company, and before completing the report he shall ask the directors whether they are aware of any assets which have not already been included in the report. The directors must provide a response, and if they fail to do so, they may incur criminal liability.¹¹⁰
- 7.4.2.2 The directors are heard by the judge delegated to oversee the drawing up of the lists of creditors' claims and attend the meeting scheduled for the verification of such claims.
- 7.4.2.3 The general criminal law principle, according to which an indicted person has the right to remain silent during the prosecution,¹¹¹ also applies to the company directors charged with the crimes described under paragraph 2.4.

7.4 Human rights

- 7.4.1 Italy is a contracting party to the European Convention for the protection of Human Rights and Fundamental Freedoms (Treaty of Rome dated 4 November 1950, the Convention), the provisions of which were incorporated into Law No. 848 of 4 August 1955.
- 7.4.2 The persons identified in the response to question 3 above will thus be entitled to rely upon the rights contained in the Convention (the Convention Rights). This is the case whether such persons are individuals or companies. In a bankruptcy context, a legal representative, director or other person entitled to Convention Rights under the Convention will be able to:
 - (a) require that a particular provision of insolvency law is construed in accordance with such Convention Rights or otherwise declared incompatible; or
 - (b) claim that judicial bodies are a public authority and are acting unlawfully in breach of that person's Convention Rights.
- 7.4.3 In the context of bankruptcy proceedings, and the duty 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 – the right to respect private and family life;
 - (d) Protocol 1, Article 1 – the right to peaceful enjoyment of possessions.
- 7.4.4 Case law on the application of the Convention to bankruptcy proceedings is, however, particularly scarce in Italy.

QUESTION 8

8. Appeals and limitation periods

- (a) **What limitation period, if any, applies to the actions referred to above?**
- (b) **What rights of appeal are available from the decision of the lower Court?**

8.1 Statute of limitations

¹¹⁰ Articles 87 and 220, Bankruptcy Law.

¹¹¹ Article 64, Criminal Procedure Code.

- 8.1.1 The statute of limitations for:
- (a) actions for damages against directors, statutory auditors, members of the supervisory board, general managers, voluntary liquidators, external auditors, and *de facto* directors, when based upon violations of their duties to the corporation, is five years from the date when the relevant person has ceased from office;¹¹²
 - (b) actions for damages against directors, general managers, statutory auditors, voluntary liquidators, external auditors and *de facto* directors, when based upon violations of their duties to creditors (2.2.5), is five years from the date when the damage has occurred,¹¹³ i.e. according to case law, from the date when the company's assets have become insufficient for the payment of the company's debts (this can be a date prior or subsequent to that in which the Court declares the company insolvent, although courts tend to presume that the two dates coincide). According to some Court decisions, if the defendant has ceased from office after the company's assets have become insufficient, the five-year period starts from the termination date;
 - (c) actions for damages against SRL directors and shareholders (paragraphs 2.2 and 3.9), is five years from the date when the damage has occurred.¹¹⁴ However, if, as is usually the case, the damage occurs before directors leave office, the five-year period starts from the termination date;
 - (d) all actions for damages described under questions 2 or 3 above which are based upon tort law principles, is five years from the date of the harmful act or omission.¹¹⁵
- 8.1.2 Sole shareholders are liable for the debts of their company in special circumstances (paragraph 3.7). Similarly, shareholders exercising a back-up business are liable for the debts incurred in such activity. Actions against them can be brought so long as the relevant claims, whether stemming from a contract or from tort, are not statute barred. Subject to specific exceptions, the statute of limitations for actions relating to claims arising from a contract is 10 years, while it is five years, as mentioned, for tort claims.
- 8.1.3 The majority of commentators hold that the liability of Directing Entities (see paragraph 3.10) is a specification of general tort law principles. If this is so, then the statute of limitations for such actions for damage is also five years. Otherwise, if liability is deemed to be contractual in nature, the statute of limitations is 10 years.
- 8.1.4 The statute of limitations for the *revocatoria ordinaria* is five years from the date when the transaction being challenged is carried out, whereas the statute of limitations for the *revocatoria fallimentare* is the earlier of three years from the date of the bankruptcy declaration and five years from the date of the challenged transaction.
- 8.1.4 According to the general rules of Italian criminal law, the statute of limitations for criminal offences depends on the applicable sanctions. Accordingly, the statute of limitations for *bancarotta semplice* and for *bancarotta fraudolenta*, under normal circumstances, is five and 15 years respectively.
- 8.2 Appeals**
- 8.2.1 Any decisions rendered by lower courts are subject to appeal on the merits, and the decisions of the courts of appeal are subject to revision by the Supreme Court, but only on the basis of violation of law.

¹¹² Articles 2393, 2396, 2407, 2489, Civil Code; Art. 223-septies, *Disposizioni di Attuazione del Codice Civile*; Art. 164, Legislative Decree No. 58 of 25 February 1998. Whether the action becomes time-barred as a result of the expiry of the relevant period can be ascertained by the Court in case, despite such expiry, the action is brought thereafter.

¹¹³ Article 2949, Civil Code; Art. 223-septies, *Disposizioni di Attuazione del Codice Civile*; Art. 164, Legislative Decree No. 58 of 25 February 1998.

¹¹⁴ Article 2949, Civil Code.

¹¹⁵ Article 2947, Civil Code.

QUESTION 9

9. Foreign corporations

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

- 9.1.1 In general, Italian company law applies to companies incorporated in Italy and to companies incorporated abroad having their administrative seat or their principal place of business in Italy.¹¹⁶ Therefore, the liability actions described above and based upon company law provisions¹¹⁷ may be brought against such entities' directors and other relevant persons.
- 9.1.2 As a general matter, it is doubtful whether, in light of the Centros case,¹¹⁸ the conflict of law rule described under paragraph 9.1 above would withstand scrutiny from the European Court of Justice with respect to companies incorporated in other EU jurisdictions.
- 9.2 According to international private law principles, Italian tort law applies if the harmful event has occurred in Italy.¹¹⁹
- 9.3 It is debated whether provisions on Directing Entities' liability apply to foreign directing entities as well. As previously highlighted, it is also uncertain whether such entities' liability for undue influence upon their subsidiaries is an application of general tort law principles. Arguably, if it is indeed an application of such principles, then the rule described under paragraph 9.2 above should apply. If it is, instead, part of company law, then the rule described under paragraph 9.1 above should apply.
- 9.4 With regard to liability of shareholders exercising a back-up business, the citizenship or nationality of the shareholders is irrelevant, provided that, according to conflict of bankruptcy law rules, their business may be declared insolvent by an Italian Court (see paragraph 9.5 below).
- 9.5 Pursuant to Article 9 of the Bankruptcy Law, the bankruptcy procedure applies not only to companies having their principal place of business in Italy, but also to companies having their principal place of business abroad but operating in Italy. The commencement of bankruptcy proceedings abroad will not prevent the commencement of bankruptcy proceedings against the same company in Italy.
- 9.6 Once jurisdiction has been accepted by an Italian Court, all judicial remedies provided by Italian law will be available.
- 9.7 At European Union level, Council Regulation No. 1346/2000 sets forth the rules governing cross-border insolvency proceedings "which entail the partial or total divestment of a debtor and the appointment of a liquidator." Pursuant to Article 3 of such Regulation, the courts of a Member State within the territory of which the centre of a debtor's main interests (COMI) is situated shall have jurisdiction to open insolvency proceedings, whereas the courts of another Member State shall have jurisdiction to open insolvency proceedings against the debtor only if it possesses an establishment within the territory of that other Member State, and the effects of those proceedings (the so-called "secondary proceedings") shall be restricted to the assets of the debtor situated in the territory of the latter Member State.¹²⁰

¹¹⁶ Article 25, Law No. 218 of 31 May 1995.

¹¹⁷ See paras. 2.2, 2.3, 3.1, 3.2, 3.3, 3.4, 3.5, 3.6, 3.7 and 3.9 above.

¹¹⁸ See Cases C-212/97, *Centros Ltd v Ehtvers-og Selskabsstyrelsen*, 1999 E.C.R. I-1459; C-208/00, *Überseering v Nordic Construction Company Baumanagement GmbH (NCC)*, 2002 E.C.R. I-9919; C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd*, ECR I-(30.9.2003).

¹¹⁹ Article 62, Law No. 218 of 31 May 1995.

¹²⁰ Regulation 1346/2000 is due to be replaced by Regulation (EU) 2015/848 of the EU Parliament and Council of 20 May 2015. The recast regulation will apply to insolvency proceedings opened from 26 June 2017 and, among other the key changes to the existing rules, it will (i) focus on restructuring and pre-insolvency proceedings (as opposed to insolvency liquidation proceedings), attempt to clarify the COMI location (regular administration of interests; third parties' perception) and avoidance of instrumental COMI shifting (prior 3 months); re-define the relationship between main and secondary proceedings (which may now be restructuring proceedings), with the introduction of "undertaking" proceedings (i.e. proceedings opened in the country where secondary proceedings could be opened, pursuant to which the insolvency practitioner would undertake to distribute proceeds of assets in accordance with the rules applicable to secondary insolvency proceedings without the need to formally open the latter) and (iv) attempt to address group insolvencies through an enhanced co-ordination among insolvency proceedings opened in different Member States but relating to companies belonging to the same group.

- 9.8 The law applicable to insolvency proceedings and their effects (i.e. the conditions of their opening, their conduct and their closure) shall be that of the Member State within the territory of which such proceedings are opened.¹²¹ The Regulation also contains specific provisions for creditors' claims.
- 9.9 The law of the State of the opening of proceedings also determines the rules relating to the voidability or unenforceability of legal acts detrimental to all creditors. However, such rule does not apply where the person who benefited from an act detrimental to all the creditors proves that (a) the said act is subject to the law of a Member State other than that of the State of the opening of proceedings, and (b) such law does not allow any means of challenging that act in the relevant case.

QUESTION 10

10. Insurance

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

- 10.1** Directors' and officers' insurance policies covering the exposure of directors of Italian corporations are available in the Italian insurance market. First introduced in the US and UK in the late fifties and in civil law countries in the late seventies, these types of insurance started to materialise in Italy in the early nineties. In most cases, insurance policies are not executed by the directors, but rather are entered into by the company on behalf of its directors.
- 10.2** In practice, while insurance companies are generally willing to cover the liability of directors *vis-à-vis* the company's creditors and shareholders as well as third parties directly damaged, they are not always available to cover the directors' liability *vis-à-vis* the company. Insurance policies typically cover the directors' civil liability resulting from faults, errors, omissions, mistakes and erroneous interpretations of legal or regulatory provisions. Insurance policies will always exclude any form of fraudulent behaviour, whereas coverage for actions which are the consequence of gross negligence can be negotiated.
- 10.3** In light of the 2003 company law reform, it is debatable which is the competent corporate body of the company that should resolve on the execution of insurance policies for and on behalf of company directors. According to the majority of Italian scholars such insurance policies constitute a form of compensation and, therefore, they must be approved by the shareholders, unless they refer to directors vested with special powers in compliance with the by-laws, in which case the relevant resolution is entrusted with the company's board of directors. If provided by the by-laws, the general meeting may establish a cap for the aggregate remuneration of all directors, including those vested with special powers.

The information provided in this country chapter is correct as at 31/01/2017

¹²¹ Article 4, Regulation No. 1346/2000.

JAPAN

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Identification and definition of directors

The directors of a stock company are elected by a resolution of its shareholders in a general meeting, constituting the body executing operations for that company. The relationship between the directors and the company is based on a contract of engagement (mandate). A director may not assert his status as a director of a company against a third party, unless such status has been registered. In the same manner, the resignation of a director may not be asserted against a third party, unless such resignation has been registered. Further, the number of directors may not be reduced below the number set forth in the company's articles of incorporation. A substitute director should be elected in advance of the resignation of a director to prevent the number of directors falling below the prescribed number. A director may resign at any time, however, where the resignation causes the number of directors to go below the foregoing minimum number of directors, he/she continues to assume the same rights and obligations as those of the other directors up until his successor is elected.

1.2 Time frames that apply

The Bankruptcy Act of Japan does not specify a so-called "twilight period." The Bankruptcy Act currently in force was enacted after major amendment as of 1 January 2005. Despite a number of subsequent minor amendments, the "twilight period" has not been specified. In many cases, when a company becomes insolvent and its insolvency is to continue, it is likely that the "twilight period" starts.

However, the right of avoidance, prescribed in Bankruptcy Act, may have an impact on some acts conducted prior to the commencement of bankruptcy proceedings. The Bankruptcy Act prescribes a number of acts that, if taking place before the commencement of bankruptcy proceedings is ordered, a bankruptcy trustee may exercise the right of avoidance to nullify under certain constraints. Acts which may be nullified is discussed below.

1.3 Acts potentially giving rise to liability

1.3.1 Avoidance of acts that the bankrupt conducted and were prejudicial to creditors (excluding acts concerning the provision of collateral or extinguishment of debt) (avoidance of prejudicial acts), which include:

- (i) acts conducted by the bankrupt while knowing that such acts would prejudice creditors (Item (i) of Paragraph 1 of Article 160);
- (ii) acts that were conducted after the bankrupt had suspended the payments or a petition for commencement of bankruptcy proceedings had been filed, and that would prejudice creditors (item (ii) of paragraph 1 of Article 160, and paragraph 2 of Article 160); and
- (iii) acts disposing of properties for an unreasonable consideration (Article 161).

1.3.2 Avoidance of acts concerning the provision of collateral or extinguishment of debt conducted by the bankrupt after they had become unable to pay debts or a petition for commencement of bankruptcy proceedings had been filed (avoidance of acts based on preference) (Article 162), only on the condition that the beneficiary of such an act was aware of the relevant prejudice.

- 1.3.3 The provision of collateral or extinguishment of debt, which is not included in the scope of the bankrupt's obligation and was conducted after, or within 30 days before, he had suspended the payments or a petition for commencement of bankruptcy proceedings had been filed, only on the condition that the beneficiary of such an act was not aware of the relevant prejudice and bears the burden of proof to establish the lack of such awareness (item (ii) of paragraph 1 of Article 162).
- 1.3.4 Any act deemed to be a gratuitous act conducted by the bankrupt after, or within six months before, he/she had suspended his payments or a petition for commencement of bankruptcy proceedings had been filed (paragraph 3 of Article 160).
- 1.3.5 In cases falling within 1.3.2 -1.3.4), even where the beneficiary of an act by the bankrupt was aware of the bankrupt's suspension of payments, if it was conducted not less than one year before the date of the filing of a petition for commencement of bankruptcy proceedings, such act may not be nullified on the ground that the beneficiary was aware of the bankrupt's suspension of payments (Article 166).

Aside from the above provisions, the general provisions of the above Act concerning the period for exercise of the right of avoidance (Article 176 of the Bankruptcy Act) is relevant to the application of the right of avoidance. Further, in practice, the right of avoidance is often not actually exercised after the prospect of successfully proving relevant facts has been taken into account, or from the aspect of recoverability. According to practitioners, if a relevant act is conducted after suspension of payments or immediately prior to the filing for bankruptcy (depending upon the case, approximately within one month prior to the filing), the probability that such act will be avoided is considered relatively high in many cases. The provision concerning the one year limitation in (e) above sets down the time limit for the exercise of the right of avoidance under the circumstances of (b), (c) or (d). Still, in the other circumstances, it is possible to exercise the right of avoidance in relation to an act conducted more than one year ago, where there is a prospect of proving the requirement of subjectivity on the part of the person who committed the act concerned. In that case, it is not likely that the trustee in bankruptcy hesitates to exercise the right.

The period during which the right of avoidance may come at issue is not directly connected with directors' and officers' liability. Nevertheless, directors, etc. are likely to be held liable where company properties have been reduced because of the sale of its properties at disproportionately low prices during the period between the company becoming insolvent or likely to become insolvent and its filing for bankruptcy. Additionally, directors, etc. are also likely to be held liable where company conducts transactions such as loans or the purchase of goods without expectation of performing its duties under those transactions or its payment. Nonetheless, in many cases, when a company has gone bankrupt, it is likely that its directors, especially the representative directors, have become personally bankrupt since representative directors often personally guarantee part of their company's liabilities. On this basis, they may not be called to account since there is no prospect of recoverability. The current Bankruptcy Act prescribes provisions concerning the assessment of officers' liability (Articles 177 to 181 of the Bankruptcy Act), enabling a trustee in bankruptcy to promptly take action to call into question the civil liability of the company's directors and other officers. In initiating these proceedings, a trustee in bankruptcy may now make a petition for provisional seizure or injunction of defendant directors' (officers') properties.

To establish some of the crimes in the Act it is necessary to prove the status or actual fact of being insolvent (unable to pay due and payable debts) or suspension of payments, or liabilities exceeding the assets in the case of corporations, or require such crimes to take place during a period in which it is objectively probable that such status or fact arises. Among the penal provisions of the Act, the ones relevant to this question are as follows:

- 1.3.6 Acts concealing or damaging the bankrupt's properties, acts disposing of such properties in a manner disadvantageous to creditors, and acts falsely increasing the bankrupt's debts fall under the crime of fraudulent bankruptcy, which is punishable by imprisonment with work for not more than ten years or a fine of not more than ten million yen, or both (items (i) and (ii) of Article 265 of the Bankruptcy Act).
- 1.3.7 With regard to the debtor's debt to a specific creditor, acts concerning the provision of security or extinguishment of debt that is not included in the scope of the debtor's obligation for the purpose of harming other creditors fall under the crime of providing security to specific creditors, etc., which is punishable by imprisonment with work for not more than five years or a fine of not more than five million yen, or both (Article 266 of the Bankruptcy Act).

Other than the Bankruptcy Act, in connection with this question, the Companies Act includes provisions concerning both civil and criminal liability.

1.4 Liability of parties

- 1.4.1 When a director, an officer or an employee of a company, in breach of his duties and for the purpose of promoting his own interest or the interest of a third party or inflicting damage on the company, commits an act potentially causing damage to the company, such act falls under the crime of aggravated breach of trust, which is punishable by imprisonment with work for not more than ten years or a fine of not more than ten million yen, or both (paragraph 1 of Article 960 of the Companies Act). Any attempt of such act is punishable, even where such attempt has failed (Article 962 of the Companies Act).
- 1.4.2 If a director neglects his duties, he will jointly and severally or individually be liable to his company for damages arising as a result thereof (paragraph 1 of Article 423 of the Companies Act). Such director's liability may be limited where he has acted in good faith or without gross negligence (Article 425 of the Companies Act). An exemption from such liability may be given if there is a resolution of shareholders in a general meeting. However, even where a director is exempted from part or all of his liability, the effect of the Bankruptcy Act may potentially set aside the exemption if bankruptcy proceedings are commenced later with regard to his company.
- 1.4.3 Directors are jointly and severally or individually liable to a third party for damages arising from their performance of an act in bad faith or with gross negligence (paragraph 1 of Article 429 and Article 430 of the Companies Act).

In reality, it is rare for a person to be held criminally liable on the basis of the penal provisions of the Bankruptcy Act. Rather, it is more likely that criminal liability is pursued on the basis of the Companies Act or other Acts. With regard to civil liability, persons whose rights are violated are likely to seek relief measures on the basis of the Companies Act or other Acts.

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 the director?
- (b) In relation to each act identified in (a) above:-
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?
 - (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 Twilight period

During the period between the company becoming insolvent or predictably becoming insolvent and its filing for bankruptcy, a director may possibly be held personally liable for acts, which reduce the assets of the company or have no expectation of performing company's duty under the transaction such as payment. If the transfer of properties is implemented without any consideration or for an extremely low consideration for the purpose of benefiting a specific creditor or if the company arranges loans during the aforementioned period, it is likely that a director is called to account for such transaction.

2.2 Acts potentially giving rise to liability

A director may be held liable under civil law as well as criminal law. With regard to civil liability, a director is held accountable on the basis of the Company's Act and/or the Civil Code. Aside from the civil liability, it is common practice in Japan that the representative directors of many small- and mid-sized businesses personally guarantee part of their companies' liabilities. In this case, such directors assume contractual responsibility for the individual corporate borrowings as joint guarantors. For this reason, in many cases, when a company goes bankrupt, its representative director is also made personally bankrupt. Therefore, pursuing the civil liability of such director has no benefit for creditors. In the case of larger companies managed by a greater number of directors, it is not usual for representatives and directors to give personal guarantees. That is where the significance of this question lies. In such a case, pursuing the civil liability of directors is meaningful.

The civil liability of a director for damages is based on the Companies Act. When a director is found in breach of the obligation of due care of a prudent director, he will be liable for all actual damages caused thereby to his company as long as the causal connection between the breach and the damage exists. In addition, where such director is also found to have acted in bad faith or with gross negligence, he will be liable for damages caused to any third party other than the company, for example creditors.

Directors participate in meetings of the board of directors and sign the minutes of the meetings. Accordingly, among directors, all of those in breach of the obligation of due care of a prudent director will be held jointly and severally or individually responsible for results of resolutions made in board meetings, unless they have expressed and recorded their dissenting opinions in these meetings. However, actual Court cases to pursue directors' liability often explore a possible amicable settlement; if this is the case, their liability may be apportioned among them according to the degree of involvement.

As above, when a person other than a trustee in bankruptcy is to pursue the civil liability of a director, it is necessary to do so on the basis of other acts such as the Companies Act. Although the twilight period, during which the risk of avoidance and personal liability is greater, is not clear, the period of extinctive prescription, according to the Civil Code of Japan, for compensation claims against directors on the basis of the Companies Act is construed, by judicial precedents, to be 10 years, which extends to claims with regard to directors' personal liability. However, as explained in the answer to Question 1 above, the risk that directors will be held liable during the twilight period becomes greater during the period between the company becoming insolvent or likely to become insolvent and its filing for bankruptcy, which means the period during which transactions reduce the company's properties to be distributed after it goes bankrupt.

With regards to criminal liabilities, if the act concerned was conducted within the normal scope of the company's operations, the person who conducted the act will not be, in principle, held criminally liable for the act concerned, unless such person conducted the act with the knowledge that the company was unable to pay its debts or insolvent. With regard to civil liabilities, an effective defence is to claim the application of the business judgment rule, which means directors shall not become liable if the judgment to conduct transactions concerned has been made fundamentally on an informed and no wasteful basis.

QUESTION 3

- 3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period**
- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?**
 - (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?**
 - (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?**

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

- (a)** The liability for damages on the basis of the Companies Act is principally based on liability applicable to key officers of that company, such as directors and statutory auditors. However, there is a judicial precedent, finding that a person who was not a director but practically the founder of the company concerned at the time of the relevant act had the power to make decisions on important internal and external matters of the company, and that this person, albeit being a third party, assumed liability pursuant to Article 429 of the Companies Act. With regard to criminal liability, in addition to directors and statutory auditors, some persons in managerial positions (those registered as having the right to represent their company) may be accused of the crime of aggravated breach of trust. Under the provisions of the Companies Act explained in the answer to Question 1 above, the scope of persons potentially subject to criminal liability is wide; an employee without an authority to execute a business may be subject to criminal liability if specified duties are assigned to this employee and he/she has acted contrary to such duties. The main parties potentially liable to third parties in connection with the twilight period are limited to director and statutory auditors; in the case of a company with a nominating committee, its executive officers are also included as such parties.
- (b)** There is no difference between directors and other persons or organizations in relation to acts that give rise to liability.
- (c)** The determination of liability is as stated in 2.2 (ii) above.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?**
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?**
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?**

4.1 Basis for setting aside transactions

- (a)** The types of acts that, if taking place before the commencement of bankruptcy proceedings, a bankruptcy trustee may exercise the right of avoidance to nullify under certain constraints are described above in 1.2. The elements in determining whether a particular act is void or not are whether at the time of the acts or immediately after the acts: (i) the company become insolvent; (ii) the acts reduce the assets of the company or constitute unfair payment or provision of

collateral to a specific creditor; or (iii) one of the parties or both parties to a transaction concerned were aware of the relevant company's status of insolvency or inability to pay debts, suspension of payments, or petition for bankruptcy.

In addition, the bankruptcy trustee may examine not only the acts which may be set aside as explained in the answer to Question 1 above, but also all contracts to which the company is a party. Further, in the case of a bilateral contract under which both the company and the counter party have not yet completely performed their obligations, the trustee in bankruptcy has the power to decide whether to cancel the part of such bilateral contract that is yet to be completed (Article 53 of the Bankruptcy Act).

- (b) There are limited defences available in relation to Court cases to nullify acts during the twilight period; generally, it depends on whether the counter party or the beneficiary was aware of the company's status of being bankrupt. When it is clear that the counter party knew it at the time of the relevant act, it is difficult to argue against the avoidance of such act. In particular, if the person who conducted such act is a relative or an officer of the bankrupt, such person is presumed to have known the company's status of being bankrupt, which renders a defence even more difficult.
- (c) In bankruptcy proceedings in Japan, a trustee in bankruptcy is appointed at the same time as the Court's order for commencement of bankruptcy proceedings. Until a bankruptcy trustee is appointed, all the authority and responsibility to manage the relevant company's business operations remains with its existing executive organs such as the board of directors of the company and appointed officers. On this basis, it is necessary to consider their fiduciary duties to the company. Aside from whether assuming new obligations leads to an increase in risk, whether such assumption is necessary for the company or not is relevant. If new obligations are regarded as within the scope of the company's normal operations and thus as necessary for the company, the board of directors and/or corporate officers normally find it necessary to assume such obligations. However, in reality, when a company becomes bankrupt, a bankruptcy trustee investigates the factual situation concerning transactions made during the twilight period. Furthermore, the results of such investigation differ in each case.

For almost all small and mid-sized enterprises in Japan, their owners serve as chief executive officers as well as representative directors. As a result, they personally guarantee a large part of their companies' debts. When such representative directors assume new obligations during the twilight period, such assumption is deemed to be natural as long as they act in the interest of their respective companies. For this reason, even when a director makes a decision to have his company accept a new obligation, his responsibility is not normally considered to go beyond the scope of responsibility under the contract associated with such obligation, unless his act gives rise to the criminal or civil liability explained above. Nonetheless, in relation to creditors without knowledge, the aforementioned persons involved in management are required to assess the debtor's capacity to pay their debts, including their company's capacity to make payments. Therefore, although the assumption of new obligations itself may not be a bad judgment, it appears difficult to leap over the hurdle of "not being aware, in advance, of the possibility that the effectiveness of the act concerned would be set aside and nullified in the future."

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

In relation to the criminal acts in the Bankruptcy Act and the Companies Act, the authority to bring a criminal action against the directors and other persons included in Question 3 above is limited to the public prosecutor.

On the other hand, in relation to the civil liability of a director to his company on the basis of Article 423 of the Companies Act, until an order for commencement of bankruptcy proceedings is issued, this authority lies with the company's statutory auditor. However, after the commencement of bankruptcy proceedings, the company's bankruptcy trustee has sole authority to bring an action as part of bankruptcy proceedings. Even if a bankruptcy trustee has not implemented relevant legal procedures after an order for the commencement of bankruptcy proceedings has been made, shareholders are construed as not being able to bring shareholder derivative actions.

A creditor who has suffered damage may bring an action on the basis of third-party liability in Article 429 of the Companies Act. The Bankruptcy Act stipulates a system to assess directors' liability for damages, which can co-exist with individual creditors taking action against directors. In Japan, there is no system that enables bankruptcy trustees and creditors to cooperate with each other in carrying forward procedures.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

In addition to the details covered in the answers to Questions 1 to 4 above, the Companies Act provides a system for an auditor to demand injunctions barring illegal acts, which is available at ordinary times before the commencement of bankruptcy proceedings. After the commencement of such proceedings, potential remedies include a provisional order that a bankruptcy trustee can use to make his planned future exercise of the right of avoidance effective, and the exercise of the right of cancellation where both parties to a contract in question have yet to complete some part thereof.

QUESTION 7

7. Duty to co-operate

- (a) **To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder's investigation into the company's affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

7.1 Extent to which directors are obliged to co-operate with the insolvency officer

Upon the request of a bankruptcy trustee or a request based on a resolution made in a creditors' meeting, the bankrupt, his directors and executive officers, etc. under bankruptcy proceedings are obliged to provide a necessary explanation in relation to the bankruptcy concerned (Article 40 of the Bankruptcy Act). Failure to fulfil this requirement amounts to an offence punishable by imprisonment with work for a period not more than three years or a fine of not more than three million yen, or both (paragraph 1 of Article 268 of the Bankruptcy Act). This obligation ensures that directors are obliged to provide all information required for the protection of the company's assets, and to co-operate with the company's bankruptcy trustee in the implementation of his duties. Should a representative director fail to comply with this obligation, (as in most cases he/she is usually liable for the company's debts as a joint guarantor), that may become the basis upon which his personal liabilities will not be discharged or released in his own bankruptcy proceedings (paragraph 11 of Article 252 of the Bankruptcy Act).

7.2 Defence against self-incrimination

There is no provision particularly concerning the defence against self-incrimination in the Bankruptcy Act. However, when one is suspected of having committed a crime, the denial of the defence against self-incrimination is contrary to the Constitution of Japan since the defence is guaranteed under the Constitution. On this basis, there is a good chance that the defence will be allowed.

QUESTION 8

8. Appeals and limitation periods

- (a) What limitation period, if any, applies to the actions referred to above?
- (b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Appeals and limitation periods

Generally, the extinctive prescription for creditors' right to pursue civil liability is 10 years under the Civil Code. Despite the lack of specific provisions in the Commercial Code or the Companies Act, the construction of civil liability based on the Commercial Code by Courts of Japan is that the liability should be equivalent to civil liability based on the Civil Code. Further, the Bankruptcy Act provides that the extinctive prescription for the right of avoidance thereunder is two years from the date of commencement of bankruptcy proceedings, and 20 years from the date on which an act subject to avoidance was conducted (Article 176 of the Bankruptcy Act). The statute of limitations for criminal liability differs depending on which Act applies. The statute of limitations for the crime of aggravated breach of trust in the Companies Act is seven years from the date on which an illegal act was conducted, and the statute of limitations for the crime of fraudulent bankruptcy in the Bankruptcy Act is seven years from the date on which a criminal act was conducted.

An appeal is available against the last ruling in which the Court found criminal or civil liability, as explained above. All the legal proceedings explained above are implemented under the jurisdiction of the relevant district Court. Accordingly, to appeal a ruling, it is necessary to follow the prescribed criminal or civil appeal procedures. There is no special appeal procedure designed for bankruptcy-related criminal or civil actions.

QUESTION 9

9. Foreign corporations

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

Under the Bankruptcy Act, foreign nationals and foreign corporations have the same status as Japanese nationals and Japanese corporations, respectively, in respect of bankruptcy (Article 8 of the Bankruptcy Act).

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 concerning insurance in the Bankruptcy Act. However, an insurance policy containing officers' liability insurance is effective under the laws of Japan. The history of the use of officers' liability insurance in Japan is still short; it became common only after 1993, when a legal reform took place to simplify the system of shareholder derivative actions. Insurance coverage differs among insurance companies. Even where officers' liability insurance covers bankruptcy-related liability, it does not necessarily mean that such insurance is examined in actual Court cases.

The information provided in this country chapter is correct as at 30/11/2016

MALAYSIA

QUESTION 1

1. The directors and the start and duration of the “twilight” period

(a) How are directors identified / defined?

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

1.1 Directors

S 4(1) of CA 1965¹ provides that unless a contrary intention appears, the term ‘director’:

“...includes any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the directors² of a corporation are accustomed to act and an alternate or substitute director.”

A director is not necessarily defined by his designation as such but rather by the dominant or controlling role that he plays in the running of the company. S 4(1) of CA 1965 encompasses a *de facto* as well as a shadow director who is “a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act.”³ The concept of “shadow directors” is reflected in CA 1965 to catch persons who, although not on the board or making day-to-day decisions at the company, are in fact pulling the strings behind the scenes.

Whilst the terms *de facto* and shadow director have been used interchangeably, case law has made a distinction between the two terms. There are contrasting authorities in this regard where one school of thought claims that the two terms are mutually exclusive⁴ whilst another school of thought held that the two terms are not mutually exclusive and it is possible for a person to conduct himself in a mixture of both roles.⁵ In Malaysia, the Courts have opined that whether the two terms are mutually exclusive or overlap would depend on the particular facts and circumstances of each individual case.⁶

1.1.1 *De facto* directors

A *de facto* director is a person who, though not validly appointed as such, purports or claims or holds himself out to be a director. To establish that a person was a *de facto* director of a company, it is necessary to plead and prove that he undertook functions in relation to the company which could properly only be discharged by a director. It is not sufficient to show that he was concerned in the management of the company’s affairs or undertook tasks in relation to its business that can properly be performed by a manager below board level.⁷

¹ Companies Act 1965 (CA 1965).

² Under the interpretation section, section 2(1) of the Companies Act 2016 (CA 2016), “director” includes “a person in accordance with whose directions or instructions the majority of directors of a corporation are accustomed to act in accordance with the person’s instructions and directions” (emphasis added). It will no longer be necessary to prove that the entire Board of Directors is accustomed to act in accordance with the person’s instructions or directions. The Companies Bill 2015 has been passed by the Parliament, received Royal Assent on 31 August 2016 and has been gazetted on 15 September 2016 as the Companies Act 2016. As of the time of writing, the Companies Act 2016 has not come into effect.

³ *Cepatwawasan Group Bhd & Anor v Tengku Dato’ Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620.

⁴ *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180; *Secretary of State for Trade and Industry v Laing & Ors* [1996] 2 BCLC 324. In *Secretary of State for Trade and Industry v Hollier and others* [2006] EWHC 1804 (Ch), Mr Justice Etherton commented that *de facto* directorships and shadow directorships are alternatives, although there may be cases, particularly where the defendant’s influence in the corporate governance was partly concealed and partly open, where it may not be entirely straightforward which of the two descriptions is most apposite.

⁵ *Re Kaytech International plc* [1999] BCC 390. In *Re Mea Corporation Ltd; Secretary of State for Trade and Industry v Aviss and others* [2006] EWHC 1846 (Ch), Lewinson J agreed with Morritt LJ’s explanation regarding the role of a shadow director in *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340. [2000] 2 All ER 365, [2000] 2 WLR 907, and further concluded that a person can be both a shadow director and a *de facto* director simultaneously. He may, for example, assume the functions of a director as regards one part of the company’s activities (say, marketing) and give directions to the board as regards another (say, manufacturing and finance). In each case, it is necessary to examine the facts, bearing in mind that, as Morritt LJ explained, the purpose of the legislation is to “identify those, other than professional advisers, with real influence in the corporate affairs of the company”.

⁶ *Cepatwawasan Group Bhd & Anor v Tengku Dato’ Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620; *Peninsular Fibre Industries Sdn Bhd v Tan Yoke Chin* [2013] 1 LNS 119.

⁷ *Re Hydrodam (Corby) Ltd* [1994] BCLC 180.

The question of whether a person is occupying the position of director or not is a question of fact.

A *de facto* director is subject to the same statutory and fiduciary duties as a director who has been validly appointed.⁸ A *de facto* director would be liable for any act of commissions or any omission on his part in the same manner and to the same extent as if he had been a *de jure* as well as a *de facto* director. It must be shown that something he did resulted in a loss to the company and for which, if he had been duly appointed as a director of the company, the company would have been entitled to a remedy against him.

A *de facto* director is also able to bind the company in contracts and agreements with bona fide third parties in his capacity as an agent of the company with actual and / or apparent authority. Under principles of general agency law, he is not personally liable under those contracts but may be liable in damages for breach of an implied warranty of authority if he can be deemed to have warranted that he had authority to act on behalf of the company when no such authority existed.

1.1.2 Shadow director

A shadow director may not necessarily in all cases act as a director but conceals or hides his role as such.⁹ A shadow director has been described to be in reality a puppeteer who pulls the string and his puppets on the board dance.¹⁰ A shadow director is a person who, through directions and instructions to the directors of the company, exercises real influence over some, if not all, of the affairs of the company. He often lurks in the shadows, but it is not a necessary ingredient that he must lurk in the shadows all the time. The primary consideration is whether real influence was exercised and not the means by which influence was exercised.¹¹

In order to establish that a person is a shadow director of the company it is necessary to allege and prove:

- (i) the identities of the directors of the company, whether *de facto* or *de jure*;
- (ii) that the person concerned directed those directors how to act in relation to the company or that he was one of the persons who did so;
- (iii) that those directors acted in accordance with such directions; and
- (iv) that those directors were accustomed so to act.

Under S 2(1) of the CA 2016, a person is to be regarded as a director of a company if “*the majority of directors of a corporation are accustomed to act in accordance with the person’s instructions and directions*” (emphasis added). As such, it will no longer be necessary to prove that the entire Board of Directors is accustomed to act in accordance with the person’s instructions or directions.

1.1.2.1 ‘Directions’ and ‘instructions’

‘Directions’ and ‘instructions’ refer to communication between an alleged shadow director and the board of directors. Communication may be written or oral and formal or informal. Whether any particular communication constitutes ‘direction’ or ‘instruction’ is a question of fact, which is to be objectively ascertained in the light of all evidence.

Whilst it is not necessary to show the existence of actual directions or instructions in order to constitute shadow directorship, there must be evidence of a controlling or commanding role exercised by the ‘shadow director’ over the *de jure* directors.¹² The implications are that the *de jure* directors did not exercise any discretion or independent judgment but exhibited a pattern of acting in compliance with the directions of the shadow director.¹³

⁸ *Corporate Affairs Commission v Drysdale* [1978] 141 CLR 236.

⁹ *Cepatwawasan Group Bhd & Anor v Tengku Dato’ Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620.

¹⁰ Walter Woon in *Company Law Book*, 2nd edn at p. 222.

¹¹ *Re Kaytech International plc* [1999] 2 BCLC 351, CA.

¹² *Australian Securities Commission v AS Nominees* [1995] 13 ACLC 1822 relied upon by *Cepatwawasan Group Bhd & Anor v Tengku Dato’ Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620.

¹³ *Cepatwawasan Group Bhd & Anor v Tengku Dato’ Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620; *PeninsularFibre Industries Sdn Bhd v Tan Yoke Chin* [2013] 1 LNS 119.

There is no requirement that the *de jure* directors be shown to have acted in a subservient role to the *de facto* or shadow director. What is required under S 4(1) of CA 1965¹⁴ is the lower threshold of compliance rather than subservience to the directions and instructions of the alleged shadow director.

1.1.2.2 Accustomed to act

The focus of ‘accustomed to act’ is directed at results flowing from directions and instructions and not the underlying means through which the results are obtained.

The ‘influence’ also need not be such as to show that the *de jure* director exercises no discretion of his own. He must be the ‘cat’s paw’ of the shadow director. He must act on the directions or instructions of the shadow director as a matter of regular practice.¹⁵ All that is required to constitute ‘accustomed to act’ is that over a period of time and as a regular course of conduct the communications of the alleged shadow director have been acted upon by proof of results, as opposed to proof of an underlying expectation or understanding that the communication would be acted upon by the recipient.¹⁶

To construe a person as a shadow director, there must be shown the existence of a ‘pattern’ or ‘custom’ in which the shadow director plays a controlling role over the *de jure* director in respect of the management of the company.¹⁷

S 4(2) of CA 1965¹⁸ provides that a person who merely gives advice to the directors in his or her professional capacity is not to be regarded as a ‘director’ for the purposes of S 4(1). This suggests that a professional adviser can be a shadow director if what he is providing the directors with is something more than just professional advice.

1.2 The twilight period

The twilight period will commence once the company is insolvent and continues until the commencement of the liquidation (presentation of a winding up petition in the case of compulsory liquidation and the passing of a resolution to wind up in the case of voluntary liquidation).¹⁹ Under S 467 of CA 2016, the winding up of a company in the case of voluntary liquidation shall be deemed to have commenced at the time of the passing of a resolution for voluntary winding up.²⁰ In any other case, the commencement of winding up shall be at the date of the winding up order.²¹ For purposes of this Chapter, S 467(2) of CA 2016 will not affect the twilight period, as the vulnerable periods remain the same as provided for under CA 2016.²²

1.2.1 Categories of insolvency

There are two categories of insolvency.

The first category concerns actual insolvency. The question is whether the company was ‘insolvent’ at the time (or as a result) of the relevant transaction. A company is insolvent when it is unable to pay its debts. There are three tests of a company’s inability to pay its debts.²³

¹⁴ Section 2(1) of CA 2016.

¹⁵ *Re Unisoft Group Ltd (No.2) Ltd* [1944] BCC 766.

¹⁶ *Secretary of State for Trade and Industry v Deverell & Anor* [2000] 2 WLR 907.

¹⁷ *Cepatwasan Group Bhd & Anor v Tengku Dato’ Kamal Ibni Sultan Sir Abu Bakar & Ors* [2008] 2 CLJ 620. In *Secretary of State for Trade and Industry v Becker* [2002] EWHC 2200 (Ch), Sir Donald Rattee held that proof of a pattern of conduct, in which the *de jure* director is accustomed to act on the instructions or directions of the alleged shadow director, is required. The test is not satisfied by showing that a *de jure* director may have acted, or indeed did act, on such instructions or directions in relation to one event at the end of the company’s life.

¹⁸ Section 2(2) in the CA 2016.

¹⁹ Section 219 of the CA 1965.

²⁰ Section 467(1) of CA 1965.

²¹ Section 467(2) of CA 2016.

²² See para 1.5 below.

²³ Loh Siew Cheang in *Corporate Powers Accountability* (2nd Edition). CA 1965 does not set out or define when a company is insolvent but merely provides the various circumstances in which the Court may order the winding up of the company; section 218 of CA 1965. There is nothing in CA 1965 to say that the three different means of proof are exhaustive or exclusive of other kinds of evidence to prove inability to pay debts under section 218(1)(e) of CA 1965. Additionally, petitioners are not restricted to and need not limit the means available to them under section 218(2) of CA 1965 (section 466(1) of CA 2016) to prove their case; *Weng Wah Construction Co Sdn Bhd v Yik Foong Development Sdn Bhd* [1994] 2 MLJ 266.

They are:

- (i) the “commercial insolvency” test - a company is insolvent when it is unable to pay debts as and when they fall due. A company may wind up an asset-rich but cash strapped company on account of deemed insolvency;²⁴
- (ii) unsatisfied execution process - clearly if execution or other process issued on a judgment is returned unsatisfied in whole or in part, it means that the company does not have cash and sufficient assets or assets of sufficient value which may be realised by judicial process to satisfy the judgment debt;²⁵ and
- (iii) the “overall assets and liability” test - a petitioner may prove to the satisfaction of the Court by positive evidence that the company is unable to pay its debts because the company’s liabilities exceed the value of its assets. In this respect, the Court shall take into account the contingent and prospective liabilities of the company.²⁶

1.2.2 For this category of insolvency, a range of ‘clawback’ provisions apply (see S 2), which will affect transactions entered into by the company.

The second category concerns the concept of ‘insolvent trading’ where the law identifies the time at which a director had no reasonable or probable ground of expectation of the company being able to pay the debt. A director who continues to trade or incur liability in such circumstances will be personally liable unless he can show that he had a reasonable or probable ground to believe that the company was able to pay the debt.

The obligations of the directors of a company will change fundamentally once a company is insolvent. In normal circumstances where a company is solvent, directors owe their duties to the company, that is, to its present and future members, who are entitled to ratify generally breaches of duty by the directors.²⁷

Where a company is insolvent, however, it is the creditors rather than the members which are likely to suffer as a result of such breaches. Therefore, where a company is insolvent, the directors owe their duties to take into account the interests of the creditors. In this circumstance, the shareholders do not have the power or authority to absolve the directors from that breach.²⁸ However, this does not, in the absence of any conferral of such right by statute, confer upon creditors any general law right against former directors of the company to recover loss suffered by those creditor.²⁹

1.3 Vulnerable periods

The winding up of a company is deemed to commence at the time of the presentation of the petition for the winding up.³⁰ The various clawback periods under CA 1965 are:

- (a) sale at an undervalue or acquisition at an overvalue - two years prior to the commencement of winding up (S 295);³¹
- (b) undue preferences - six months prior to the commencement of winding up (S 293);³² and
- (c) invalid floating charges - six months prior to the commencement of winding up (S 294).³³

²⁴ Section 218(2)(a) of CA 1965; section 466(1)(a) of CA 2016: *Sri Hartamas Development Sdn Bhd v MBf Finance Bhd* [1992] 1 MLJ 313; *Datuk Mohd Sari bin Datuk Hj Nuar v Idris Hydraulics (M) Bhd* [1997] 5 MLJ 377; *Malayan Plant Pte Ltd v Moscow Narodny Bank Ltd* 1980] 2 MLJ 53.

²⁵ Section 218(2)(b) of CA 1965; section 466(1)(b) of CA 2016 – a company is deemed to be insolvent if ‘execution or other process issued on a judgment’ is ‘returned unsatisfied in whole or in part’.

²⁶ Section 218(2)(c) of CA 1965; section 466(1)(c) of CA 2016.

²⁷ *Gilbert Engineering Co Inc v Zainuddin Ahmad & Ors* [2001] 7 CLJ 489 where Vincent Ng J held that directors generally do not owe a fiduciary duty to the company’s creditors.

²⁸ *Kinsela v Russell Kinsela Pty Limited (In Liq)* [1986] 4 NSWLR 722.

²⁹ *Sycotex Pty Ltd v Baseler & Ors* [1994] 12 ACLC 494.

³⁰ Section 219(2) of CA 1965; Pursuant to section 467(2) of CA 2016, the commencement of winding up shall be at the date of the winding up order.

³¹ Section 530(3) of CA 2016: two years before the presentation of the winding up petition (compulsory liquidation) or the passing of the winding up resolution (voluntary liquidation).

³² Section 528(1) of CA 2016: six months from the date of the company being wound up or the presentation of a winding up petition.

³³ Section 529 of CA 2016: within six months of the presentation of the winding up petition (compulsory liquidation) or the passing of the winding up resolution (voluntary liquidation).

In addition, S 223 of CA 1965 also provides that any dispositions made after the commencement of the winding up by the Court shall, unless the Court otherwise orders, be void.³⁴

CA 1965 confers on a provisional liquidator (known as ‘Interim Liquidator’ in CA 2016³⁵) power to exercise all functions and powers of a liquidator subject to certain prescribed limitations and restrictions or as specified by the Court in the order appointing him.³⁶ However, there are certain actions which can only be initiated by a liquidator; for instance, transactions which will be affected by the clawback provisions (see para 2). A provisional liquidator may not initiate actions to set aside such transactions which will be affected by the clawback provisions because he is appointed by the Court after the presentation of a winding up petition and before the making of a winding up order. In reality, a winding up order as against a company in provisional liquidation may or may not be granted.

QUESTION 2

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 the director?
- (b) In relation to each act identified in (a) above:
- (i) Is the director’s liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?
 - (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 trading³⁷

- (a) In the course of winding up or any other proceedings against a company where it appears that an officer of the company who was knowingly a party to the contracting of a debt had, at the time of contracting, no reasonable or probable ground of expectation of the company being able to pay the debt, the officer commits an offence. Proof of reasonable ground of expectation is judged by the standards of a director or manager of ordinary competence.³⁸
- (b) (i) Liability is criminal and civil. A person guilty of this offence is liable to imprisonment for one year or a RM 5,000 fine. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding five years or to a fine not exceeding RM 500,000 or to both.³⁹

³⁴ Given that under section 467(2) of CA 2016, the commencement of winding up shall be at the date of the winding up order, section 472(1) makes clear that dispositions of property of a company after the *presentation of the winding up petition* shall be void. Section 472 also excludes an “exempt disposition” which means a disposition made by a liquidator, or by an interim liquidator of the company in exercise of its powers.

³⁵ Section 476 of CA 2016.

³⁶ Section 231 of CA 1965.

³⁷ Section 303(3) of CA 1965; section 539(3) of CA 2016.

³⁸ *3M Australia Pty Ltd v Kemish* [1986] 4 ACLC 185.

³⁹ Section 539(3) of CA 2016.

- (ii) S 304(2) of CA 1965⁴⁰ provides that where a person is convicted of insolvent trading, the Court may declare that the person shall be personally responsible without any limitation of liability for the payment of the whole or any part of that debt. Personal liability under this section is dependent on a conviction being obtained under S 303(3) of CA 1965.⁴¹ The Court also has powers to make consequential orders to give effect to the declaration.⁴²
- (iii) The Court has wide discretion to determine the extent of liability.
- (iv) There is no specified period.
- (v) The defence to this offence is that the director or officer at the time of contracting of a debt had a reasonable or probable ground of expectation of the company being able to pay the debt.

2.2 Fraudulent trading⁴³

- (a) Where it appears that any business of the company had been “*carried on with intent to defraud creditors of the company or the creditors of any other person or for any fraudulent purpose*”, the Court may if it thinks proper to do so, declare that any person who was knowingly a party to the carrying on of the business in that manner is to be personally responsible without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct.⁴⁴ The application for such declaration may be made by the liquidator or any creditor or contributory of the company. The elements of the offence are as follows:
 - (i) This section is not restricted to winding up proceedings against the company and could apply even prior to the winding up of a company. It applies where the company is in the course of winding up or where there are other proceedings against the company.⁴⁵
 - (ii) Fraud and fraudulent purpose connote actual dishonesty involving, according to current notions of unfair trading among commercial men, real moral blame in relation to the expected standard of an ordinary and honest people.⁴⁶ The test applicable is whether the party concerned was fulfilling his role of “The Reasonable Expectations of an Honest Businessman”.⁴⁷ “Defraud” requires a person (natural or corporate) as its object. An accused is guilty of fraud if he intends by deceit to induce a person to act in a way that puts that person’s economic interests in jeopardy, even though he does not intend that he should ultimately suffer loss.
 - (iii) The scope of liability for “fraudulent trading” is wider than “insolvent trading” as the former applies to “any person who was knowingly a party” whilst the latter is confined only to “officers of the company”.
 - (iv) In theory, it could be wide enough to catch a financier who funded the fraudulent trading knowing that it was being done dishonestly.
 - (v) It is not necessary in order to establish an offence to show that creditors were in fact defrauded.⁴⁸ An intention to defraud is sufficient. An intent to defraud is an intent to deprive creditors, or some creditors, of an economic advantage or inflict upon them some economic loss.⁴⁹

⁴⁰ Section 540(2) of CA 2016.

⁴¹ Section 539(3) of CA 2016.

⁴² Section 304(3) of CA 1965; section 540 (3) of CA 2016.

⁴³ Section 304 of CA 1965; section 540 of CA 2016.

⁴⁴ Section 304(1) of CA 1965; section 540 (1) of CA 2016.

⁴⁵ *Tang Eng Iron Works Co. Ltd v Ting Ling Kiew & Anor* [1990] 3 CLJ (Rep) 211.

⁴⁶ *H. Rosen Engineering B.V. v Siow Yoon Keong* [1997] 1 CLJ 137. In *H. Rosen’s* case, the High Court considered the word “fraud” and stated that “*The term ‘fraud’ has a distinctive meaning given in the Concise Oxford Dictionary - 9th Edn. as ‘the use of false representation to gain an unjust advantage; a dishonest artifice or trick; a person not fulfilling what is expected of him/her’.* “Fraudulent Purpose” - *achieving by fraud; or dishonestly.*”

⁴⁷ In *H. Rosen Engineering B.V. v Siow Yoon Keong* [1997] 1 CLJ 137 it was stated that “*keeping in mind that ‘honesty is the best policy’ the defendant was expected to live to the standards to be observed by honest businessmen and not of an unconscionable conduct contrary to good conscience. The law of equity and good conscience is to be the order to be adopted in such commercial transactions to make good the resulting loss to an innocent person whose trust in the defendant has been betrayed by his misconduct.*”

⁴⁸ Section 304(5) of CA 1965.

⁴⁹ *Coleman v The Queen* [1987] 5 ACLC 766. In *Siow Yoon Keong v H Rosen Engineering BV* [2003] 4 MLJ 569, the Court of Appeal held that the usual standard of proof for fraud in civil proceedings is beyond reasonable doubt, as laid down in *Yong Tim v Hoo Kok Chong & Anor* [2005] 3 CLJ 229. However, section 304(1) only uses the term ‘if it appears’ which indicates a lower degree of proof.

- (b) (i) Liability may be criminal or civil. A person guilty of this offence is liable to imprisonment for three years or a RM 10,000 fine. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding ten years or to a fine not exceeding RM 1,000,000 or to both.⁵⁰
- (ii) The Court has a wide discretion to order compensation for the loss caused to the company by the director's conduct. While declarations under S 304(2) of CA 1965 refer only to personal liability for that particular debt, under S 304(1),⁵² personal liability may be for all the company's liabilities. Creditors benefit because the insolvent company is then in a better position to pay its debts. The Court also has powers to make consequential orders.⁵³
- (iii) The Court has wide discretion to determine the extent of liability.
- (iv) There is no specified period.
- (v) The defence is that the party concerned was not dishonest and that he had no intention to defraud creditors. As long as he honestly believed that the new debt incurred would ultimately be repaid in full, he may not be found liable.

2.3 Offences by officers of companies in liquidation

2.3.1 Misconduct in the course of a company being wound up⁵⁴

- (a) Personal liability will attach to a past or present officer of the company who:
 - (i) does not to the best of his knowledge and belief fully and truly discover to the liquidator all the property movable and immovable of the company, and how and to whom and for what consideration and when the company disposed of any part thereof except such part as has been disposed of in the ordinary course of business.⁵⁵ Under CA 2016, the phrase "to the best of his knowledge and belief fully and truly discover" has been replaced with "disclose";⁵⁶
 - (ii) does not deliver up to the liquidator all the movable and immovable property of the company (including all books and papers) in his custody or under his control and which he is required by law to deliver up.⁵⁷ Under CA 2016, delivery must be made whether or not the officer has been directed to do so;⁵⁸
 - (iii) knowing or believing that a false debt has been proved by any person fails for a period of one month⁵⁹ to inform the liquidator;⁶⁰
 - (iv) prevents the production of any book or paper affecting or relating to the property or affairs of the company.⁶¹
- (b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for two years or a RM 5,000 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding five years or to a fine not exceeding RM 3,000,000 or to both.⁶²
- (ii) & (iii) In exercising its punitive jurisdiction under this section the Court is not seeking to compensate the company.

⁵⁰ Section 540(5) of CA 2016.

⁵¹ Section 540(2) of CA 2016.

⁵² Section 540(1) of CA 2016.

⁵³ Section 304(3) of CA 1965; section 540(3) of CA 2016.

⁵⁴ Section 300 of CA 1965; section 536 of CA 2016.

⁵⁵ Section 300(1)(a) of CA 1965; section 536(1) of CA 2016.

⁵⁶ Section 536(1) of CA 2016.

⁵⁷ Sections 300(1)(b)(i) and (ii) of CA 1965; sections 536(1)(b)(i) and (ii) of CA 2016.

⁵⁸ Section 536(1)(b) of CA 2016.

⁵⁹ The time period has been changed to 30 days under section 536 of CA 2016.

⁶⁰ Section 300(1)(e) of CA 1965; section 536(1)(e) of CA 2016.

⁶¹ Section 300(1)(f) of CA 1965; section 536(1)(f) of CA 2016.

⁶² Section 536(3) of CA 2016.

- (iv) The offences must have taken place when a company is being wound up.
- (v) Absence of intention to defraud is a defence to a charge under 2.3.1(a)(i) or (ii) above and absence of intent to conceal the state of affairs of the company or to defeat the law is a defence to a charge under 2.3.1(a)(iv) above.⁶³

2.3.2 Fraud in the course of a company being wound up⁶⁴

(a) A past or present officer of the company commits an offence if he has:

- (i) concealed any part of the property of the company to the value of RM 50 or upwards, or has concealed any debt due to or from the company;⁶⁵
- (ii) fraudulently removed any part of the property of the company to the value of RM 50 or upwards;⁶⁶
- (iii) concealed, destroyed, mutilated, falsified or has been privy to the concealment, destruction, mutilation or falsification of any book or paper affecting or relating to the property or affairs of the company;⁶⁷
- (iv) made or has been privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company;⁶⁸
- (v) fraudulently parted with, altered or made any omission in, or has been privy to fraudulent parting with, altering or making any omission in, any document affecting or relating to the property or affairs of the company;⁶⁹
- (vi) by any false representation or other fraud, has obtained any property for or on behalf of the company on credit which the company has not subsequently paid for;⁷⁰
- (vii) obtained on credit, for or on behalf of the company, under the false pretence that the company is carrying on its business in any property which the company has not subsequently paid for;⁷¹
- (viii) pawned, pledged or disposed of any property of any company which has been obtained on credit and has not been fully paid for unless the pawning, pledging or disposing was in the ordinary way of the business of the company;⁷² or
- (ix) attempted to account for any part of the property of the company by fictitious losses or expenses.⁷³

(b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for two years or a RM 5,000 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding five years or to a fine not exceeding RM 3,000,000 or to both.⁷⁴

(ii) & (iii) In exercising its punitive jurisdiction under this section the Court is not seeking to compensate the company.

(iv) The acts in question must have occurred either:

- (1) within the twelve months prior to the commencement of the winding up, or

⁶³ Section 300(4) of CA 1965; section 536(4) of CA 2016.

⁶⁴ Section 300(1)(c) of CA 1965; section 536(1)(c) of CA 2016.

⁶⁵ Section 300(1)(c)(i) of CA 1965; section 536(1)(c)(i) of CA 2016.

⁶⁶ Section 300(1)(c)(ii) of CA 1965; section 536(1)(c)(ii) of CA 2016.

⁶⁷ Section 300(1)(c)(iii) of CA 1965; section 536(1)(c)(iii) of CA 2016.

⁶⁸ Section 300(1)(c)(iv) of CA 1965; section 536(1)(c)(iv) of CA 2016.

⁶⁹ Section 300(1)(c)(v) of CA 1965; section 536(1)(c)(v) of CA 2016.

⁷⁰ Section 300(1)(c)(vi) of CA 1965; section 536(1)(c)(vi) of CA 2016.

⁷¹ Section 300(1)(c)(vii) of CA 1965; section 536(1)(c)(vii) of CA 2016.

⁷² Section 300(1)(c)(viii) of CA 1965; section 536(1)(c)(viii) of CA 2016.

⁷³ Section 300(1)(g) of CA 1965; section 536(1)(g) of CA 2016.

⁷⁴ Section 536(3) of CA 2016.

(2) at any time after the commencement of the winding up.⁷⁵

- (v) Absence of intention to defraud is a defence to a charge under 2.3.2(a)(i), (vii) or (viii) above and absence of intent to conceal the state of affairs of the company or to defeat the law is a defence to a charge under 2.3.2(a)(iii) or (iv) above.

2.4 Falsification of books⁷⁶

- (a) Every officer or contributory of any company being wound up commits an offence if he destroys, mutilates, alters or falsifies any books, papers or securities, or makes or is privy to the making of any false or fraudulent entry in any register or book of account or document belonging to the company with intent to defraud or deceive any person.
- (b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for five years or a RM 30,000 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding ten years or to a fine not exceeding RM 3,000,000 or to both.⁷⁷
 - (ii) & (iii) In exercising its punitive jurisdiction under this section the Court is not seeking to compensate the company.
 - (iv) This offence applies when a company is being wound up.
 - (v) Absence of intent to defraud or deceive is a defence to this charge.

2.5 False representations to creditors⁷⁸

- (a) Any past or present officer of the company commits an offence if he is guilty⁷⁹ 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.
- (b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for two years or a RM 5,000 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding five years or to a fine not exceeding RM 3,000,000 or to both.⁸⁰
 - (ii) & (iii) In exercising its punitive jurisdiction under this section the Court is not seeking to compensate the company.
 - (iv) This offence applies to false representations made when a company is being wound up.
 - (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.

2.6 Material omissions from a statement relating to the company's affairs⁸¹

- (a) A past or present officer of a company commits an offence if he makes any material omission in any statement relating to the affairs of the company.
- (b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for two years or a RM 5,000 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding ten years or to a fine not exceeding RM 3,000,000 or to both.⁸²

⁷⁵ Section 300(1)(c) of CA 1965; section 536(1)(c)(i) of CA 2016.

⁷⁶ Section 302 of CA 1965; section 538 of CA 2016.

⁷⁷ Section 538 of CA 2016.

⁷⁸ Section 300(1)(h) of CA 1965; section 536(1)(h) of CA 2016.

⁷⁹ Under section 536(1)(h) of CA 2016, the word "guilty" has been replaced with "convicted".

⁸⁰ Section 536(3) of CA 2016.

⁸¹ Section 300(1)(d) of CA 1965; section 536(1)(d) of CA 2016.

⁸² Section 536(3) of CA 2016.

(ii) & (iii) In exercising its punitive jurisdiction under this section the Court is not seeking to compensate the company.

(iv) This offence applies to statements made when a company is being wound up.

(v) Absence of intent to defraud is a defence to this charge.

2.7 Misfeasance⁸³

- (a) (i) Any person who has taken part in the formation or promotion of the company or past or present liquidator or officer of the company who has misapplied or retained or become liable or accountable for any money or property of the company may be examined by the Court.
- (ii) The Court may do the same where such parties are guilty of any misfeasance or breach of trust or duty in relation to the company. The application to the Court for such examination may be made by the liquidator or any of the company's creditors or contributories.⁸⁴
- (iii) In the case of an officer of the company, the Court's power extends to and applies in respect of the receipt of any money or property by any officer of the company during the two years preceding the commencement of the winding up whether by way of salary or otherwise appearing to the Court to be unfair or unjust to other members of the company.⁸⁵
- (b) (i) Liability is civil.
- (ii) The Court may order the director to repay or restore the money or property or any part of it, with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust or duty as the Court thinks just.
- (iii) The Court has wide discretion in relation to the making of orders under this provision. It is able to apportion the order made against individual directors in proportion to their involvement and culpability.
- (iv) Apart from the offence in respect of the receipt of any money or property by an officer of the company (during the two years preceding the commencement of the winding up), there is no time period within which the impugned acts must have occurred in order for liability to attach.
- (v) It shall be a defence if the director in default can show that he has acted honestly and reasonably and the Court concludes that he ought fairly to be excused.

2.8 Proper accounts not kept⁸⁶

- (a) (i) This offence applies where it is shown that proper books of account were not kept by the company for the period of two years immediately preceding the commencement of the investigation or winding up. The liability is on each officer who is in default.⁸⁷
- (ii) Proper books of account shall be deemed not to have been kept in the case of any company if there have not been kept such books or accounts as are necessary to exhibit and explain the transactions and financial position of the trade or business of the company, or if the books or accounts have not been kept in such manner as to enable them to be conveniently and properly audited, whether or not the company has appointed an auditor.

⁸³ Section 305 of CA 1965; section 541 of CA 2016.

⁸⁴ Section 305(1) of CA 1965; section 541(1) of CA 2016.

⁸⁵ Section 305(2) of CA 1965; section 541(2) of CA 2016.

⁸⁶ Section 303 of CA 1965; section 539 of CA 2016.

⁸⁷ Under section 539(1) of CA 2016, the phrase "who is in default" has been omitted.

- (b) (i) Liability is criminal. A person guilty of this offence is liable to imprisonment for three years or RM 10,000 fine. The gravity of the wrongdoing will be reflected in the length of imprisonment or the extent of the fine that is ordered. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding three years or to a fine not exceeding RM 500,000 or to both.⁸⁸
- (ii) & (iii) In exercising its punitive jurisdiction under this section the Court is not seeking to compensate the company.
- (iv) The act in question must have occurred throughout the period of two years immediately preceding the commencement of the investigation or winding up or the period between the incorporation of the company and the commencement of the investigation or winding up (whichever is lesser).⁸⁹
- (v) It shall be a defence if the director in default shows that he acted honestly and that in the circumstances in which the business of the company was carried on, the default was excusable.⁹⁰

2.9 General duties of a director

- (a) (i) The general duties of a director are codified in S 132 of CA 1965,⁹¹ which states that a director of a company shall at all times exercise his powers for a proper purpose and in good faith in the best interest of the company. These statutory duties largely restate the fiduciary duties under the general law. As long as the company is solvent, the interests of the company are the interests of its shareholders. However, the company's creditors' interests become increasingly important when the company is in financial difficulties.
- (ii) The fiduciary duties of directors include:
 - (1) duty to act *bona fide* in the interests of the company;
 - (2) duty to act for their proper purpose;
 - (3) duty to retain their discretionary powers;
 - (4) duty to avoid conflicts of interest and duty;
 - (5) duty to disclose interests in contracts at general law; and
 - (6) duty not to make secret profits.
- (iii) The statutory duties above operate in addition to any general law duties.⁹² The main duties are set out in further detail below.
- (b) (i) Liability is criminal and civil. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding five years or to a fine not exceeding RM 3,000,000 or to both.⁹³
- (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.
- (iii) Liability to the company for any profit made by him or for any loss and damage 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.

⁸⁸ Section 539(1) of CA 2016.

⁸⁹ Section 303(1) of CA 1965; section 539(1) of CA 2016.

⁹⁰ This defence has been omitted from section 539(1) of CA 2016.

⁹¹ Section 213 of CA 2016.

⁹² Section 132(5) of CA 1965; section 220 of CA 2016.

⁹³ Section 539(1) of CA 2016.

- (iv) Subject to the Limitation Act considerations,⁹⁴ there is no time limit within which action may be taken against a director.
- (v) (a) There is no breach where a director acts in what he honestly believes to be in the interests of the company. The Court is generally reluctant to override the business judgement of directors. A director is presumed to have acted *bona fide* for the benefit of his company and persons alleging a breach of duty bear the onus of proving that he has not acted *bona fide*.⁹⁵
- (b) A director of a company is only expected to exercise reasonable care, skill and diligence with the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities and any additional knowledge, skill and experience which the director in fact has.⁹⁶

2.10 Duty to act *bona fide* in the interests of the company

S 132(1) of CA 1965⁹⁷ requires a director to exercise his powers for a proper purpose and in good faith in the best interest of the company at all times. This provision corresponds with S 181(1) of the Corporations Act 2001 of Australia (Australian Act).

2.10.1 Good faith

This duty is two-pronged in that it imposes a duty on the director to act “in good faith” and “in the best interest of the company”. The requirements of the duty to act in good faith are that the director must:

- (1) exercise his powers in the interest of the company;
- (2) not misuse or abuse his power;
- (3) avoid conflict between his personal interests and those of the company;
- (4) not take advantage of his position to make secret profits; and
- (5) not misappropriate the company’s assets for himself.⁹⁸

The test as to whether or not a director has acted *in the best interest of the company* is a subjective one. A director must act *bona fide* in what he considers - and not what the Court may consider - is in the best interest of the company. This test precludes the Court from second guessing the commercial decisions of the director as to where the best interest of the company lies.⁹⁹

A director’s primary duty is to act in the interests of the company of which he is a director. The proper test in the absence of evidence of the subjective state of mind of the director is whether ‘an honest and intelligent man in the position of the directors, taking an objective view, could reasonably have concluded that the transactions were in the interests of the company’. If the Court concludes that an honest and intelligent person could have reasonably concluded that the transactions were in the interests of the company, there is no breach of fiduciary duty.¹⁰⁰

⁹⁴ The usual limitation period is 6 years for actions founded on a contract or on tort.

⁹⁵ *Intraco Pte Ltd v Multi-Pak Singapore Ltd* [1995] 1 SLR 313, CA.

⁹⁶ Section 132(1A) of CA 1965; section 213(2) of CA 2016.

⁹⁷ Section 213(1) of CA 2016.

⁹⁸ *Chew v R* (1991) 5 ACSR 473.

⁹⁹ *Henrick International Hotels & Resorts Pte Ltd v YTL Hotels & Properties Sdn Bhd & Ors & Another Case* [2005] 8 CLJ 176.

¹⁰⁰ *Intraco Ltd v Multi-Pak Singapore Pte Ltd* [1995] 1 SLR 313 at 325, CA.

2.11 Duty to exercise powers for proper purposes

The requirement to act for a proper purpose is distinct from the requirement that the directors act *bona fide*. The test is whether the director's actions had been taken in accordance with the purpose for which it was intended and was exercised for the benefit of the company. A director may therefore still breach this duty even if he honestly believes his actions are in the best interests of the company as a whole. The Court will first examine the power which the director had exercised to determine the purpose for which the power was granted. Then, the Court will determine the substantial purpose for which the power was in fact exercised to determine if the power was exercised honestly and in the interest of the company.¹⁰¹

The onus of establishing that a director had acted in breach of such duty is on those alleging the breach.

2.12 Duty to act with reasonable care, skill and diligence

S 132(1A) of CA 1965¹⁰² provides a partly subjective and partly objective test for reasonable care, skill and diligence:

“A director of a company shall exercise reasonable care, skill and diligence with

- (a) the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and
- (b) any additional knowledge, skill and experience which the director in fact has.”

A director is thus required to take, in the performance of his duties, such care as an ordinary man might be expected to take and he is also required to exhibit in the performance of these duties such degree of skill as may reasonably be required from a person with his knowledge and experience.¹⁰³

S 132(1B) of CA 1965¹⁰⁴ states that a director who makes a business judgment is deemed to meet the requirements of reasonable care, skill and diligence test in sub-section (1A) and the equivalent duties under the common law and equity if the director:

- (a) makes the business judgment in good faith for a proper purpose;
- (b) does not have a material personal interest in the subject matter of the business judgment;
- (c) is informed about the subject matter of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and
- (d) reasonably believes that the business judgment is in the best interest of the company.

S 214(2) of CA 2016 states that for the purposes of the section, “business judgment” means any decision on whether or not to take action in respect of a matter relevant to the business of the company.¹⁰⁵

The ‘business judgment rule’ was developed to protect an honest director and other officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and because of a desire to refrain from stifling innovation and entrepreneurship.

This rule is developed on the general principle that it is not the function of the Court to substitute its judgement for the business judgment of a director as it is expected or presumed that a director knows best about the business of the company and have more time and expertise at his disposal to evaluate the best interest of the company. In order to satisfy the business judgment rule, it is not necessary to show that the decision itself was reasonable

¹⁰¹ *Howard Smith Ltd v Ampol Petroleum* [1974] AC 821, PC.

¹⁰² Section 213(2) of CA 2016.

¹⁰³ *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498 at 501-502, Foster J.

¹⁰⁴ Section 214 of CA 2016.

¹⁰⁵ Section 214(2) of CA 2016.

or that the Court would have arrived at the same decision. Rather, it is sufficient for a director to show that he took reasonable steps to inform himself about the subject matter before making the business judgment and that he reasonably believed that judgement was in the best interest of the company.

The business judgment rule only qualifies the scope of the duty to act with reasonable care, skill and diligence prescribed in S 132(1A) of CA 1965.¹⁰⁶ It does not provide a defence to a breach of a director's statutory duty to act for a proper purpose and in good faith in the best interest of the company under S 132(1).¹⁰⁷

2.13 Duty to avoid conflict of interests and to avoid secret profits

A director has an obligation to avoid conflict of interests. S 132(2) of CA 1965¹⁰⁸ codified the common law prohibition against the improper use of the company's property, position and corporate opportunity. This sub-section prohibits a director of a company from using property of the company or his position as a director of the company to gain directly, or indirectly, a benefit for himself or any person, or cause detriment to the company.

A director is regarded as a trustee of the property of the company. Such property may only be used for the purposes of the company. A director who uses the property of the company to make a profit for himself or any other person not only commits a breach of his duty to the company, but will also commit a criminal offence if the property is misappropriated.

The same section also prohibits a director from using any information or opportunity of the company which he acquired or became aware of, in the performance of his functions as a director of the company to gain directly, or indirectly, a benefit for himself or any other person, or cause detriment to the company.

A director who obtains information and knowledge, and which he withholds from the company and uses for his personal gain, will be liable to account for the profits earned. This is because the information had come into his possession when he was a director of the company and the information was relevant for the company to know. The director is not absolved from liability even if the company is not deprived of any profits.¹⁰⁹

The duty of a director not to make use of his position to obtain a profit for himself is similar to an agent's duty not to make secret profits out of his position as agent. The rule that prohibits a director from making secret profits is so strict that a director is liable to account for profits made in breach of this duty even though the director is not guilty of any moral wrong. Lack of bad faith will not absolve a director from such liability. Once it is established that what the director did was so related to the affairs of the company that it could properly be said to have been done in the course of his management and using his opportunities and special knowledge as directors, the director will be liable to account for the profits obtained.¹¹⁰

A director's duty not to usurp for himself, or divert to his associates, a maturing business opportunity which the company is actively pursuing is imposed on the director even after his resignation where the resignation may fairly be said to be prompted or influenced by a wish to acquire for himself the opportunity sought by the company.¹¹¹ Therefore, a director's duty does not end upon resignation.

A director is not prohibited from engaging in business which is in competition with the company so long as he does not breach his fiduciary duties and duties of confidentiality to the company. A director is at liberty to be a director of a rival company unless prohibited from doing so by the articles of association of a company.¹¹²

¹⁰⁶ Section 213(2) of CA 2016.

¹⁰⁷ Section 213(1) of CA 2016.

¹⁰⁸ Section 218 of CA 2016.

¹⁰⁹ *Industrial Development Consultants v Cooley* [1972] 1 WLR 433.

¹¹⁰ *Regal (Hastings) Ltd v Gulliver* [1942] All ER 378, HL.

¹¹¹ *Canadian Aero Services v O'Malley* [1973] 40 DLR 371, SC.

¹¹² *London and Mashonaland Exploration Co Ltd v New Mashonaland Exploration Co Ltd* [1891] WN 165 cited with approval by *Bell v Lever Bros Ltd* [1932] AC 161, HL and appears to be accepted in *Berli Hestia (NZ) Ltd v Ferrybough* [1980] 2 NZLR 151 as the correct legal position in New Zealand.

QUESTION 3

3. Other persons involved with the company's affairs who may become liable in relation to their actions during the "twilight period"
- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 Introduction

Malaysian law is similar to English law in that it may impose liability on a wide variety of persons who have been involved in the management of a company during the "twilight period" depending on the particular act or offence. Malaysian courts have adopted the English position citing with approval the English authorities.¹¹³ Malaysian law recognises that a company's affairs during this time are not only influenced by those formally appointed as directors but also by a wide range of other people. If such persons have caused loss to the company and its creditors during this time, they may also be found personally liable for such loss. Malaysian law may impose personal liability on "shadow" and "de facto" directors in certain circumstances.

Third parties who are not in any way involved in the management of the company but who may be a party to transactions during the "twilight period" may also have transactions challenged and set aside under the clawback provisions for undue preference.

Finally, third parties who have knowledge of breach of duty of a director or directors when entering into transactions, or had either fraudulently assisted in that breach and/or received property from the company with knowledge of that breach, will under general equitable principles be liable as a constructive trustee of such property and be liable to return it or to pay compensation to the company.

3.2 Officers

Liability for many of the acts identified in Question 2 above is often imposed on an 'officer' of the company. S 4(1) of CA 1965 defines 'officer' to include directors, secretaries, employees and receivers and managers, and liquidators under a voluntary winding up.

3.3 Other persons who may be held liable

A third party may be held liable either to return such property or provide such compensation as the Court may order if he receives property as a result of transactions at undervalue, preference or as a result of a transaction defrauding creditors.

If a third party receives property of the company which has been disposed of after the winding up order has been made without the Court's validation, the disposal will be void.¹¹⁴

A third party who is knowingly a party to the carrying on of a business with the intent to defraud creditors will be liable for fraudulent trading.

Any third party who has dishonestly assisted in a breach of duty by a director or other officer of a company or knowingly received property arising from such a breach will be liable for any loss arising.

¹¹³ The English authorities were cited with approval and discussed at great lengths in the case of *Kejutaan Holdings Sdn Bhd v Magnum 4D (Perak) Sdn Bhd & 9 Ors* [2008] 4 AMR 26.

¹¹⁴ Section 223 of CA 1965; section 472 of CA 2016.

3.4 Summary

3.4.1 Liability may attach to persons not formally appointed as directors for the following offences:

Offence / activity	Persons liable	Extent of liability
Insolvent trading	Officer of a company.	Same as for director
Fraudulent trading	Any person who was knowingly a party to the carrying on of the business for a fraudulent purpose.	Same as for director
Misconduct in the course of company being wound up	Past or present officer or a contributory of the company.	Same as for director
Fraud in the course of company being wound up	Past or present officer or a contributory of the company.	Same as for director
Falsification of books	Every officer or contributory of a company.	Same as for director
Proper accounts not kept	Officer of a company.	Same as for director
False representations to creditors	Past or present officer or a contributory of the company.	Same as for director
Material omissions from statement relating to company's affairs	Past or present officer or a contributory of the company.	Same as for director
Misfeasance or breach of trust or duty	Any person who has taken part in the formation or promotion of the company or any past or present liquidator or officer who has misapplied or retained or become liable or accountable for any money or property of the company or been guilty of any misfeasance or breach of trust or duty in relation to the company.	Same as for director
Preference	Recipient of preference. Return of property received or removal of specific benefit received.	Same as for director
Sale at undervalue or overvalue	Recipient of property received.	Return of property received and / or pay compensation to the company

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Introduction

As in most legal systems, Malaysian law too has provisions that seeks to undo transactions prejudicial to a company and/or which are unfairly beneficial to a counterparty, particularly when they are entered into during the "twilight period."

4.2 Summary of heads of challenge

The potential heads of challenge which may lead to transactions with the company being set aside from the point of view of a counterparty, are as follows:

- (a) sale at an undervalue or overvalue;
- (b) undue preference;
- (c) invalid floating charges;
- (d) breach of a director's fiduciary duties;
- (e) disclaimer of onerous property;
- (f) dispositions of the company's property made after the commencement of winding up; and
- (g) failure to register a charge.

4.3 Sale at undervalue or acquisition at an overvalue¹¹⁵

S 295 of CA 1965 provides as follows:

- (1) Where any property, business or undertaking has been acquired by a company for a cash consideration within a period of two years before the commencement of the winding up¹¹⁶ of the company:
 - (a) from a person who was at the time of the acquisition a director of the company; or
 - (b) from a company of which, at the time of the acquisition, a person was a director who was also a director of the first-mentioned company, the liquidator may recover from the person or company from which the property, business or undertaking was acquired any amount by which the cash consideration for the acquisition exceeded the value of the property, business or undertaking at the time of its acquisition.

Under CA 2016, the liquidator's right to recover has been extended to cover persons connected with a director.¹¹⁷

¹¹⁵ Section 295 of CA 1965; section 530 of CA 2016.

¹¹⁶ Under CA 2016, it is presentation of winding up petition.

¹¹⁷ Section 530 of CA 2016.

Conversely, in similar circumstances, where the company has sold any such property, the liquidator may recover from the person or company to whom the property, business or undertaking was sold, any amount by which the value of the property, business or undertaking at the time of the sale exceeded the cash consideration.¹¹⁸

4.3.1 Conditions for setting aside a sale at undervalue or acquisition at an overvalue

The Court can only make an order for restoration of the status quo by way of relief under this provision if the following conditions are satisfied:

- (1) the company is in liquidation and an application is made by the liquidator;
- (2) the company acquired / sold property, business or undertaking within a period of two years before the commencement of the winding up¹¹⁹ of the company; and
- (3) the property, business or undertaking was acquired / sold for a cash consideration. ‘Cash consideration’ means a consideration for the acquisition or sale which is payable otherwise than by the issue of shares in the company.¹²⁰

‘Value’ includes the value of any goodwill or profits that might have been made from the business or undertaking or similar considerations.¹²¹

4.4 Undue preference¹²²

S 293 of CA 1965 deals with undue preferences. This section incorporates the provisions of S 53 of the Bankruptcy Act 1967 (BA 1967), by giving the liquidator the power to recover the value of certain pre-liquidation dispositions of the company’s property from creditors. These dispositions are referred to as preferences. S 293 is designed to preserve the sanctity of the *pari passu* principle by which creditors in a winding up share rateably in the assets available for distribution.¹²³

By virtue of S 53 of BA 1967, every transfer of property, every payment made and every obligation incurred by any person unable to pay his debts as they become due, from his own money in favour of any creditor shall be deemed to have given a creditor a preference over other creditors if the person making the same is adjudged bankrupt on a petition presented within six months after making the same and such act shall be deemed fraudulent and void as against the Director General of Insolvency.

There is no requirement in S 53(1) of BA 1967 that the transactions were carried out with the view to creating a preference or with a desire to produce the effect of preference.

Under S 528 of CA 2016, the cross-referencing to the provisions of the BA 1967 on issues relating to undue preference transactions have been removed. In its place, the CA 2016 sets out the parameters of transactions which fall under the provision, as follows:

“Any transfer, mortgage, delivery of goods, payment, execution or other act relating to property made or done by or against a company which is unable to pay its debts, as the debts become due, from its own money in favour of any creditor or any person in trust for any creditor shall be deemed to have given such creditor a preference over other creditors in the event of the company being wound up on a winding up petition presented within six months from the date of making or doing the same and every such act shall be deemed fraudulent and void.”

The acts / transactions which will be void as being undue preferences are inter alia payments made to an existing creditor within the six-month period prior to the presentation of the winding up petition. The commencement date of winding up is deemed to be:

¹¹⁸ Section 295(2) of CA 1965; section 530(2) of CA 2016.

¹¹⁹ Under CA 2016, it is presentation of winding up petition.

¹²⁰ Section 295(4) of CA 1965; section 530(5) of CA 2016.

¹²¹ Section 295(3) of CA 1965; section 530(4) of CA 2016.

¹²² Section 293 of CA 1965; section 528 of CA 2016.

¹²³ *Sime Diamond Leasing (M) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (In Liquidation)* [1998] 4 MLJ 569; *Tee Siew Kai (as the liquidator for Kumpulan Kerjaya Bhd (the receiver and manager appointed)) (in liquidation) v Affin Bank* [2011] 4 MLJ 491.

¹²⁴ Under section 528(2) of CA 2016, the date upon which the winding up is deemed by CA 2016 to have commenced.

- (1) the date of presentation of the winding up petition; or
- (2) where before the presentation of the petition a resolution has been passed by the company for voluntary winding up, the date upon which the resolution to wind up the company voluntarily is passed, whichever is the earlier; and
- (3) in the case of a voluntary winding up, the date upon which the winding up is deemed by CA 1965 to have commenced.¹²⁴

The effect of the payment on the other creditors is to be determined objectively. The test is whether the payment has the effect of giving a creditor a preference over the other creditors and it is irrelevant whether the debtor intended to give the creditor preferential treatment.¹²⁵

Under CA 1965, the ‘preferences’ relating to companies are merely voidable at the option of the liquidator.¹²⁶ However, S 528(1) of CA 2016 states that such acts / transactions shall be deemed fraudulent and void.

4.4.1 Conditions for setting aside a ‘preference’

Under CA 1965, the Court can only make an order for restoration of the status quo by way of relief under this provision if the following conditions are satisfied:

- (i) the transaction in question must take place within six months prior to the commencement of the winding up;
- (ii) it must be the type of transaction mentioned in S 53(1) of BA 1967;
- (iii) it took place at a time when the company was insolvent;
- (iv) the person in whose favour the transaction was effected was a creditor to the company; and
- (v) the effect of that transaction was to confer on that person a preference, priority or advantage over other creditors in the winding up.¹²⁷

Under the new S 528(4) of CA 2016, such acts / transactions shall be void except if it is in favour of any person dealing with the company for valuable consideration and without any actual notice of the contravention. “Valuable consideration” means a consideration fair and reasonable money value in relation to the value of the property conveyed, assigned or transferred or the known or reasonably anticipated benefits of the contract, dealing or transaction.¹²⁸ “Notice” includes knowledge of inability to pay a debt by the company or any winding up proceedings against the company or of the facts insufficient to indicate to the person dealing with the wound-up company.¹²⁹

4.5 Invalid floating charges¹³⁰

S 294 of CA 1965 deals specifically with the situation where the security takes the form of a floating charge. A floating charge on the undertaking or property of the company created within six months of the commencement of the winding up is invalid except to the amount of any cash paid to the company at the time of, or subsequently to the creation of, and in consideration for the charge together with interest at five per cent per annum.¹³¹ The floating charge is not invalid if the creditor proves the company was solvent immediately after the creation of the charge.

This section aims to prevent companies which are on the verge of insolvency from securing past debts by granting floating charges over its assets in favour of particular creditors.

¹²⁵ *Arab Malaysian Merchant Bank Bhd v Orient Apparel Bhd & Ors* [2002] 1 MLJ 89 following the Australian High Court case of *Airservices v Ferrier* 21 ACSR 1.

¹²⁶ *Meiden Electric Sdn Bhd v Mtrans Holdings Sdn Bhd* [2006] 5 MLJ 749, *Sime Diamond Leasing (M) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (In Liquidation)* [1998] 4 MLJ 569.

¹²⁷ *Sime Diamond Leasing (Malaysia) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (In Liq)* [1998] 4 MLJ 569, *Bensa Sdn Bhd (in liquidation) v Malayan Banking Bhd & Anor* [1993] 1 MLJ 119. This case was referred to and followed in *Tee Siew Kai v Affin Bank and Anor* [2011] 4 MLJ 491.

¹²⁸ Section 528(5) of CA 2016.

¹²⁹ Section 528(6) of CA 2016.

¹³⁰ Section 294 of CA 1965; section 529 of CA 2016.

¹³¹ See *Sabah Bank Bhd v Ho Juan Hua & Anor* [1993] 3 MLJ 113.

4.5.1 Conditions for setting aside

A floating charge on the undertaking or property of the company is invalid under this provision if the following conditions are satisfied:

- (1) the company is insolvent; and
- (2) the charge is created within six months of the commencement of winding up.¹³²

It should be noted that S 294 of CA 1965 only invalidates the floating charge and not the debt. The debt can still be proved.¹³³ Further, the section only affects the recovery of money under the debenture creating a floating charge. It does not affect the ability to recover money secured by a separate contract of guarantee.¹³⁴

4.6 Breach by directors of general / common law duties

If the directors cause the company to contract with another party on terms disadvantageous to the company, they may be in breach of their general / common law duty to put the company's interests first. Where the counterparty has knowledge of this, there may be circumstances where there are proprietary or restitutionary rights to recover the property. These are rights under the general law and, whilst not dependent upon insolvency, are more likely to be examined and/or exercised after a formal insolvency event.

4.7 Disclaimer of onerous property¹³⁵

In order to preserve the remaining assets of the company, S 296 of CA 1965 enables the liquidator to disclaim any onerous property on behalf of the company. This includes:¹³⁶

- (a) any estate or interest in land which is burdened with onerous covenants;
- (b) shares in corporations;
- (c) unprofitable contracts; or
- (d) any other property that is unsaleable, or not readily saleable, by reason of it binding the possessor to the performance of any onerous act, or to the payment of any sum of money.

The purpose of the power of disclaimer is to relieve the company of an asset, which in reality is a liability. This power may only be exercised within 12 months after the commencement of the winding up and only with the leave of the Court or the committee of inspection. The disclaimer operates to terminate the rights, interests and liabilities of the company as from the date of disclaimer.¹³⁷ However, all liabilities arising up to the date of commencement of winding up remain and rank with other debts of equal priority.

The disclaimer determines the rights, interest and liabilities of the company and the property of the company in or in respect of the property disclaimed. The disclaimer does not (except so far as necessary for the purpose of releasing the company from any liability) affect the rights or liabilities of any other person. Any person injured by the operation of a disclaimer is deemed to be a creditor of the company to the amount of the injury, and may prove the amount as a debt in the winding up.¹³⁸

There can be no disclaimer if the liquidator fails, within a period of twenty-eight days after the receipt of an application requiring him to decide whether he will or will not disclaim, to give notice to the applicant that he intends to apply to Court or committee for leave to disclaim.¹³⁹

¹³² Under section 529 of CA 2016, it is presentation of the winding up petition in a compulsory liquidation or the passing of the resolution in the case of voluntary liquidation.

¹³³ *Re Parkes Garage (Swadlincote) Ltd* [1929] 1 Ch 139.

¹³⁴ *Sabah Bank Bhd v Ho Juan Hua & Anor* [1993] 3 MLJ 113.

¹³⁵ Section 296 of CA 1965; section 531 of CA 2016.

¹³⁶ Section 296 of CA 1965; section 531(1) of CA 2016.

¹³⁷ Section 296(2) of CA 1965; section 531(2) of CA 2016.

¹³⁸ Section 296(8) of CA 1965; section 531(10) of CA 2016.

¹³⁹ Section 296(4) of CA 1965; section 531(5) of CA 2016.

4.8 Disposition of property of the company made after the commencement of winding up¹⁴⁰

S 223 of CA 1965 provides that any disposition of the company's property including things in action and any transfer of shares or alteration in the status of the members of the company made after the commencement of the winding up¹⁴¹ by the Court is void, unless validated by the Court. Under S 472 of CA 2016, exempt dispositions (which are dispositions made by liquidator or by an interim liquidator of the company) are not void.

A company may seek a Court validation order in respect of transactions in this period, when perhaps it is unclear whether the company will be able to pay off the petitioning creditors. The question of validating such transaction is at the discretion of the Court, following an application by the person seeking an order for validation.¹⁴² The commencement of the winding up backdates to the date of presentation of the petition for compulsory winding-up if an order is ultimately made.

4.9 Failure to register a charge¹⁴³

S 108 of CA 1965 sets out the charges (whether legal or equitable) which must be registered with the Registrar of Companies. The charges required to be registered under S 108(3) of CA 1965¹⁴⁴ are:

- (a) a charge to secure any issue of debentures;
- (b) a charge on uncalled share capital of a company;
- (c) a charge on shares of a subsidiary of the company which are owned by the company;
- (d) a charge or an assignment created or evidenced by an instrument which if executed by an individual within Peninsular Malaysia and affecting property within Peninsular Malaysia would be invalid or of limited effect if not filed or registered under the Bills of Sale Act, 1950;
- (e) a charge on land wherever situate or any interest therein;
- (f) a charge on book debts of the company;
- (g) a floating charge on the undertaking or property of a company;
- (h) a charge on calls made but not paid;
- (i) a charge on a ship or aircraft or any share in a ship or aircraft;
- (j) a charge on goodwill, on a patent or licence under a patent, on a trade mark, or on a copyright or a licence under a copyright; and
- (k) a charge on the credit balance of the company in any deposit account.

It appears that the charges required to be registered under S 108(3) of CA 1965 are exhaustive. This is because charges which are not referred to in S 108 of CA 1965 do not require registration; for instance, fixed charges over partnership interests and commercial contracts.¹⁴⁵

Where a company does not lodge a notice of charge within the prescribed period of 30 days after its creation, the charge will be void as against the liquidator or any creditor of the company. The time limit of 30 days is subject to any extension ordered by the Court under S 114 of CA 1965.¹⁴⁶ Where the charge is void against a liquidator, the chargee nevertheless remains a creditor of the company, but without security, thereby rendering him or her as merely an unsecured creditor of the company. S 108 of CA 1965 applies without prejudice to any contract or obligation for repayment of the money secured by a charge. When a charge becomes void under this section, the money

¹⁴⁰ Section 223 of CA 1965; section 472 of CA 2016.

¹⁴¹ Under section 472 of CA 2016, it is presentation of the winding up petition.

¹⁴² *Kimoyana Elektrik (M) Sdn Bhd v Metrobilt Construction Sdn Bhd* [1990] 3 MLJ 309; *Zulpadli & Edham v Inai Offshore & Marine Engineering Sdn Bhd (in liquidation)* [2011] 4 MLJ 161.

¹⁴³ Section 108 of CA 1965; section 352 of CA 2016.

¹⁴⁴ Section 353 of CA 2016.

¹⁴⁵ *United Builders Pty Ltd v Mutual Acceptance Ltd* [1980] 144 CLR 673 (HC).

¹⁴⁶ Section 361 of CA 2016.

secured thereby shall immediately become payable.¹⁴⁷ This means that the contract, or obligation for repayment of the money secured by the charge, would be valid and enforceable, and would immediately become payable.¹⁴⁸

The main purpose of these provisions is to enable a potential creditor of that company, who proposes to lend money on security of particular assets, to ascertain whether the company has already given a charge over those assets. They also enable an unsecured creditor to determine the extent to which the assets of a company have been charged, and thereby to ascertain the rights of secured creditors who rank ahead of an unsecured creditor in priority of payment.

4.10 Incurring further credit during the twilight period

The incurring of further credit during the twilight period may be used as one of the grounds of liability discussed above.

Generally, directors do not owe a fiduciary duty to the company's creditors. However, where a company is insolvent or nearing insolvency, the creditors are to be seen as having a direct interest in the company and that interest cannot be overridden by the shareholders. Nevertheless, this restriction does not, in the absence of any conferral of such a right by statute, confer upon creditors any general law right against former directors of the company to recover losses suffered by those creditors.¹⁴⁹

A claim by a liquidator for damages for breach of duties may arise where the directors incur further credit which cannot be satisfied in full when due, and which leads to an inability to satisfy the claims of other creditors in full.

There may also be liability for fraudulent trading, insolvent trading, undue preference and sale at undervalue or acquisition at overvalue. However, the director or officer may not be found liable for such offences if he is able to show that at the time the credit was incurred, he had honestly believed or had a reasonable or probable ground of expectation that the company would be able to repay the new debt incurred in full.

A reckless incurring of credit by directors during the "twilight period", without proper consideration as whether the company can make full repayment, may also lead to disqualification of directors. To prevent personal liability or vulnerability to disqualification proceedings, a director should not incur credit during the "twilight period", unless, following proper consideration, he is satisfied that there is a reasonable prospect that the credit can be discharged when due. Nonetheless, when a director or officer is uncertain of his potential liability, he should obtain independent professional advice on the legal and accounting sides to ascertain the Company's legal and financial position and to bolster any decision made for the Company to carry on trading.¹⁵⁰

¹⁴⁷ Section 108(2) of CA 1965; section 352(3) of CA 2016.

¹⁴⁸ *Sime Diamond Leasing (Malaysia) Sdn Bhd v JB Precision Moulding Industries Sdn Bhd (in liq.)* [1998] 4 MLJ 569, 584.

¹⁴⁹ *Sycotex Pty Ltd v Baseler & Ors* [1994] 12 ACLC 494.

¹⁵⁰ It may not be enough to take advice if that advice is predicated on the directors' honest and reasonable belief that the company will be able to avoid insolvent liquidation if, in the light of the directors' actual knowledge, there is no reasonable basis for that belief: *Re The Rod Gunner Organisation Ltd (Rubin v Gunner)* [2004] All ER (D) 05.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Introduction

A liquidator is required to review the action taken by directors and other persons involved in the affairs of the company during the “twilight period” as part of his duty to collect and then realise assets of the company for the benefit of the creditors. If the circumstances require, he is obliged also to bring proceedings to obtain compensation for the company for any loss caused to the company by persons interested in the company, including directors. Consequently, in most cases, it is the liquidator who is empowered to bring actions against directors.

5.2 Criminal proceedings

In the course of a winding up of a company by the Court, if it appears to the Court that any past or present officer, or any member of the company has been guilty of an offence in relation to the company for which he is criminally liable, the Court may direct the liquidator either himself to prosecute the offender or to refer the matter to the Minister charged with the responsibility for companies within S 4 of CA 1965 (Minister). The Court may give such directions either on the application of a person interested in the winding up or of its own motion.¹⁵¹

In the case of a voluntary winding up, where it appears to the liquidator that such persons mentioned above are guilty of such offences, the liquidator must report forthwith the matter to the Minister and furnish the Minister with such information or documents relating to the matter and give to him such access to and facilities for inspecting and taking copies of any documents as may be required.¹⁵²

The Minister may, if he thinks fit, investigate the matter and may then apply to the Court for an order conferring on him or any other person designated by him powers of investigating the affairs of the company as are provided by CA 1965 in the case of a winding up by the Court.¹⁵³ If the Minister considers that the case is one in which a prosecution ought to be instituted, he may institute proceedings accordingly, and the liquidator and all past and present officers and agents of the company shall give the Minister or Official Receiver all assistance in connection with the prosecution which they are reasonably able to give.¹⁵⁴

If any person fails or neglects to give assistance in the manner as required, the Court may, on an application of the Minister or official receiver, direct that person to provide such assistance. If the application is made with respect to a liquidator, unless it appears that the failure or neglect to comply was due to the liquidator not having in his hands sufficient assets of the company to enable him to do so, the Court may direct that the costs of the application be borne by the liquidator personally.¹⁵⁵

The Minister may direct that the whole or any part of any costs and expenses properly incurred by the liquidator in such proceedings be defrayed out of moneys provided by Parliament.¹⁵⁶ All other costs and expenses shall be payable out of the assets of the company as part of the costs of winding up.¹⁵⁷

However, if it appears to the Minister that the case is not one in which proceedings ought to be taken by him, he shall inform the liquidator accordingly, and thereupon subject to the approval by the Court, the liquidator may himself take proceedings against the offender.¹⁵⁸

¹⁵¹ Section 306(1) of CA 1965; section 542(1) of CA 2016.

¹⁵² Section 306(2) of CA1965; section 542(2) of CA 2016.

¹⁵³ Section 306(4) of CA 1965; section 542(4) of CA 2016.

¹⁵⁴ Section 306(6) of CA 1965; section 542(6) of CA 2016.

¹⁵⁵ Section 306(8) of CA 1965; section 542(8) of CA 2016.

¹⁵⁶ Section 306(9) of CA 1965; section 542(9) of CA 2016.

S 371(1) of CA 1965 provides that, except where provision is otherwise made in CA 1965, proceedings for any offence of that Act may be taken by the Registrar or, with the written consent of the Minister, by any person.¹⁵⁹

S 589(1) of CA 2016 states:

“The Registrar or any person shall not institute any proceeding for any offence under this Act except with the written consent of the Public Prosecutor.”

The following are criminal offences in CA 1965 in respect of which either the liquidator or Minister may bring an action against the directors and others involved:

- (a) inducement to be appointed liquidator – S 301 (S 537 of CA 2016);
- (b) falsification of books - S 302 (S 538 of CA 2016);
- (c) proper accounts not kept - S 303(1) (S 539 of CA 2016);
- (d) insolvent trading - S 303(3) (S 539(3) of CA 2016);
- (e) fraudulent trading - S 304 (S 540 of CA 2016);
- (f) misconduct in the course of company being wound up - S 300(1)(a), (b), (e) and (f) (sections 536(1)(a), (b), (e) and (f) of CA 2016);
- (g) fraud in the course of company being wound up - S 300(1)(c) (S 536(1)(c) of CA 2016);
- (h) false representations to creditors - S 300(1)(h) (S 536(1)(h) of CA 2016);
- (i) material omissions from statement relating to company’s affairs - S 300(1)(d) (S 536(1)(d) of CA 2016); and
- (j) misfeasance or breach of trust or duty - S 305 (S 541 of CA 2016).

5.3 Civil proceedings

As for civil proceedings, the ability to bring actions against directors and others is primarily held by the liquidator of the company.

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

Activity / transaction	Person able to bring proceedings
Misfeasance	Liquidator, creditor or contributory of the company
Fraudulent trading	Liquidator, creditor or contributory of the company
Insolvent trading	Liquidator, creditor or contributory of the company
Sale at undervalue or acquisition at overvalue	Liquidator only
Undue preference	Liquidator, creditor or contributory of the company

¹⁵⁷ Section 306(10) of CA 1965; section 542(10) of CA 2016.

¹⁵⁸ Section 306(4) of CA 1965; section 542(4) of CA 2016.

¹⁵⁹ This is in contrast to Article 145(3) of the Federal Constitution which provides that the powers to institute, conduct or discontinue any proceedings for a criminal offence are vested in the Attorney-General. Pursuant to section 376(i) of the Criminal Procedure Code, the Attorney-General shall be the Public Prosecutor and shall have the control and direction of all criminal prosecutions and proceedings under the said Code.

Activity / transaction	Person able to bring proceedings
Undue preference	Liquidator, creditor or contributory of the company
Disposition of the company's property made after the commencement of winding up	Liquidator, creditor or shareholder ¹⁶⁰ of the company
Disqualification as director	Registrar, Official Receiver or any person. Any person intending to apply for the leave of Court for this order must give to the Registrar notice of his intention to apply and the Registrar shall be made a party to the proceedings.
Breach of director's duties	Liquidator only

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Offence	Remedy available under CA 1965	Remedy available under CA 2016
Falsification of books	Imprisonment for five years or a RM 30,000 fine.	Imprisonment for a term not exceeding ten years or to a fine not exceeding RM 3,000,000 or to both.
Inducement to be appointed liquidator	Imprisonment for one year or a RM 1,000 fine.	Imprisonment for a term not exceeding three years or to a fine not exceeding RM 100,000 fine or to both.
Proper accounts not kept	Imprisonment for three years or a RM 10,000.00 fine.	Imprisonment for a term not exceeding three years or to a fine not exceeding RM 500,000 or to both.
Insolvent trading	<p>The Court may, on the application of the liquidator or any creditor or contributory of the company, declare that the person shall be personally responsible without any limitation of liability for the payment of the whole or any part of that debt.</p> <p>The Court also has powers to make consequential orders to give effect to the declaration above.</p> <p>Where the Court makes a declaration under S 303(3) of CA 1965 that an individual is liable to make contribution to the company's assets, then whether or not an application has been made for his disqualification, the Court may make an order that the individual be disqualified from acting as a company director and prohibit him from being in any way concerned in or taking part in the management of a corporation for a period of five years from the date of order.</p>	<p>The Court may, on the application of the liquidator or any creditor or contributory of the company, declare that the person shall be personally responsible without any limitation of liability for the payment of the whole or any part of that debt.</p> <p>The Court also has powers to make consequential orders to give effect to the declaration above.</p> <p>Where the Court makes a declaration under section 539(3) of CA 2016 that an individual is liable to make contribution to the company's assets, then whether or not an application has been made for his disqualification, the Court may make an order that the individual be disqualified from acting as a company director and prohibit him from being in any way concerned in or taking part in the management of a corporation for a period of five years from the date of order.</p>
	Imprisonment for one year or a RM 5,000 fine.	Imprisonment for a term not exceeding five years or to a fine not exceeding RM 500,000 or to both.

¹⁶⁰ *Re Argentum Reductions (UK) Ltd* [1975] 1 All ER 605.

Offence	Remedy available under CA 1965	Remedy available under CA 2016
Fraudulent trading	<p>The Court may, on the application of the liquidator or any creditor or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in that manner shall be personally responsible without any limitation of liability, for all or any of the debts or other liabilities of the company.</p> <p>The Court also has powers to make consequential orders to give effect to the declaration above.</p> <p>Where the Court makes a declaration under S 304 of CA 1965 that an individual is liable to make contribution to the company's assets, then whether or not an application has been made for his disqualification, the Court may make an order that the individual be disqualified from acting as a company director and prohibit him from being in any way concerned in or taking part in the management of a corporation for a period of five years from the date of order.</p> <p>Imprisonment for three years or a RM 10,000 fine.</p>	<p>The Court may, on the application of the liquidator or any creditor or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in that manner shall be personally responsible without any limitation of liability, for all or any of the debts or other liabilities of the company.</p> <p>The Court also has powers to make consequential orders to give effect to the declaration above.</p> <p>Where the Court makes a declaration under S 540 of CA 2016 that an individual is liable to make contribution to the company's assets, then whether or not an application has been made for his disqualification, the Court may make an order that the individual be disqualified from acting as a company director and prohibit him from being in any way concerned in or taking part in the management of a corporation for a period of five years from the date of order.</p> <p>Imprisonment for a term not exceeding ten years or to a fine not exceeding RM 1,000,000 or to both.</p>
Misconduct in the course of company being wound up	Imprisonment for two years or a RM 5,000 fine.	Imprisonment for a term not exceeding five years or to a fine not exceeding RM 3,000,000.00 or to both.
Fraud in the course of company being wound up	Imprisonment for two years or a RM 5,000 fine.	Imprisonment for a term not exceeding five years or to a fine not exceeding RM 3,000,000 or to both.
False representations to creditors	Imprisonment for two years or a RM 5,000 fine.	Imprisonment for a term not exceeding five years or to a fine not exceeding RM 3,000,000 or to both.
Material omissions from statement relating to company's affairs	Imprisonment for two years or a RM 5,000 fine.	Imprisonment for a term not exceeding five years or to a fine not exceeding RM 3,000,000 or to both.
Misfeasance	The Court may order the director to repay or restore the money or property or any part of it, with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust or duty as the Court thinks just.	The Court may order the director to repay or restore the money or property or any part of it, with interest at such rate as the Court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust or duty as the Court thinks just.
Fiduciary duties	The director may be ordered to compensate the company for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit or profits obtained in breach of fiduciary duty.	The director may be ordered to compensate the company for any loss or damage caused by breach of his fiduciary duty, to restore to the company any property appropriated or acquired in breach of his fiduciary duty and to account to the company for any benefit or profits obtained in breach of fiduciary duty.
Duties of skill and care	The director may be ordered to compensate the company for all loss and damage caused by breach of his duty of skill and care.	The director may be ordered to compensate the company for all loss and damage caused by breach of his duty of skill and care.

Offence	Remedy available under CA 1965	Remedy available under CA 2016
Conduct rendering a director unfit to be concerned in the management of a company	The Court may order disqualification for a period not exceeding five years. There is no financial penalty.	The Court may order disqualification for a period not exceeding five 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.	The Court may make such order as it thinks fit in order to restore the position to that which would have existed if the company had not entered into the impugned transaction.
Invalid floating charges	The Court can declare that the floating charge is invalid.	The Court can declare that the floating charge is invalid.

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Introduction

There is no provision in CA 1965 imposing a general duty on directors and others involved in the affairs of the company to co-operate with a liquidator, provisional liquidator or Official Receiver, as can be found under English law in S 235 Insolvency Act 1986 (IA 1986). Liquidators in Malaysia must rely on the specific provisions, which are set out below, when investigating the company’s affairs.

A person is guilty of an offence against CA 1965 if he:¹⁶¹

- (a) does an act which by or under CA 1965 he is forbidden to do;
- (b) does not do that which by or under CA 1965 he is required or directed to do; or
- (c) otherwise contravenes or fails to comply with any provision of CA 1965.

A person who is convicted of an offence under CA 1965 shall be liable to a penalty or punishment not exceeding that expressly mentioned for the offence, or if no such penalty or punishment is expressly mentioned, to a penalty not exceeding RM 5,000.¹⁶²

Under CA 2016, a person guilty of an offence shall, on conviction, be liable to a penalty or punishment not exceeding the penalty or punishment expressly mentioned for the offence, or if no such penalty or punishment is expressly mentioned, in the case of a person who is an individual, to a fine not exceeding RM 50,000 or to imprisonment for a term not exceeding three years or to both, but in the case of a person other than an individual, to a fine not exceeding RM 50,000.¹⁶³

¹⁶¹ Section 369(1) of CA 1965; section 588(1) of CA 2016. In *Lembaga Kumpulan Wang Simpanan Pekerja v Adorna RMIT Sdn Bhd & Ors* [2003] 4 MLJ 729, the Court held that the relevant section is sufficient to include the director’s liability which was joint and several. Kamalanathan Ratnam J added that as directors are the alter ego of a company, it is therefore not appropriate for a director to attempt to escape culpability by pleading that he is a sleeping partner or director, or a silent director or a non-active director.

¹⁶² Section 369(2) of CA 1965.

¹⁶³ Section 588(2) of CA 2016.

Further, under S 428(1) of CA 2016, there is a statutory duty on directors and others involved in the affairs of the company to co-operate with a judicial manager appointed by the Court pursuant to the new provisions on Judicial Management under CA 2016. Such persons shall give to the judicial manager such information concerning the company and its promotion, formation, business dealings, affairs or property as the judicial manager may at any time after the date of the judicial management order reasonably require and attend on the judicial manager at such times as the judicial manager may reasonably require.

Under S 428(2) of CA 2016, a person who, without reasonable excuse, contravenes the obligation in S 428(1) commits an offence and, in the case of a continuing offence, to a further fine not exceeding RM 1,000 for each day during which the offence continues after conviction.

7.2 Obligation to produce for inspection books and papers of the company¹⁶⁴

The Court may order the inspection of the books and papers of the company by creditors and contributories as the Court thinks just, and any books and papers in the possession of the company may be inspected by creditors or contributories accordingly.¹⁶⁵

7.3 Company's statement of affairs¹⁶⁶

In a compulsory liquidation, S 234 of CA 1965¹⁶⁷ requires persons who were the directors and secretary at the time of the winding up order to submit a report to the liquidator in the prescribed form as to the affairs of the company. This statement as to the affairs of the company as at the date of the winding up order must show:

- (i) the particulars of its assets, debts and liabilities;
- (ii) the names and addresses of its creditors;
- (iii) the securities held by them respectively;
- (iv) the dates when the securities were respectively given; and
- (v) such further information as is prescribed or as the Official Receiver or the liquidator requires.

The report must be submitted within 14 days after the date of the winding up order unless otherwise extended.¹⁶⁸ Persons who may also be required to supply information on the affairs of the company if requested by the liquidator are:

- (i) present or former officers;
- (ii) persons who have taken part in the formation of the company within a year of the date of the winding up order; or
- (iii) persons who are or have been within that period officers in the employment of a corporation which is, or within that period was, an officer of the company to which the statement relates.¹⁶⁹

Such persons making the statement may be paid, out of the assets of the company, such costs and expenses incurred in and about the preparation and making of the statement as the Official Receiver or the liquidator considers reasonable.¹⁷⁰

¹⁶⁴ Section 248 of CA 1965; section 501 of CA 2016.

¹⁶⁵ In *SP Setia Berhad v Gasing Heights Sdn Bhd* [2004] MLJU 498, Abdul Wahab JC found that a creditor may apply for inspection of the books and papers of the company which are with the liquidator. The right of a petitioner in respect of those documents relating to certain questionable transactions would be entertained by the Court if the liquidator had not requested the directors to do so or having done so, the directors had failed to surrender them.

¹⁶⁶ Section 234 of CA 1965; section 484 of CA 2016.

¹⁶⁷ Section 484 of CA 2016.

¹⁶⁸ Section 234(3) of CA 1965; section 484(3) of CA 2016.

¹⁶⁹ Section 234(2) of CA 1965; section 484(2) of CA 2016.

¹⁷⁰ Section 234(4) of CA 1965; section 484 (5) of CA 2016.

Every person who commits a default in submitting such a report without reasonable excuse shall be liable to imprisonment for three years or a fine of RM 10,000 or both. Under CA 2016, a person, on conviction will be liable to imprisonment for a term not exceeding three years or to a fine not exceeding RM 100,000 or to both. In the case of continuing offence, further fine not exceeding RM 500 for each day during which the offence continues.¹⁷¹ The liquidator shall report such default to the Court.¹⁷²

7.3.1 Preparation of statement of affairs¹⁷³

The liquidator may from time to time hold personal interviews with such persons who are required to submit and verify a statement of affairs of the company mentioned above for the purpose of investigating the company's affairs. Such persons are duty bound to attend on the liquidator at such time and place as the liquidator may appoint and give the liquidator all information that he may require.¹⁷⁴

7.3.2 Information subsequent to statement of affairs

After the statement of affairs of a company has been submitted to the liquidator, it shall be the duty of each person who has made or concurred in making it, if and when required, to attend on the liquidator and answer all such questions as may be put to him and give all such further information as may be required of him by the liquidator in relation to the statement of affairs.

7.4 Private examination¹⁷⁵

The Court may summon before it and examine on oath any officer of the company or person:

- (i) who is known or suspected to have in his possession any property of the company; or
- (ii) who is supposed to be indebted to the company; or
- (iii) whom the Court deems capable of giving information concerning the promotion, formation, trade dealings, affairs or property of the company.¹⁷⁶

The Court may examine such persons on oath either by word of mouth or on written interrogatories and may reduce his answers to writing and require him to sign them, and any writing so signed may be used in evidence in any legal proceedings against him.¹⁷⁷

Such persons may also be required to produce any books and papers in his custody or power relating to the company. However, where he claims any lien on books or papers the production shall be without prejudice to that lien, and that the Court shall have jurisdiction to determine all questions relating to that lien.¹⁷⁸

If any person so summoned after being tendered a reasonable sum for his expenses refuses to come before the Court at the time appointed not having a lawful excuse, the Court may cause him to be apprehended and brought before the Court for examination.¹⁷⁹

The proposed examinee can oppose or discharge an application for examination by showing:

- (a) a case of oppression or unfair prejudice;
- (b) that the information is not reasonably required;
- (c) the liquidator is acting inappropriately outside his statutory functions or is motivated by improper considerations;
- (d) that there has been a lack of full and frank disclosure by the liquidator; or

¹⁷¹ Section 484(6) of CA 2016.

¹⁷² Rule 44 of Companies (Winding Up) Rules 1972.

¹⁷³ Rule 41 of Companies (Winding Up) Rules 1972.

¹⁷⁴ Rule 41(2) of Companies (Winding Up) Rules 1972.

¹⁷⁵ Section 249 of CA 1965; section 502 of CA 2016.

¹⁷⁶ Sections 249(1) and (2) of CA 1965; section 502(1) of CA 2016.

¹⁷⁷ Section 249(2) of CA 1965; section 502(2) of CA 2016.

¹⁷⁸ Section 249(3) of CA 1965; section 502(3) of CA 2016.

¹⁷⁹ Section 249(5) of CA 1965; section 502(5) of CA 2016.

(e) that the examination is sought to give the company an undue tactical advantage.¹⁸⁰

7.5 Public examination of officers¹⁸¹

The liquidator is obliged to submit a preliminary report to the Court as soon as practicable after receipt of the statement of affairs from one of the persons identified in S 234(2) of CA 1965.¹⁸² In his report, he may opine as to whether any fraud has been committed or any material fact has been concealed by any person in the promotion or formation of the company or by an officer in relation to the company since its formation or that an officer has failed to act honestly and diligently or has been guilty of any impropriety or recklessness in relation to the affairs of the company.¹⁸³

Where the liquidator has submitted a report under S 235(2) of CA 1965, the Court may, after consideration of the report publicly examine:

- (i) any person or officer or any other person who was previously an officer of the company, including any banker, advocate or auditor or any person who is known or suspected to have in his possession any property of the company or is supposed to be indebted to the company; or
- (ii) any person whom the Court deems capable of giving information concerning the promotion, formation, trade dealings, affairs or property of the company.

The Court may direct that such person shall attend before the Court on a day appointed and be publicly examined as to the promotion or formation or the conduct of the business of the company, or in the case of an officer or former officer as to his conduct and dealings as an officer thereof.¹⁸⁴

In the examination, the Court may put or allow to be put such questions as the Court thinks fit.¹⁸⁵

The liquidator and any creditor or contributors may take part in the examination either personally or by an advocate.¹⁸⁶

The person is examined under oath and is obliged to answer all such questions as the Court puts or allows to be put.¹⁸⁷ The notes of the examination:¹⁸⁸

- (i) shall be reduced into writing;
- (ii) shall be read over to or by and signed by the person examined;
- (iii) may thereafter be used in evidence in any legal proceedings against him; and
- (iv) shall be open to the inspection of any creditor or contributory at all reasonable times.

7.6 Obligation to assist with delivery of property to liquidator¹⁸⁹

A liquidator may apply to the Court for orders requiring certain persons to hand over any money, property, books and papers to which the company is prima facie entitled. Such persons include any contributory, trustee, receiver, banker, agent or officer of the company. The Court may require such persons forthwith or within such time as the Court directs to pay, deliver, convey, surrender or transfer such property to the liquidator or provisional liquidator.¹⁹⁰

¹⁸⁰ *Hicom Bhd v Bukit Cahaya Country Resorts Sdn Bhd* [2005] MLJU 418. In *Liquidators of W&P Piling Pte Ltd v Chew Yin What* [2004] 3 SLR 164, the Singaporean High Court held that an examination under section 249 must not be used for improper third party collateral purposes that afforded no benefit to the winding up of the company.

¹⁸¹ Section 250 of CA 1965; section 503 of CA 2016.

¹⁸² Section 235(1) of CA 1965; section 485(1) of CA 2016.

¹⁸³ Section 250(1) of CA 1965; section 503(1) of CA 2016.

¹⁸⁴ Section 250(1) of CA 1965; section 503(1) of CA 2016.

¹⁸⁵ Section 250(3) of CA 1965; section 503(4) of CA 2016.

¹⁸⁶ Section 250(2) of CA 1965; section 503(3) of CA 2016.

¹⁸⁷ Section 250(4) of CA 1965; section 503(5) of CA 2016.

¹⁸⁸ Section 250(7) of CA 1965; section 503(8) of CA 2016.

¹⁸⁹ Section 277(5) of CA 1965; section 511 of CA 2016.

¹⁹⁰ The section does not apply where there is a bona fide dispute as the company is not then 'prima facie entitled'; *Re Palace Restaurants* [1914] 1 Ch 492.

7.7 Sanction for absconding contributories¹⁹¹

The Court may cause a contributory, director or former director of the company to be arrested and his books and papers and movable personal property to be seized from him, to be safely kept until such time as the Court orders, on proof of probable cause for believing that such person:

- (i) is in hiding or has absconded;
- (ii) is about to quit Malaysia or otherwise to abscond or to remove or conceal any of his property for the purpose of evading payment of calls or of avoiding examination respecting the affairs of the company; or
- (iii) is otherwise avoiding, delaying or embarrassing proceedings in the winding up.

The Court may make such order at any time before or after making a winding up order.

7.8 Human rights

The Human Rights Commission of Malaysia Act 1999 (HRCMA 1999) came into force on 20 April 2000 which essentially gave statutory recognition to the Universal Declaration of Human Rights 1948 (1948 Declaration). In furtherance of the protection and promotion of human rights in Malaysia, the functions of the Commission shall be:

- (a) to promote awareness of and provide education in relation to human rights;
- (b) to advise and assist the Malaysian Government in formulating legislation and administrative directives and procedures and recommend the necessary measures to be taken;
- (c) to recommend to the Malaysian Government with regard to the subscription or accession of treaties and other international instruments in the field of human rights; and
- (d) to inquire into complaints regarding infringements of human rights referred to in S 12 HRCMA 1999.

S 4(4) HRCMA 1999 provides that for the purpose of the Act, regard shall be had by the courts¹⁹² to the 1948 Declaration to the extent that it is not inconsistent with the Federal Constitution.

However, the Malaysian Federal Court has opined that the 1948 Declaration is not legally binding on Malaysian courts.¹⁹³

¹⁹¹ Section 251 of CA 1965; section 504 of CA 2016.

¹⁹² *Mohamad Ezam Mohd Noor v Ketua Polis Negara & Other Appeals* [2002] 4 CLJ 309 (FC) where Siti Norma Yaakob FCJ stated that “the use of the words ‘regard shall be had’ in s. 4(4) of the Human Rights Commission of Malaysia Act can only mean an invitation to look at the 1948 Declaration if one was disposed to do and to consider the principles stated therein and be persuaded by them if need be.”

¹⁹³ *Mohamad Ezam Mohd Noor v Ketua Polis Negara & Other Appeals* [2002] 4 CLJ 309 (FC). The Federal Court upheld the case of *Merdeka University Berhad v. Government of Malaysia* [1981] 1 CLJ 175; [1981] CLJ (Rep) 191 where the 1948 Declaration was described as a non-legally binding instrument as some of its provisions depart from existing and generally accepted rules; “It is merely a statement of principles devoid of any obligatory character and is not part of our municipal law”.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower courts?

8.1 Limitation periods

8.1.1 Limitation period for criminal proceedings

S 371(2) of CA 1965 provides that:

Notwithstanding anything in any Act, proceedings for any offence against the Act may be brought within the period of seven years after the commission of the alleged offence or, with the consent of the Minister, at any later time.¹⁹⁴

8.1.2 Limitation period for civil actions

In relation to any liabilities created by the provisions of CA 1965, the limitation period is six years from the date on which the cause of action accrued.¹⁹⁵

In relation to breaches of the director's fiduciary duties, the limitation period is generally six years from the date on which the cause of action accrued.¹⁹⁶

In relation to breaches of the director's common law duties, the limitation period is also six years from the date on which the cause of action accrued.¹⁹⁷

8.2 Appeals

8.2.1 Winding up

The High Court¹⁹⁸ or a judge thereof has jurisdiction over winding up proceedings.¹⁹⁹

Winding up orders can be withdrawn, altered or modified before being perfected.²⁰⁰ Once perfected, the order cannot be discharged or varied; any application to discharge or vary the order must be by way of appeal. The decision of the High Court is appealable. There are two levels of appeals, namely to the Court of Appeal, and thereafter to the Federal Court (with leave).

The appeal to the Court of Appeal in relation to a petition for winding up is as of right, and no leave of Court is required. The Court of Appeal may review the exercise of the High Court's discretion in making the order to wind up the company. However, the Court of Appeal would not interfere with the exercise of the discretion unless:

- (i) it was exercised on a wrong principle;
- (ii) it was obviously "misused"; or
- (iii) it has effected a substantial injustice to one or other of the parties.²⁰¹

¹⁹⁴ This sub-section is not in section 589 of CA 2016.

¹⁹⁵ Section 6(1)(d) of the Limitation Act, 1953.

¹⁹⁶ Section 22(3) of the Limitation Act, 1953.

¹⁹⁷ Section 6(1)(a) of the Limitation Act, 1953 in the case of liability founded in tort.

¹⁹⁸ *Goh Boon Kim v Taman Sungai Dua Development Sdn Bhd* [1995] 4 MLJ 553, it was held that the plaintiff is entitled to file an action in any branch of the high Court in Malaya irrespective of where the respondents are situated.

¹⁹⁹ Section 4 of CA 1965; section 2(1) of CA 2016.

²⁰⁰ *Apirami Sdn Bhd v Tamil Nesan (M) Sdn Bhd* [1986] 1 CLJ 493.

²⁰¹ *Malayan Plant (Pte) Ltd v Moscow Narodny Bank Ltd* [1980] 2 MLJ 53.

The final level of appeal is to the Federal Court, and leave must be obtained from the Federal Court before the appeal can be made.

S 96 of the Courts of Judicature Act 1964 provides that subject to any rules regulating the proceedings of the Federal Court in respect of appeals from the Court of Appeal, an appeal shall lie from the Court of Appeal to the Federal Court with the leave of the Federal Court:

- (a) from any judgment or order of the Court of Appeal in respect of any civil cause or matter decided by the High Court in the exercise of its original jurisdiction involving a question of general principle decided for the first time or a question of importance upon which further argument and a decision of the Federal Court would be to public advantage; or
- (b) from any decision as to the effect of any provision of the Constitution including the validity of any written law relating to any such provision.

8.2.2 Civil suit

Hearings take place at first instance either at the Magistrates Court, Sessions Court or the High Court depending on the nature of the case and the value of the amount in issue. The Magistrates Court has jurisdiction to try all actions and suits of a civil nature where the amount in dispute or value of the subject matter does not exceed RM 100,000²⁰² whereas the Sessions Court has jurisdiction to try all actions and suits of a civil nature where the amount in dispute or the value of the subject matter does not exceed RM 1,000,000, save for actions and suits in respect of motor vehicle accidents, landlord and tenant and distress, where the Sessions Court has unlimited jurisdiction.²⁰³

In addition, S 69 of the Subordinate Courts Act 1948 sets out the subject matters where an action must commence at the High Court.

If the Court of first instance is the Magistrates Court / Sessions Court (subordinate courts), the aggrieved party may appeal to the High Court and thereafter the Court of Appeal. There can be no appeal to the High Court from a decision of a subordinate Court where the amount in dispute or the value of the subject matter is RM 10,000 or less except on a question of law.²⁰⁴ The final level of appeal here is the Court of Appeal. S 67(1) of the Courts of Judicature Act 1964 states that the Court of Appeal has jurisdiction to hear and determine appeals from any judgment or order of any High Court subject to the Act or any other written law.

Where the amount of claim exceeds RM 250,000, the appeal to the Court of Appeal is as of right. There is a right to appeal without leave of Court²⁰⁵ for, inter alia a certiorari, declaration, injunction, and petition for winding up bankruptcy proceedings. Leave of Court is required where the amount of claim is less than RM 250,000 or the judgment is on costs only. However, there can be no appeal where by any written law for the time being in force, the judgment or order of the High Court, is expressly declared to be final.²⁰⁶

8.2.3 Criminal suit

Hearings take place at first instance either at a Magistrates Court, Sessions Court or the High Court depending on the nature of the offence. S 371(3) of CA 1965 states that proceedings for any offence against CA 1965 other than an offence punishable with imprisonment for a term exceeding three years may be prosecuted in a Magistrates Court. In the case of any offence punishable with imprisonment for a term of three years or more, it shall be prosecuted in the Sessions Court or in the High Court. Under CA 2016, proceedings for any offence under CA 2016 other than an offence punishable with imprisonment for a term exceeding five years may be prosecuted in a Magistrates Court and in the case of an offence punishable with imprisonment for a term of five years or more shall be prosecuted in the Sessions Court.²⁰⁷

²⁰² Section 90 of the Subordinate Courts Act 1948.

²⁰³ Section 65 of the Subordinate Courts Act 1948.

²⁰⁴ Section 28 of Courts of Judicature Act 1964.

²⁰⁵ Court of Appeal Practice Direction No. 2 of 1996.

²⁰⁶ Section 68 of Courts of Judicature Act 1964.

²⁰⁷ Section 589 (3) of CA 2016.

The Sessions Court may also impose any punishment authorised by CA 1965 notwithstanding that it is a greater punishment than the Sessions Court is otherwise empowered to impose.²⁰⁸ This provision has been removed in the CA 2016.

If the Court of first instance is the Magistrates Court/Sessions Court, the aggrieved party may appeal to the High Court and thereafter the Court of Appeal (with leave). Such appeal shall be confined only to questions of law which have arisen in the course of the appeal or revision and the determination of which by the High Court has affected the event of the appeal or revision²⁰⁹ However, no leave of the Court of Appeal is required where the appeal is by the Public Prosecutor.²¹⁰

If the Court of first instance is the High Court, the aggrieved party may appeal to the Court of Appeal and thereafter the Federal Court. An appeal to the Federal Court in this instance is as of right²¹¹ and may lie on a question of fact or a question of law or a question of mixed fact and law.²¹²

QUESTION 9

9. Foreign corporations

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

9.1 Definition of foreign corporations

A “foreign company” is defined²¹³ as:

- (a) a company, corporation, society, association or other body incorporated outside Malaysia; or
- (b) an unincorporated society, association or other body which under the law of its place of origin may sue or be sued, or hold property in the name of the secretary or other officer of the body or association duly appointed for that purpose and which does not have its head office or principal business in Malaysia.

A foreign corporation may be wound up in Malaysia as an unregistered company²¹⁴ provided that the principal place of business of the company in Malaysia shall for all the purposes of the winding up be the registered office of the company.²¹⁵

S 332(1) of CA 1965 states the duties of every foreign company desiring to establish a place of business or to carry on business within Malaysia to lodge with the Registrar for registration:²¹⁶

- (a) a certified copy of the certificate of its incorporation or registration in its place of incorporation or origin or a document of similar effect;
- (b) a certified copy of its charter, statute or memorandum and articles or other instrument constituting or defining its constitution;
- (c) a list of its directors containing similar particulars with respect to its directors as are by this Act required to be contained in the register of the directors, managers and secretaries of a company incorporated under this Act;

²⁰⁸ Section 371(5) of CA 1965.

²⁰⁹ Section 50(2) of Courts of Judicature Act 1964.

²¹⁰ Section 50(3) of Courts of Judicature Act 1964.

²¹¹ Section 87(1) of Courts of Judicature Act 1964.

²¹² Section 87(3) of Courts of Judicature Act 1964.

²¹³ Section 4 of CA 1965; section 2(1) in CA 2016.

²¹⁴ Section 314(1) of CA 1965; section 544 of CA 2016.

²¹⁵ Section 315(1)(a) of CA 1965; section 545 of CA 2016.

²¹⁶ Section 562(1) of CA 2016 sets out its own checklist.

- (d) where the list includes directors resident in Malaysia who are members of the local board of directors, a memorandum duly executed by or on behalf of the foreign company stating the powers of the local directors;
- (e) a memorandum of appointment or power of attorney under the seal of the foreign company or executed on its behalf in such manner as to be binding on the company and, in either case, verified in the prescribed manner, stating the name and address of one or more persons resident in Malaysia, not including a foreign company, authorised to accept on its behalf service of process and any notices required to be served on the company; and
- (f) a statutory declaration in the prescribed form made by the agent of the company.

An “agent” of the company, defined as a person named in a memorandum of appointment or power of attorney lodged under CA 1965 or under any corresponding previous written law:²¹⁷

- (i) shall be answerable for the doing of all such acts, matters and things as are required to be done by the company by or under CA 1965; or
- (ii) be personally liable to all penalties imposed on the company for any contravention of CA 1965 unless he satisfies the Court hearing the matter that he should be not so liable.²¹⁸

9.2 Winding up of foreign companies

The provisions with respect to winding up of a domestic company by the Court shall apply to a foreign company (see para 9.2) and the Court or liquidator may exercise any powers or do any act in the case of a foreign company which might be exercised or done by it or him in winding up companies.²¹⁹

A foreign corporation may be wound up in Malaysia notwithstanding the fact that it is being wound up, or has been dissolved, or has otherwise ceased to exist as a company under or by virtue of the laws of the place under which it was incorporated.²²⁰

No unregistered company may be wound up voluntarily.²²¹

An unregistered company may be wound up if:²²²

- (a) it is dissolved or has ceased to have a place of business in Malaysia, or has a place of business in Malaysia only for the purpose of winding up its affairs, or has ceased to carry on business in Malaysia;
- (b) it is unable to pay its debts;
- (c) the Court is of opinion that it is just and equitable that the company should be wound up; and
- (d) the company is being used for unlawful purposes or any purpose prejudicial to or incompatible with peace, welfare, security, public interest, public order, good order or morality in Malaysia.²²³

An unregistered company shall be deemed to be unable to pay its debts if:²²⁴

- (a) a creditor by assignment or otherwise to whom the company is indebted in a sum exceeding RM 500²²⁵ then due has served on the company a demand under his hand requiring the company to pay the sum so due and the company has for three weeks after the service of the demand neglected to pay the sum or to secure or compound for it to the satisfaction of the creditor;

²¹⁷ Section 330 of CA 1965.

²¹⁸ Section 333(2) of CA 1965; section 563(1) of CA 2016.

²¹⁹ Section 314(2) of CA 1965; section 543 of CA 2016.

²²⁰ Section 315(3) of CA 1965; section 545 of CA 2016.

²²¹ Section 315(1)(b) of CA 1965; section 545 (1)(b) of CA 2016.

²²² Section 315(1)(c) of CA 1965; section 545 (1)(c) of CA 2016.

²²³ This is newly inserted into section 545(1)(c)(iv) of CA 2016.

²²⁴ Section 315(2) of CA 1965; section 545(2) of CA 2016.

²²⁵ Section 545(2) of CA 2016 does not expressly provide the amount of RM 500.00 but instead states “the amount as may be prescribed by the Minister”.

- (b) any action or other proceeding has been instituted against any member for any debt or demand due / claimed to be due from the company or from him in his character of member, and notice in writing of the institution of the action or proceeding has been served on the company and the company has not within ten days after service of the notice paid, secured / compounded for the debt or demand, or procured the action or proceeding to be stayed, or indemnified the defendant to his reasonable satisfaction against the action or proceeding and against all costs, damages and expenses to be incurred by him;
- (c) execution or other process issued on a judgment, decree or order obtained in any Court in favour of a creditor against the company, any member or any person authorised to be sued as a nominal defendant on behalf of the company is returned unsatisfied; or
- (d) it is otherwise proved to the satisfaction of the Court that the company is unable to pay its debts.

S 316 of CA 1965²²⁶ provides that:

- (1) On an unregistered company being wound up, a contributory shall be:
 - (a) a person who is liable to pay or contribute to the payment of:
 - (i) any debt or liability of the company;
 - (ii) any sum for the adjustment of the rights of the members among themselves; or
 - (iii) the costs and expenses of winding up; or
 - (b) where the company has been dissolved in the place in which it is formed or incorporated, who immediately before the dissolution was so liable, and every contributory shall be liable to contribute to the assets of the company all sums due from him in respect of any such liability.

QUESTION 10

10. Insurance

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

10.1 Directors' and officers' management liability insurance

Directors and officers may take out Directors' and Officers' Management Liability Insurance to protect the directors and officers against personal liability that may arise in connection with the issues raised in Questions 1-9 above. The company and directors / officers may jointly pay the premiums. This insurance coverage provides independent protection to directors and officers personally and also reimburses companies for costs incurred in defending the directors and officers.

10.2 Indemnity

At common law, a director as agent or trustee of a company is entitled to indemnity for acts carried out on behalf of the company where he is acting within the powers conferred upon him.

²²⁶ Section 546 of CA 2016.

However, the scope of indemnities a company can make available to a director is restricted by S 140 of CA 1965. Any provision (whether contained in the articles or in any contract with a company or otherwise) for exempting any officer or auditor of the company from, or indemnifying him against, any liability which by law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust, of which he may be guilty in relation to the company, is void.²²⁷

However, notwithstanding the above, a company may, pursuant to its articles or otherwise, indemnify any officer or auditor against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted or in connection with any application in relation thereto in which relief is under CA 1965 granted to him by the Court.²²⁸

The wording in S 289 of CA 2016 on indemnity and insurance for officers and auditors is wider than S 140 of CA 1965. S 289 states that unless provided otherwise in this section, a company shall not indemnify or directly or indirectly effect insurance for an officer or auditor of the company in respect of the liability for any act or omission in his capacity as an officer or auditor or the costs incurred by that officer or auditor in defending or settling any claim or proceedings relating to any such liability. An indemnity given in breach of S 289 shall be void.

“Effect insurance” in S 289 of CA 2016 includes pay, whether directly or indirectly, the costs of the insurance. “Indemnify” includes relieve or excuse from liability, whether before or after the liability arises, and “indemnity” has a corresponding meaning.

However, similar to S 140 of CA 1965, S 289(3) provides for circumstances in which a company may indemnify its officer or auditor. In addition to the circumstances set out in S 140 of CA 1965, S 289(3) allows a company to indemnify an officer or auditor where proceedings against him are discontinued or not pursued.

Further, apart from indemnity in relation to costs incurred by the director or officer or auditor in defending or settling any claim or proceedings (except liability to pay a fine imposed in criminal proceedings or a sum payable to a regulatory authority by way of a penalty in respect of non-compliance with any requirement of a regulatory nature), indemnity to the officer or auditor may be extended to any liability to any person other than the company.²²⁹

The company may, with the prior approval of the Board of Directors, effect insurance for an officer or auditor of the company.²³⁰ The directors shall record or cause to be recorded in the minutes of the Board of Directors and disclose or cause to be disclosed in the directors’ report the particulars of any indemnity given to, or insurance effected for, any officer or auditor of the company,²³¹ failing which, the officer or auditor shall be personally liable to the company for the cost of effecting the insurance unless the officer or auditor satisfies the Court that he is not liable.²³²

The information in this country chapter is accurate as at 22/01/2017

²²⁷ Section 140(1) of CA 1965; section 288 of CA 2016.

²²⁸ Section 140(2) of CA 1965.

²²⁹ Section 289(4) of CA 2016.

²³⁰ Section 289(5) of CA 2016.

²³¹ Section 289(7) of CA 2016.

²³² Section 289(8) of CA 2016.

NEW ZEALAND

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Identification and definition of directors

1.1.1 The Companies Act 1993 (the Act)¹ contains a wide but not exhaustive definition of “director”. A person could be a director despite not being formally appointed or named as a director. Some categories of the definition apply only for the purposes of certain sections of the Act. Any person who is responsible for management decisions of the company could well fall within one or more legs of the definition. Receivers of companies (appointed by secured creditors or by the Court) are excluded from the definition. A brief description of the categories of “director” follows.

1.1.2 *De facto* directors

A “*de facto*” director is one who acts as a director and is treated as such by the rest of the board, even though he 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).

“Director” is defined in S 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.

De facto directors owe the same duties to the company as directors who have been formally appointed.

1.1.3 Shadow directors

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 is 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)).

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

¹ References to the Act and all section references in this paper are to the Companies Act 1993, unless otherwise stated.

1.1.4 In practice, what conduct makes someone a shadow director?

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 (and therefore 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.

1.1.5 Deemed directors

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)).

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.

1.1.6 Shareholders as deemed directors

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)).

1.1.7 Professional advisers

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)).

1.1.8 Disqualified persons

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).

1.2 Twilight period - overview

1.2.1 Transactions vulnerable to attack

The Act 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 therefore contains provisions in Ss 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.

The vulnerability periods for transactions entered into by a company before the commencement of formal insolvency proceedings (liquidation) which are vulnerable to attack are:

- (a) insolvent transactions – that is, transactions having preferential effect (s.292) – two years

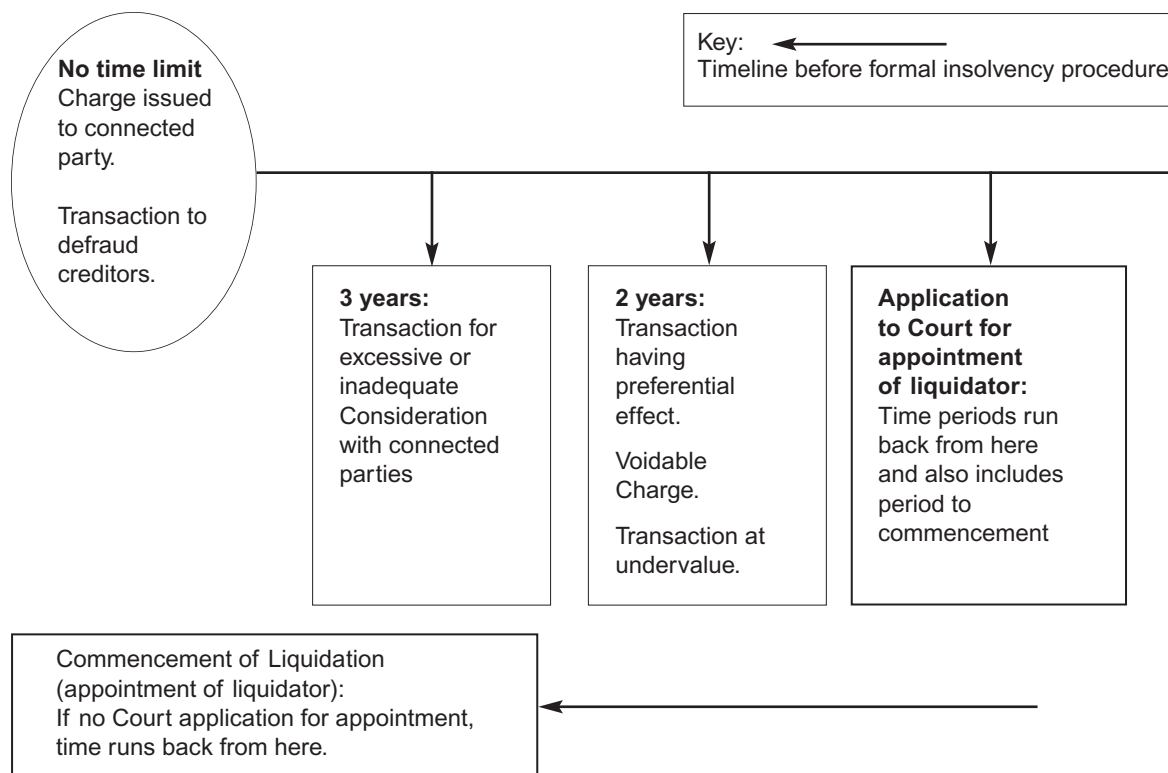
- (b) voidable charges (s.293) – two years
- (c) transactions at an undervalue (s.297) – two years
- (d) transactions for inadequate or excessive consideration with directors and certain related parties (s.298) – three years
- (e) securities and charges issued by the company in favour of directors and certain related parties (s.299) – no time limit.

In each case where the liquidation is initiated by resolution of the shareholders of the company, the period runs back from the date on which a liquidator is appointed to the company. However, where either:

- (a) the liquidator is appointed by the Court; or
- (b) an application is made to the Court to put a company into liquidation and after the making of the application a liquidator is appointed by resolution of the shareholders of the company,
- (c) 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.

The Property Law Act 2007 also contains provisions which have the effect of avoiding, or requiring compensation to be paid in respect of, any transfer of property or other transactions made with intent to prejudice creditors. The transaction is challengeable at the instance of the person prejudiced or the liquidator of the company. There is no time limit. However, the transaction cannot be avoided and no compensation will be payable if the property was transferred to a purchaser in good faith and for value and who had no notice of the intention to prejudice creditors.²

The following time line shows in graphic form the periods in respect of which certain types of transaction are vulnerable.



² Sections 344-350, Property Law Act 2007.

1.3 Personal liability of directors

Among the statutory duties of directors under New Zealand law is 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.

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

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 the director?
- (b) In relation to each act identified in (a) above:
 - (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or 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 trading³

- (a) The elements of insolvent trading are:
 - (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. Directors who are not involved, therefore, in the process of authorising the company's obligations might escape liability, at least in relation to this specific duty (as opposed to the statutory duty of care referred to later). However, the Courts generally use a very broad interpretation of "agree". Also, unless the company's constitution expressly states otherwise, a director who is at a directors' meeting is taken to have agreed to the company's

³ Section 136.

⁴ See paragraph 1.2 above

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) – S 301.
- (b) (i) Liability is civil.
- (ii) The Court has a wide discretion in determining the extent of the personal liability of a director found liable for insolvent trading. However, the essence of the law is to compensate creditors for the loss caused by the director's conduct. The trend of the cases is that the measure of damages broadly equates with most of the losses (or, sometimes, debt) incurred by the company after a date on which the Court considers the company was clearly insolvent and should have stopped trading.
- (iii) Where more than one director is involved there is an element of proportionality, depending on the degree of involvement and culpability of the particular director and the duration that director was involved.
- (iv) There is no specified period.
- (v) For defences, refer to paragraph 2.3 below.

2.2 Reckless trading⁶

- (a) The elements of reckless trading are:
- (i) it applies to directors, “*de facto* directors”, “shadow directors” and “deemed directors”⁷ of a company;
 - (ii) a director has a duty not to agree to, or cause or allow, the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors;
 - (iii) these concepts are objective and the director's subjective belief would therefore not excuse breach of the duty.
- (b) (i) Liability is civil.
- (ii) The Court enjoys a wide discretion to compensate for the loss caused to the company by the director's conduct - in exceptional cases it may also include a punitive element in the award of damages made.
- (iii) As with insolvent trading, there is usually an element of proportionality, although the Court's discretion is very wide.
- (iv) There is no specified period.
- (v) For defences, refer to paragraph 2.3 below.

2.3 Defences to insolvent trading and reckless trading actions

The fact that a director has no knowledge of the company's affairs will almost certainly not excuse a breach of duty. The days of sleeping directors are long gone – directors must monitor the management of the company.⁸

⁵ *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 CA.

⁶ Section 135.

⁷ See paragraph 1.2 above.

⁸ *Mason v Lewis* (2006) 9 NZCLC 264, 024.

A non-executive director may not be expected to have the same involvement in the company as an executive director.⁹

Reliance on information provided by others

When exercising powers or performing his or her duties, a director may rely on reports, statements, financial data and other information prepared or supplied by, and on professional or expert advice given by:

- an employee the director believes on reasonable grounds to be reliable and competent in a particular area;
- a professional adviser or expert in relation to the matter believed on reasonable grounds to be within the person's competence; or
- any other director or committee of directors in relation to an area of designated authority (s.138).

In each case there is a requirement of subjective belief coupled with objective grounds for the belief.

Also, reliance is only permitted if the director:

- acts in good faith; and
- makes proper enquiry where the need for enquiry is indicated by the circumstances; and
- has no knowledge that such reliance is unwarranted.

Although the Act does not provide for the consequences of reliance by a director on information or advice provided by others, the implication appears to be that where a breach of duty has arisen as a result of incorrect advice or information given to the director, this reliance may be raised as a defence. Some matters will, however, require the director to exercise his or her own judgement, and in such cases it will not be permissible to pass responsibility on to someone else.

2.3.1 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).

⁹ *AWA Limited v Daniels* (1992) 10 ACLC 993.

2.4 Liability to repay distributions made to shareholders¹⁰

- (a) A board of a company may not authorise a distribution to shareholders unless the board is satisfied on reasonable grounds that the company will, immediately after the distribution, satisfy the statutory solvency test.¹¹ Directors who vote in favour of a distribution must sign a certificate stating that, in their opinion, the company will, immediately after the distribution, satisfy the solvency test and the grounds for that opinion.

A distribution made to a shareholder at a time when the company did not, immediately after the distribution, satisfy the solvency test might 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 (s.56).

- (b) (i) The liability is civil and in part criminal (a director commits an offence if he or she voted in favour of a distribution and fails to sign the solvency certificate – s.52(5)).
- (ii) Civil liability is limited to repayment of so much of the distribution as cannot be recovered from shareholders. However, where a company could have satisfied the solvency test by making a distribution of a lesser amount, the Court in an action against a director or shareholder has the discretion to permit the shareholder to retain (or relieve the director from liability in respect of) an amount equal to the value of any distribution that could properly have been made.
- (iii) Liability of the relevant directors concerned will be joint.
- (iv) There is no specified period – the critical element is whether immediately after the distribution the solvency test was satisfied.
- (v) A director has a defence if he or she can show that they took reasonable steps to ensure that the statutory procedure, which is a prerequisite to authorising a dividend, was followed, or that there were reasonable grounds to believe the company would satisfy the solvency test.

2.5 Liability if proper accounting records are not kept¹²

- (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 (S 194).
- (b) (i) The liability in relation to the duty is both criminal and civil. If the board fails to comply every director commits an offence.
- (ii) If a company that is in liquidation is insolvent and there has been failure to comply with these duties, and the Court considers that the failure to comply:
- contributed to the company's inability to pay all its debts; or

¹⁰ Section 56 - A distribution to shareholders is defined in section 2(1) as:

(a) the direct or indirect transfer of money or property (other than the company's own shares) to or for the benefit of the shareholder; or
(b) the incurring of a debt to or for the benefit of the shareholder, in relation to shares held by that shareholder.

¹¹ Section 52 -

A company satisfies the solvency test if:

(a) the company is able to pay its debts as they become due in the normal course of business; and
(b) the value of the company's assets is greater than the value of its liabilities including contingent liabilities (section 4).

¹² Sections 194 and 300.

- has resulted in substantial uncertainty as to the assets and liabilities of the company; or
- has substantially impeded the orderly liquidation; or
- for any other reason it is proper to make a declaration,

the Court on the application of a liquidator, may declare that any one or more of the directors or former directors are personally responsible for all or any part of the debts and other liabilities of the company.

(iii) The liability may be joint or proportional.

(iv) There is no specified period.

(v) In relation to the civil liability, the director has a defence if he can satisfy the Court that he:

- took all reasonable steps to secure compliance by the company with the provision; or
- had reasonable grounds to believe and did believe that a competent and reliable person was charged with the duty, and was in a position to discharge the duty.

In relation to criminal liability a director charged with an offence concerning a duty imposed on the board of a company has a defence if the director proves that:

- he 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 could not reasonably have been expected to take steps to ensure that the board complied with the duty (s.376).

2.6 Wrongdoing¹³

(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 S (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.

¹³ Section 301.

- (v) There are no specific statutory defences to an action against directors under these heads. The Court, however, has considerable discretion as to the quantum of any order against the directors.

2.7 Liability in relation to other statutory duties under the Act

2.7.1 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 Ss 131 – 149 a restatement of many of the duties previously found in the general law. Some of the statutory duties are duties of a fiduciary nature which accompany the office of director.

Duties owed to the company¹⁴ include:

- to act in good faith in the best interests of the company¹⁵ (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; and
- duties relating to disclosure of company information and the use of that information (s.145).

Duties owed to shareholders¹⁶ 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.

2.7.2 Liability to creditors?

Directors are not liable to creditors as fiduciaries, or for negligence in the management of the company. Creditors therefore are not entitled to interfere in the company's affairs while it remains solvent.

The Companies Act 1993 imposes on directors no express duty to creditors. The duties not to trade recklessly or while insolvent (ss.135 and 136) are duties owed to the company (in loose terms the shareholders as a whole), not creditors (s.169). However, where the company is insolvent or near insolvency, shareholders are unable to ratify breaches by directors of duties owed to the company such as the duty not to permit insolvent trading and not to trade recklessly.¹⁷

2.7.3 The duty to exercise care (S 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

¹⁴ Section 169.

¹⁵ In certain circumstances the constitution of a subsidiary may permit, the directors to act in the best interests of the holding company if the other shareholders consent, and if the constitution of a joint venture company permits, directors of joint ventures may act in the best interests of the shareholder that appointed them.

¹⁶ Section 169.

¹⁷ *Ukon Line Limited of Korea* [1998] 2 BCLC 485, and *Spies v The Queen* [2000] 8 HCA 43.

- the position of the director and the nature of the responsibilities undertaken by him.

2.8 Carrying on business fraudulently¹⁸

- (a) A director (or any other person) who is knowingly a party to a company carrying on business with intent to defraud creditors of the company or any other person or for a fraudulent purpose, commits an offence.

Also, every director commits an offence who:

- (i) by false pretences or other fraud induces a person to give credit to the company; or
 - (ii) with intent to defraud creditors of the company:
 - gives, transfers or causes a charge to be given on property of the company; or
 - causes property to be given or transferred to any person; or
 - caused or was a party to execution being levied against property of the company; or
 - (iii) with intent to defraud a creditor or creditors of the company, does anything that causes material loss to any creditor.
- (b) (i) Liability is criminal, but may also be civil (see paragraph 2.6).
- (ii) A person guilty of these offences is liable to imprisonment or a fine, and is automatically prohibited from being a director of or managing a company for 5 years without leave of the Court (s.382).
- (iii) The gravity of the wrongdoing will be reflected in the length of imprisonment or the amount of the fine. In exercising its punitive jurisdiction under this section, the Court is not seeking to compensate the company.
- (iv) There is no specified period.
- (v) Absence of intent to defraud a creditor or the creditors of the company (as applicable) is a defence.

2.9 Avoidance or obstruction¹⁹

- (a) A director of a company (or any other person) commits an offence if he:
- (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.

¹⁸ Section 380.

¹⁹ Section 273.

- (ii) the acts in question must have occurred either after the company has gone into liquidation or after an application has been made to the Court for an order that the company be put into liquidation.

2.10 Failure to identify and deliver property to a liquidator²⁰

- (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 liquidator's request, deliver property to the liquidator or as directed, or dispose of the property as directed.
- (b) (i) Liability is criminal (there may also be civil liability – refer paragraph 2.6) and the answers to 2.8 (b) (ii) and (iii) will apply – except that there is no automatic prohibition from being a director or manager.
 - (ii) The specified period is during the liquidation of the company.

2.11 Other actions giving rise to liability for directors

- (a) (i) Directors can be held liable under the Act in a number of other situations. These include:
 - in respect of a document required by or for the purposes of the Act and in certain other circumstances, making false or misleading statements, or omitting from a document something which makes the document false or misleading in a material particular, or authorising this (s.377);
 - fraudulently taking or applying company property for a use or purpose other than the use or purpose of the company, or fraudulently concealing or destroying the property of the company (s.378);
 - destroying, mutilating, altering or falsifying any document belonging to or relating to the company, or making a false entry in any such document, or being a party to those acts (s.379);
- (b) (i) Liability of a director is criminal.
 - (ii) The Act sets out maximum penalties for each type of offence – these are imprisonment or a fine. The director is also automatically prohibited from being a director of or managing a company for five 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.

²⁰ Section 274.

The actions of the directors can constitute misleading or deceptive conduct in trade. A number of recent New Zealand Court decisions have held that where the directors are the source of the information or misrepresentation and not a mere conduit of information, and were responsible for the manner in which the company's business was conducted with suppliers and other creditors, those directors can be held personally liable for the representations, irrespective of whether the representations were made on behalf of the company rather than in a personal capacity. Where a director is a mere conduit, they may still be personally liable if they intentionally aid or abet, or are directly or indirectly knowingly concerned in the deceptive conduct of the company.²¹

- (b) (i) The liability is civil.
- (ii) The director making the representation will be personally liable for the loss suffered by the particular creditor as a result of the misrepresentation.
- (iii) There is no specified period, but generally the company will need to be in financial difficulties.

2.13 Liability of directors to disqualification for acts done in the “twilight zone”

2.13.1 The Registrar of Companies can prohibit any person who within the previous five years has been a director of, or concerned in or taken part in the management of, a company which becomes insolvent or which enters into a compromise or arrangement with its creditors, from being a director or promoter of a company (or being concerned in, or taking part, whether directly or indirectly in the management of, a company) for a period up to five years (s.385).

2.13.2 If a person becomes involved in the management of a company during the prohibition period, that person will automatically be personally liable to a liquidator of the company for every unpaid debt incurred by the company (and to a creditor of the company for a debt to that creditor incurred by the company), while the person was so acting. The person also commits an offence and on conviction is liable to a substantial fine or prison term (ss.385 & 386).

2.13.3 A person who has done any of the following things can be disqualified by the Court from being a director or promoter of, or in any way, whether directly or indirectly, being concerned in or taking part in the management of, a company for a period of up to 10 years, without leave of the Court:

- (a) while a director of a company and whether convicted or not -
 - persistently failed to comply with the Act, the Securities Markets Act 1988, the Securities Act 1978 (dealing with the issue of securities to the public) or the Takeovers legislation or, where the company has failed to comply, persistently failed to take all reasonable steps to obtain such compliance; or
 - been guilty of fraud in relation to the company or of a breach of duty to the company, or a shareholder; or
 - acted in a reckless or incompetent manner in the performance of his 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; or
- (c) been prohibited in another country from acting as a director, promoter or manager of a company.

Applications to the Court for disqualifying a person can be made by the Registrar of Companies, the liquidator of the company or a creditor of the company (s.383).

²¹ *Kinsman v Cornfields Ltd (2001) 10 TCLR 342 (CA); Newport v Coburn (2006) 8 NZBLC 101,717 (CA).*

2.13.4 Directors (and others) convicted of certain offences are automatically disqualified from being directors of companies for a period of five years unless they obtain the leave of the Court (s.382).

The persons affected are those who:

- have been convicted on indictment of any offence in connection with the promotion, formation, or management of a company; or
- have been convicted of certain offences under the Act (those referred to in paragraphs 2.8 & 2.11 above), or any crime involving dishonesty.

2.13.5 Failure to seek leave of the Court constitutes an offence and exposes a director to personal liability for unpaid debts incurred by the company while the person acted without leave (s.382 and 384).

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?**
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?**
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to 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 term²² which is capable of including a variety of persons who, while not formally appointed as directors, may have played a role in the company's management during the twilight period and who may be held liable in respect of certain acts of the company during this time. In particular, New Zealand law will impose liability on "shadow", "de facto" and "deemed" directors in certain circumstances - these concepts are explained in S 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.

²² Section 126.

3.2 Actions for which liability may attach to *de facto*, shadow or deemed directors and other persons not formally appointed as directors

Offence / activity	Person liable	Extent of liability
Insolvent and Reckless Trading and other statutory duties (Ss131 – 141)	Past director and past and present <i>de facto</i> , 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 and past and present <i>de facto</i> directors.	Same as for director
Leaving New Zealand or concealing destroying or removing property (Ss 273 and s.373(3)(a))	Any person	Same as for director
Failure to identify or deliver company property (Ss 274 & 373(3)(a))	Past director and past or present employee.	Same as for director
Wrongdoing – negligence or default or breach of duty (S 301)	Any past director; past or present <i>de facto</i> , shadow and certain deemed directors; administrator; liquidator; manager; receiver; any person involved in the formation or promotion of the company.	Same as for director
Acting as a director or taking part in management of the company when disqualified (S 384 and S 386)	Any person	All debts incurred by the company during that period.

3.3 Other third parties who may be held liable to the company or its liquidator

- 3.3.1 Liquidators, administrators and receivers may be found liable for negligence, default or breach of duty owed to the company (s.301).
- 3.3.2 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.
- 3.3.3 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	Person liable	Extent of liability
Transactions at an undervalue (S 297)	Recipient of property	Pay compensation to the Company
Transactions having preferential effect (Ss 292 & 293)	Recipient of preference or charge	Return of property received or removal of specific benefit received or payment of an amount fairly representing benefit received.
Transactions for inadequate or excessive consideration with connected parties. (S 298)	Other party to transaction	Pay compensation to the company.
Voidable charges (S 293) and charges issued to connected parties (S 299)	Recipient of charge	Setting aside of charge.
Transactions prejudicing creditors (Property Law Act 2007)	Recipient of property (if they have the requisite knowledge or are a volunteer).	Return of property received (or compensation).
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. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (a) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (b) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Summary of heads of challenge

4.1.1 Brief details of those types of transaction entered into by a company before the commencement of formal insolvency proceedings which are vulnerable to attack are transactions:

- (a) which are at an undervalue;
- (b) which are insolvent transactions (that is, transactions which have preferential effect);
- (c) which constitute voidable charges;
- (d) for inadequate or excessive consideration with directors or other related parties;

- (e) which are securities or charges issued by the company in favour of directors or other related parties;
- (f) in breach of the directors' fiduciary duties;
- (g) with intent to prejudice creditors; and
- (h) which constitute onerous property.

We look briefly at each head of challenge in turn. We also consider the status of unregistered security interests.

4.2 Transactions at an undervalue (S 297)

4.2.1 A transaction is at undervalue if the value received by the company was less than the value provided by the company and, when the transaction was entered into, the company:

- (a) was unable to pay its due debts; or
- (b) became unable to pay its due debts as a result of the transaction.

4.2.2 If the company is put into liquidation, a liquidator can recover from the counterparty to the transaction the amount by which the value of the consideration or benefit provided by the company exceeded the value of the consideration or benefit received by the company. The liquidator can only do this in respect of transactions the company entered into within 2 years before liquidation (refer paragraphs 2.1 for a full explanation of this vulnerability period).

4.2.3 “Transaction” is defined in the section dealing with insolvent transactions (refer paragraph 4.3.4).

4.2.4 However, the term “transaction” does not include bilateral netting (set-off) agreements, or certain multilateral netting agreements which are subject to the rules of a recognised clearing house, entered into by the company – except to the extent that the effect of entering into the netting agreement is to reduce any amount that was owing by or to the company at the time the company entered into the agreement (s.310G).

4.2.5 A guarantee by a company to a bank of the liabilities of a parent or sister company might be a classic example of an undervalue transaction - if, say, the objective is simply to use the company to benefit its financially troubled parent or sister company. In relation to guarantees, there is no authority on the test to apply to ascertain the value provided by the guarantor and provided by the bank.

4.3 Insolvent transactions - transactions having preferential effect (S 292)

4.3.1 An insolvent transaction is a transaction entered into by the company at a time when it was unable to pay its due debts, and which enables another person to receive more towards satisfaction of a debt than the person would receive or would be likely to receive in the liquidation.

4.3.2 If the company is put into liquidation, a liquidator can recover from the counterparty to the transaction an amount which fairly represents the benefits received by the party (for example, if the transaction was the payment of a debt, an amount equivalent to the payment), or in some cases property which was transferred to that party as part of the transaction. The liquidator can only do this in respect of transactions the company entered into within two years before liquidation (refer paragraphs 1.2.2 and 1.2.3 for a full explanation of this vulnerability period).

4.3.3 If the transaction was entered into within six months before liquidation, there is a statutory presumption that the transaction was made at a time when the company was unable to pay its due debts. The onus of rebutting this presumption is on the counterparty to the transaction.

4.3.4 “Transaction” is widely defined. It includes the incurring of any obligation by the company, the giving of a security or charge over the property of the company, and the payment of money by the company under a judgment or order of the Court. The transaction must be a transaction of the company. The Courts have held that the transaction must be with a creditor of the company.

4.3.5 However, the term “transaction” does not include bilateral netting (set-off) agreements, or certain multilateral netting agreements which are subject to the rules of a recognised clearing house, entered into by the company – except to the extent that the effect of entering into the netting agreement is to reduce any amount that was owing by or to the company at the time the company entered into the agreement (s.310G).

4.3.6 Until legislative changes in November 2007, a transaction could not be an insolvent transaction if it had occurred in the ordinary course of business. The meaning of “ordinary course of business” has been the subject of a considerable amount of judicial interpretation. This “defence” has now been removed. However, the defences provision (see S 4.7 of this paper) has been amended to give protection to parties who are unaware that the company is or was about to become insolvent at the time of the transaction.

4.3.7 Where a transaction is, for commercial purposes, an integral part of a continuing business relationship (for example, a running account) between a company and a creditor and in the course of that relationship the level of the company’s net indebtedness to the creditor is increased and reduced from time to time as a result of a series of transactions forming part of that relationship, for the purpose of establishing whether a transaction is an insolvent transaction, all the transactions forming part of the continuing business relationship are to be regarded as a single transaction (s.292(4B)).

4.3.8 Generally speaking, where a liquidator has recovered any amount from a counterparty in relation to a transaction having preferential effect, the counterparty is able to prove as a creditor in the liquidation for an amount equivalent to the sum or value of the property the liquidator recovered.

4.4 Voidable charges (S 293)

4.4.1 Any charge given by the company is voidable against the liquidator of the company if given within 2 years before liquidation (see paragraphs 1.2.2 & 1.2.3) unless:

- (a) (and only to the extent that) the charge secures money actually advanced or paid, or the actual price or value of property sold or supplied to the company, or any other valuable consideration given in good faith by the recipient of the charge at the time of, or at any time after, the giving of the charge;²³ or
- (b) immediately after the charge was given the company was able to pay its due debts; or
- (c) the charge is in substitution for a charge given before the two 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, S 293 includes a provision that all payments received by the grantee of a charge after it was given will be treated as being appropriated as far as may be necessary towards repayment of money actually advanced or paid (or payment of the actual price or value of property sold) by the grantee to the company on or after the giving of the charge.

4.4.4 Case law has made it clear that simply forbearing to sue for past debts will not be valuable consideration given in good faith by the charge holder for purposes of this section, unless the forbearance can be shown to have some reasonable value or worth to the debtor.²⁴

²³ A charge given to secure the unpaid purchase price of property, whether or not the charge is given over that property, will be valid so long as it is executed not later than 30 days after the sale of the property.

²⁴ *Meo & Anor v The Official Assignee* (1987) 3 NZCLC 100,206, Court of Appeal.

4.5 Transactions for inadequate or excessive consideration with directors or related parties (S 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 1.2.2 and 1.2.3 for a full explanation of this vulnerability period).
- 4.5.3 There is no need to establish whether the company was insolvent before or as a result of the transaction.
- 4.5.4 The categories of related parties from whom recovery is possible are extensive. They include a nominee or relative or a trustee for a director, a person or relative of a person who at the time had control of the company, related companies and companies controlled by a director of the company or by a nominee, relative or trustee of a director.

4.6 Securities and charges issued by the company in favour of directors or related parties (S 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 S 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 S 292 (insolvent transactions— see S 4.3 of this paper) or S 293 (voidable charges – see S 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 reluctant to set aside a security if it had been issued in respect of a bona fide commercial transaction with no intention of defeating creditors.

4.7 Defences available to a counter-party (ss.296(3) and 239 ACB)

- 4.7.1 Under S 296(3), even though a transaction may be a transaction at an undervalue, an insolvent transaction or a type of transaction referred to in Ss 4.4 – 4.6 of this paper, the Courts must deny recovery by the liquidator of property or its equivalent value from the counterparty if the person from whom recovery is sought proves that when they received the property:
- (a) they acted in good faith; and
 - (b) a reasonable person in their position would not have suspected, and they did not have reasonable grounds for suspecting, that the company was, or would become, insolvent; and
 - (c) they gave value for the property or altered their position in the reasonably held belief that the transfer of the property to them was valid and would not be set aside.

- 4.7.2 The test of good faith appears to be one of simple honesty.²⁵ An awareness of financial difficulty of the company is not in itself sufficient to give rise to a conclusion that any actions were not taken in good faith.²⁶
- 4.7.3 Value for the property received (e.g. payment for goods or services) includes value given at the time of original supply.²⁷ To alter position, a counterparty must have deliberately taken or omitted some action in reliance on the apparent validity of the transaction. Examples of alteration of position would be to continue to supply goods or services and provide further credit.
- 4.7.4 The second limb of the defence under S 296(3) in part was included in the legislation as a result of the changes to the insolvent transaction provisions which came into effect in November 2007 (see paragraph 4.3.6). The provisions are now very similar to the equivalent Australian provisions, which should provide useful guidance to New Zealand practitioners and Courts. However, the Australian Courts have grappled with the objective/subjective formulation of their equivalent to the second limb of the New Zealand provision.
- 4.7.5 S 239 ACB states that the insolvent transaction and voidable charge provisions do not apply to a transaction by a company in administration if the transaction is:

- (a) carried out by or with the authority of the administration or deed administrator; or
- (b) specifically authorised by the deed of company arrangement and carried out by the deed administrator.²⁸

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.²⁹

4.9 Transactions with the intent to prejudice creditors³⁰

- 4.9.1 Where a company disposes of property with intent to prejudice creditors or by way of gift or at an undervalue, that transfer is challengeable at the instance of the persons prejudiced or the liquidator of the company.
- 4.9.2 The transaction can only be challenged if the company:
- (a) was insolvent at the time, or became insolvent as a result, of making the disposition; or
 - (b) was engaged, or was about to engage, in a business or transaction for which the remaining assets of the company were, given the nature of that business or transaction, unreasonably small; or
 - (c) intended to incur, or believed, or reasonably should have believed, that the company would incur, debts beyond the company's ability to pay (S 346 Property Law Act 2007).
- 4.9.3 There is no statutory time limit.
- 4.9.4 If a Court finds that the applicant has been prejudiced by the disposition of property, it can either vest the property in the company or require the recipient to pay reasonable compensation to the company (Ss 348 and 350 Property Law Act 2007).

²⁵ *Re Excel Freight Limited (In Liquidation)* (1999) 8 NZCLC 261,827.

²⁶ *Re Island Bay Masonry Limited (In Liquidation)* (1998) 8 NZCLC 261,751.

²⁷ *Allied Concrete Ltd v Meltzer* [2016] NZLR 141

²⁸ See the Appendix for an explanation of the formal administration process.

²⁹ See generally discussion of directors' duties in answer to Question 2.

³⁰ Sections 344 to 350 Property Law Act 2007.

4.9.5 If the property is transferred to a person who acquires it for value in good faith without knowledge of the fact the disposition was caught by S 346, the property cannot be recovered, and the person cannot be required to pay compensation.

4.9.6 The Court may decline to make a vesting or compensation order (or may make one with limited effect) against a person who received the property if that person proves that they received the property in good faith without knowledge of the fact the disposition was caught by S 346 and the person's circumstances have so changed since receipt of the property that it is unjust to order that the property be restored or reasonable compensation be paid – in either case in part or in full.

4.10 Disclaimer of onerous property (S 269)

4.10.1 When a company is in liquidation, the liquidator may disclaim any onerous property even though he has taken possession of it, tried to sell it, or otherwise exercised rights of ownership in respect of it. The liquidator must give prompt notice of disclaimer to every person whose rights are, to the knowledge of the liquidator, affected by the disclaimer.

4.10.2 Onerous property means (a) any unprofitable contract; or (b) other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform an onerous act; or (c) a litigation right that, in the opinion of the liquidator, has no reasonable prospect of success or cannot reasonably be funded from the assets of the company. It does not include certain netting agreements³¹ 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.

A person whose rights would be affected by the disclaimer of onerous property may require a liquidator to elect whether to disclaim that property – if the liquidator does not do so within a stated period after receiving notice of the requirement, the liquidator will be unable to disclaim that property in the future.

4.11 Failure to register a security interest

4.11.1 The Personal Property Securities Act 1999 governs security interests in virtually all types of property other than ships longer than 24 metres and land. “Security interest”, is widely defined as an interest in personal property created or provided for by a transaction that in substance secures payment or performance of an obligation, without regard to either the form of the transaction or the identity of the person who has a title to the personal property. The definition therefore covers finance leases, retention of title rights and goods supplied on consignment.

4.11.2 The Act provides for the establishment of a Register of security interests in personal property and contains rules for the determination of priority between security interests in the same personal property. It also contains rules for the determination of priority between security interests and other types of interests in the same personal property, and a regime for the enforcement of security interests.

³¹ See paragraph 4.2.4 for an explanation of this expression.

4.11.3 Generally speaking, if a security interest is not registered, the only consequence is that it will rank in priority after those security interests which have been registered and, in some circumstances, after certain creditors such as employees who are given a statutory preference. An unregistered security interest remains enforceable against a liquidator if the company goes into liquidation - the unregistered security interest will rank ahead of unsecured creditors.

4.12 Incurring further credit during the twilight period

4.12.1 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.

4.12.2 In *Sandell v. Porter*³² 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.³³ Similar principles apply in New Zealand, where the Courts have also, when considering whether directors have traded recklessly, drawn a distinction between the taking of legitimate and illegitimate business risks. When a company enters troubled financial waters the directors are required to make a “sober assessment” as to the company’s likely future income and prospects, on an ongoing basis.³⁴

4.12.3 Insolvent trading and reckless trading provisions apply to directors, (including “*de facto* directors”, “shadow directors”, and “deemed directors”³⁵).

4.13 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?

4.13.1 The risk of dealing with a company which is or may become insolvent is that the New Zealand legal system, like many others, has a vulnerability period running back from the date the insolvency process begins. In New Zealand, that period is generally two years (refer paragraphs 1.2.2 and 1.2.3 for a full explanation of how the vulnerability period is calculated).

4.13.2 Generally speaking, a transaction which an unconnected third party enters into with a company for “market value” during the twilight period, where the party has no reasonable grounds to suspect the company’s insolvency, will not be struck down when the company is subsequently the subject of the formal insolvency process (liquidation). For instance, if security for debt is given at the time of incurring the debt, the security cannot be challenged later, but if the security is given for an earlier debt, this can be challenged by the liquidator.

4.13.3 Full details of the types of transaction entered into by a company before the commencement of the formal insolvency process which are vulnerable to attack, and the defences available to the other party or parties to the transaction, are set out in Question 4.

³² (1966) 115 CLR 666.

³³ 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.

³⁴ *Mason v Lewis* (2006) 9 NZCLC 264,024.

³⁵ 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.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above)?

5.1 Introduction

- 5.1.1 While not exclusively relevant to the “twilight” period, until liquidation the company is the appropriate claimant for any breach of the statutory duties of directors described in answer to Question 3. The company is also the appropriate applicant for relief where the claim is in respect of a breach of the general law duty of directors of companies which are insolvent, near insolvent or of doubtful solvency to exercise their powers having regard to the interests of that company's creditors (see S 2.7 of this paper).
- 5.1.2 If a company goes into liquidation, the authority and powers of the directors are at that time superseded by those of the liquidator. The liquidator is required to review the action taken by the directors and others during the twilight period and where relevant bring proceedings to obtain compensation for the benefit of creditors in respect of any loss caused to the company. Consequently, the general rule is that after liquidation only the liquidator is empowered to bring civil actions against directors and others where there has been a breach of either legal or fiduciary duties owed to the company. There are a few exceptions to this rule in respect of certain transactions for which action may be brought by creditors or others directly. These are detailed in the table in paragraph 5.3.2. A creditor may also have personal remedies against a director of an insolvent company – for example, in some circumstances the Courts have held directors liable under the Fair Trading Act 1986 for misrepresenting to a trade creditor the company's financial position as a result of which the creditor has continued to supply goods on credit.
- 5.1.3 The primary exception to this general rule is in respect of criminal proceedings brought against directors or others under the Companies legislation. These actions must be brought by the Registrar of Companies.

5.2 Criminal proceedings

- 5.2.1 A liquidator of a company who considers that an offence that is material to the liquidation has been committed by the company or any director of the company under the Crimes Act 1961, the Companies Act 1993 and other company-related legislation must report this to the Registrar of Companies. The following acts are the main offences under the Companies legislation relating to insolvency in respect of which the Registrar of Companies may bring an action against the directors and others involved. Those who may be liable in respect of the following offences in addition to the directors are listed in Question 3.

Offences

- (a) Liability if proper accounting records not kept – S 194.
- (b) Carrying on business fraudulently – S 380.
- (c) Leaving New Zealand, concealing or removing company property or destroying, concealing or removing company records – S 273.
- (d) Failure to identify and deliver property to a liquidator – S 274.
- (e) Making false or misleading statements or omissions – S 377.
- (f) Fraudulently taking or applying company property for a non-authorized use (or fraudulently concealing or destroying property) – S 378.
- (g) Destroying, mutilating, altering or falsifying any company document by making false entries – S 379.

(h) Disqualification as a director – Ss 382 – 386.

5.3 Civil proceedings

- 5.3.1 In relation to civil proceedings, after liquidation the ability to bring actions against directors and others lies primarily with the liquidator. However, in respect of certain actions which have caused loss to the company and its creditors, the law allows a wider range of persons to bring action to recover funds for the benefit of the company's creditors. Where an action for a contribution to the company's assets is successful, even if the person bringing the action is not the liquidator, generally any recoveries made will be for the benefit of all creditors of the company and will be distributed amongst the creditors in accordance with the normal rules relating to priority.
- 5.3.2 The table below sets out those people who may bring an action against the directors and others after liquidation in connection with certain transactions which the company has entered into.

Activity / transaction	Person able to bring proceedings after liquidation
Wrongdoing (S 301)	Liquidator, a creditor or a shareholder
Insolvent trading (Ss136 & 301)	Liquidator, a creditor or a shareholder
Reckless trading (Ss135 & 301)	Liquidator, a creditor or a shareholder
Failure to keep proper accounting records (S 300)	Liquidator only
Liability to repay distributions made to shareholders (Ss 56 & 301)	Liquidator, a creditor or a shareholder
Breach of Fair Trading Act 1986	The affected creditors

QUESTION 6

6. Remedies: orders available to the domestic Court

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Offence	Remedy available
Insolvent and reckless trading (Ss135-136)	<p>The Court may order a director to make such contribution to the company's assets by way of compensation as the Court thinks fit.</p> <p>The trend of the cases is that the measure of compensation broadly equates with most of the losses (or, sometimes) debt) incurred by the company after a date on which the Court considers the company was clearly insolvent and should have stopped trading. Where more than one director is involved each director may be held to be liable for different amounts, depending on the degree of involvement and culpability of the particular director and the duration of that director's involvement (S 301).</p>
Distributions to shareholders when, or as a result of which, the company is insolvent (S 56)	<p>The distributions may in certain circumstances be recovered from the shareholders.</p> <p>To the extent that a distribution is not able to be recovered from a shareholder (either because the shareholder has no obligation to repay it or because the shareholder has insufficient assets or for any other reason), any director who failed to take reasonable steps to ensure the correct procedures for authorizing distributions were followed, or who signed the required solvency certificate when there were no reasonable grounds for believing at that time that the company would satisfy the solvency test, will be liable to the company to repay the distribution.</p>

Offence	Remedy available
Failure to keep proper accounting records (Ss194 & 300)	<p>Civil liability</p> <p>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.</p> <p>Criminal liability</p> <p>A director convicted of this offence is liable to a fine not exceeding \$10,000.</p>

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) (Ss131-134; 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
<p>Conduct rendering a director unfit to be a director (Ss382 – 386)</p>	<p>The Registrar of Companies may order disqualification in certain circumstances for a period of up to five years;</p> <p>The Court may order disqualification for a period up to ten years.</p> <p>(This is in addition to the automatic disqualification which follows conviction for certain offences referred to above.)</p>
<p>Breaches of the Fair Trading Act 1986</p>	<p>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.</p>
<p>Transactions at an undervalue (S 297)</p>	<p>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.</p>
<p>Insolvent transactions having preferential effect (S 292)</p>	<p>If a transaction is set aside as against the liquidator, the Court may order one or more of the following:</p> <ul style="list-style-type: none"> (a) that any property transferred as part of the impugned transaction be restored to the company; (b) that any property which represents the application of either the proceeds of sale of the property or money originally transferred be vested in the company; (c) repayment of money paid by the company; (d) the release or discharge of any security given by the company; (e) a person to pay the company such sums as represent the value of any benefits received by him from the company as a result of the transaction; (f) that security be provided for the discharge of any obligation imposed by or arising under the order; (g) the extent to which any person affected by the setting aside of a transaction or any order made as noted above may claim as a creditor in the liquidation (S 295). <p>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).</p>
<p>Transactions for inadequate or excessive consideration with connected parties (S 298)</p>	<p>The liquidator may recover from the connected party the excessive value or the undervalue, as applicable.</p>
<p>Securities and charges issued in favour of connected parties (S 299)</p>	<p>The Court can set aside the charge or security (in whole or in part).</p> <p>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.</p>
<p>Voidable charge (S 293)</p>	<p>The charge can be set aside in whole or in part.</p> <p>The setting aside of a charge or security cannot 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).</p>

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holders investigation into the company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

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

- 7.1.1 As soon as a company goes into liquidation, present and former directors of the company must give the liquidator details of the property of the company in their possession or under their control (S 274).
- 7.1.2 The liquidator can by notice require those persons to deliver that property to the liquidator or the liquidator's nominee, or to dispose of the property in the manner the liquidator directs (S 274).
- 7.1.3 The liquidator can require any person to deliver to the liquidator books, records or documents of the company in that person's possession or under that person's control. The liquidator can also require a director or former director of the company, a shareholder, an employee or former employee, and certain other persons having knowledge of the affairs of the company to do any of the following things:
- (i) to meet with the liquidator at a reasonable time or times;
 - (ii) to give the liquidator such information about the business, accounts or affairs of the company as the liquidator requests;
 - (iii) to be examined on oath or affirmation by the liquidator or the liquidator's solicitor on any matter relating to the affairs of the company;
 - (iv) to assist in the liquidation to the best of that person's ability (S 261).

Liquidators often use these powers to require a director to attend the first meeting of creditors in the liquidation, and to obtain information to enable the liquidator to prepare a statement of affairs for the company at the commencement of the liquidation. These powers are also used to assist the liquidator in investigating the company's affairs and the actions of directors.

- 7.1.4 Whilst the failure by a director to comply with obligations referred to in paragraphs 7.1.1 – 7.1.3 is punishable as an offence, as a matter of practice a liquidator wishing to obtain information will rely on the examination provisions of the Act. A Court can require a person to comply with a requirement of a liquidator under S 261 and may itself summon a person for examination by the Court about a company's affairs (S 266).
- 7.1.5 A person is not excused from answering a question in the course of being examined by the liquidator or by the Court under these provisions, on the grounds that the answer may incriminate or tend to incriminate that person. The person's answers can be used as evidence in civil actions against the person for negligence, default or breach of duty or trust. However, the answers are not admissible as evidence in criminal proceedings against that person except on a charge of perjury in relation to the testimony (S 267).

7.2 Applicable human rights laws

- 7.2.1 Much of New Zealand's human rights laws can be found in the Human Rights Act 1993 (which deals primarily with unlawful discrimination), the Privacy Act 1993 (which promotes and protects the privacy of natural persons— in particular the use of personal information held by other parties – in accordance with international guidelines) and the New Zealand Bill of Rights Act 1990 (which affirms, protects and promotes human rights and fundamental freedoms in New Zealand).

- 7.2.2 New Zealand is a signatory to the International Covenant on Civil and Political Rights 1966, and has acceded to the Optional Protocol. New Zealand's commitment to this Covenant is affirmed and reflected in the New Zealand Bill of Rights Act 1990.
- 7.2.3 Liquidators, in carrying out their functions and duties and exercising their powers, must have regard to the human rights laws in the same way as anyone else carrying out functions, powers or duties must do.
- 7.2.4 The New Zealand Bill of Rights Act 1990 expressly states that whenever an enactment can be given a meaning that is consistent with the rights and freedoms contained in the Bill of Rights, that meaning shall be preferred to any other meaning.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions 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 S 273 (leaving New Zealand, concealing or removing company property or destroying, concealing or removing company records) and S 274 (failure to identify and deliver company property to a liquidator) are triable summarily. Information to commence prosecution of directors (or other parties who may be liable) for these offences must be laid within three years after the date of the offence.

Limitation period for civil actions

- 8.1.3 In relation to most civil liabilities identified in Questions 2 and 6, the limitation period is generally six years from the date on which the cause of action accrued.³⁶
- 8.1.4 In relation to breaches of the director's statutory and other duties, the limitation period is generally six years from the date on which the cause of action accrued.³⁷ 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.³⁸
- 8.1.5 Generally, proceedings against a director under the Fair Trading Act 1986 (refer S 2.12 of this paper) must be commenced within three years after the date on which the loss or damage, or the likelihood of the loss or damage, was discovered or ought reasonably to have been discovered.³⁹

8.2 Appeals

- 8.2.1 Appeals are available from the decisions of the lower Courts.

³⁶ Section 11 and 12 Limitation Act 2010.

³⁷ Section 11 and 12 Limitation Act 2010.

³⁸ Sections 48 and 49 Limitation Act 2010.

³⁹ Section 43 Fair Trading Act 1986.

QUESTION 9

9. Foreign corporations

Do the provisions 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 ten 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 Ss 2.1, 2.2, 2.4 and 2.7 of this paper).

9.2 Liquidation in New Zealand of an overseas company

- 9.2.1 Irrespective of whether the overseas company is registered as such in New Zealand, a creditor, director or shareholder of that company, or the company itself or the New Zealand Registrar of Companies, can apply to the High Court of New Zealand for the liquidation of that company. An application can be made irrespective of whether the company has been placed in liquidation abroad, or has been dissolved or otherwise has ceased to exist as a company under the laws of any other country (S 342).
- 9.2.2 The liquidation in New Zealand of an overseas company will be carried out in general terms in accordance with the standard liquidation regime for a New Zealand company. This means that the transactions entered into by an overseas company during the “twilight” period identified in Question 4 as being vulnerable to attack will be vulnerable to attack under the provisions referred to in Question 4.
- 9.2.3 The Court’s power to appoint a liquidator in New Zealand to an overseas company is discretionary. In addition to any other grounds on which the Court might generally decline to appoint a liquidator, the Court is unlikely to appoint a liquidator unless the following three core requirements are fulfilled:
- (a) there must be a sufficient connection with New Zealand which may, but does not necessarily have to, consist of assets within the jurisdiction;
 - (b) there must be a reasonable possibility, if a liquidation order is made, of benefit to those applying for the liquidation order; and
 - (c) one or more persons interested in the distribution of assets of the company must be persons over whom the Court can exercise a jurisdiction.⁴⁰
- 9.2.4 Where the overseas company has no assets in New Zealand, and where it is continuing to trade in its country of incorporation and elsewhere in the world, there would need to be exceptional circumstances for the Court to order that the overseas company be placed in liquidation in New Zealand.⁴¹

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,⁴² with minor amendments.⁴³

⁴⁰ *Soczniá Gdanska v Latreefers* (No 2) [2001] 2 BCLC 116 (CA); *Real Estate Development Co* [1991] BCLC 210, 217.

⁴¹ *Banco Nacional de Cuba v Cosmos Trading Corp* [2000] BCLC 813, 819 (CA).

⁴² Adopted by the United Nations Commission on International Trade Law on 30 May 1997, and approved by the General Assembly of the United Nations on 15 December 1997.

⁴³ New Zealand Law Commission Report No. 52 *Cross-Border Insolvency: Should New Zealand Adopt the UNCITRAL Model Law on Cross-Border Insolvency?* (1999)

- 9.3.2 The Model Law seeks to provide uniformity of approach to the initiation of cross-border insolvency proceedings while allowing for flexibility of approach, on a case-by-case basis, to the finding of solutions.
- 9.3.3 The Insolvency (Cross-border) Act 2006 came into force on 24 July 2008. That Act implements the Model Law, with minor amendments. The Act empowers New Zealand Courts to act in aid of or be auxiliary to foreign Courts in relation to an insolvency proceeding in respect of which the foreign Court has jurisdiction. In doing so, the New Zealand Court may exercise the powers that it could exercise in respect of the matter had it arisen in its own jurisdiction.

QUESTION 10

10. Insurance

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

- 10.1** Directors' and employees' liability insurance is available in New Zealand. Policies offer cover for "wrongful acts", typically breach of duty while acting as a director or employee. The policies are often drafted broadly enough to cover directors and employees sued for failing to exercise diligent control over management and thus failing to safeguard against losses caused by reckless decisions and by embezzlement. Cover is also available to the company itself if it pays out under an indemnity it grants to the director or employee.
- 10.2** In general, these policies do not specifically deny indemnity to companies or directors for liabilities arising from insolvent trading. However, on the ground of public policy, the policies do not allow for insurance against liabilities arising from directors' or employees' deliberate fraudulent acts or omissions, wilful breaches of duty or legislation and deliberate criminal acts. Arguably, in certain situations insolvent trading that involves the directors in personal liability could come within these general exclusions, so that directors are not insured.
- 10.3** A company may effect insurance cover for, or pay the premium for policies taken out to cover, directors and employees in respect of:
- (a) liability, other than criminal liability, for any act or omission in their capacity as a director or employee; or
 - (b) costs incurred in defending or settling any claim relating to any such liability; or
 - (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.

APPENDIX

Summary of NEW ZEALAND insolvency procedures and commercial issues

1. Introduction – probable law reform

- 1.1 Unlike many jurisdictions, New Zealand has no licensing or registration system for insolvency practitioners. There are very few restrictions on who can be appointed to act as a liquidator, receiver or administrator of a company. Such restrictions as there are generally relate to those who have a direct connection with the company or have provided professional services or had a continuing business relationship with the company within the previous two years. Persons who have been prohibited from being a director or manager of a company are also disqualified.

In August 2008, the then Government announced a decision to introduce a new negative licensing system for the insolvency profession. Given the small size of the profession in New Zealand, the Government saw a negative licensing system as a cost effective method of dealing with incompetent and poorly skilled insolvency practitioners.

As part of the reform it was proposed that the existing disqualification criteria will be tightened and the Court's powers to replace insolvency practitioners in relation to particular assignments will be widened - the Registrar of Companies, creditors and other interested parties would be able to apply to the Court to replace an insolvency practitioner who is not independent or has a conflict of interest.

The negative licensing regime would empower the Registrar of Companies to prohibit or ban a person from acting as an insolvency practitioner where the person lacks the relevant skills or competencies or is shown to have failed to perform statutory duties under the relevant legislation. Persons who have been banned would have a right of appeal to the Court.

- 1.2 However, the reforms have yet to be implemented. In 2015, the government appointed a working party of experts to make recommendations on insolvency law reform including licensing or registration of insolvency practitioners. That group issued its first report in August 2016 recommending a much more regulated licensing regime than what was proposed in 2008. At the time of writing the government was seeking industry and public feedback on the proposals.

2. Summary of existing insolvency regime in New Zealand

- 2.1 The insolvency regime in New Zealand is contained mainly in the following legislation:
- (a) Insolvency Act 2006 - insolvency of natural persons
 - (b) Companies Act 1993 - insolvency of corporations
 - (c) Receiverships Act 1993 – receivers appointed over the assets of natural persons or corporations
 - (d) Corporations (Investigation and Management) Act 1989 – can be used to regulate the affairs of corporations at risk, and associated persons (including natural persons) of those corporations.
 - (e) Insolvency (Cross-border) Act 2006 – implementing the UNCITRAL Model Law on Cross-Border Insolvency, with minor amendments.
- 2.2 Special provisions modifying the standard insolvency regime apply in the insolvency of corporations carrying on insurance or banking business. Entities which are not corporations are subject to modified versions of the standard insolvency regime for corporations, or a different regime altogether.
- 2.3 The Companies Act sets out the duties and liabilities of directors. Significantly, if the company has traded whilst insolvent, directors can be personally liable for debts incurred by the company when the company had no reasonable likelihood of being able to pay those debts. In addition, taxation legislation imposes personal liability on directors in certain circumstances for some of their company's unpaid tax debts.

2.4 Directors of failed companies can also be disqualified from becoming directors for a period of time which varies according to the circumstances. A common period is 2 - 5 years.

3 Summary of insolvency procedures for corporations

Compromises with creditors

3.1 The board of directors of a company, a receiver of all or most of the assets and undertaking of the company (see paragraph 3.9 below) or, with the leave of the Court, any creditor or shareholder of the company, if they believe that the company is insolvent (unable to pay its debts) or is likely to become insolvent, can initiate a compromise proposal with creditors of the company.

3.2 The procedures and steps required to give effect to a compromise are set out in Part XIV of the Companies Act 1993. A compromise proposal becomes binding on a company and all creditors (or if there is more than one class, on all creditors of that class) to whom notice of the proposal is given if at least 50% in number and 75% in value of creditors or the relevant class of creditors who vote approve the compromise (with or without amendment).

3.3 It is not necessary for there to be a formal administrator of the compromise scheme, although often the terms of the compromise proposal provide for the appointment of an independent administrator or manager.

3.4 The Courts are not involved except:

- at the request of the proponent or the company, to impose a short moratorium period while the proposed compromise is being considered by creditors (proceedings in relation to debts are prohibited, although this does not affect secured creditors rights to enforce their security); or
- to deal with disputes or irregularities on the application of a disaffected creditor.

Voluntary administration

3.5 The board of a company can appoint an administrator if in the opinion of the directors voting for the resolution the company is insolvent or may become insolvent (that is, unable to pay its debts). The Court can appoint an administrator on the application of a creditor, the liquidator (if the company is in liquidation), or the Registrar of Companies if the Court is satisfied that the company is or may become insolvent and that an administration is likely to result in a better return for the company's creditors and shareholders than would result from an immediate liquidation of the company; or that it is just and equitable to appoint an administrator. A creditor who holds a charge over the whole or substantially the whole of the company's property may also appoint an administrator if the charge has become enforceable (provided the company is not already in liquidation).

3.6 The administrator is required to investigate the affairs of the company and report to creditors within prescribed time limits (these limits can be extended by the Court). While the company is in voluntary administration, there is a moratorium period during which no creditor (except in limited circumstances a secured creditor with a charge over all or substantially all of the company's assets) can take any enforcement action against the company. At a "watershed" meeting, creditors vote on three options:

- a deed of company arrangement should be entered into between the creditors and the company, which may allow the continued operation of the company or an orderly wind down of the company's affairs.
- the company should be put into liquidation (see paragraph 3.8).
- the company should be returned to the control of the directors (this is very rare).

The requisite majority is a majority in number and 75% in value of those voting.

- 3.7 The Courts are involved in the following situations: the administrator or a creditor can apply to the Court for a wide range of supervisory orders and any creditor prejudiced by the administration or who may be prejudiced by the deed of company arrangement can apply to the Court for relief or for termination of the deed.

Liquidation of the company

- 3.8 This is also known as winding up. This can be a voluntary process instigated by the shareholders or an involuntary process by Court order (almost always initiated by creditors). A liquidator is appointed whose role is to realise the assets of the company and distribute proceeds to creditors in accordance with statutory priorities. A liquidator has the right to avoid some transactions entered into before liquidation.

Receivership

- 3.9 Secured creditors stand outside liquidation, and often stand outside formal creditors' compromises. The right of secured creditors to realise their security is not affected by a creditors' compromise or deed of company arrangement (unless they agree, or in the case of a deed of company arrangement, the Court orders otherwise) or, generally speaking, on liquidation of a debtor company. A secured creditor who holds a charge over all the assets of an insolvent company can generally appoint a receiver over those assets or an administrator under the voluntary administration regime (see paragraph 3.5 above). With certain statutory exceptions, the secured creditor has first rights over the secured assets until its debt is paid in full.

- 3.10 The Court also has power, separately from a secured creditor, to appoint a receiver where the Court considers it appropriate to do so. The legislation dealing with receiverships (including Court appointed receivers) is the Receiverships Act 1993.

Statutory management

- 3.11 Statutory management is a legal regime that can apply to any corporation which is operating fraudulently or recklessly, or to which it is desirable that the Act should apply:

- for the purpose of preserving the interests of the corporations' members or creditors; or
- for the purpose of protecting any beneficiary under any trust administered by the corporation; or
- for any other reason in the public interest,

if those members, creditors, or beneficiaries or the public interest cannot be adequately protected under the Companies Act 1993 or in any other lawful way.

- 3.12 Statutory Managers are appointed by the Government in accordance with a recommendation of the New Zealand Securities Commission which must be satisfied that certain statutory criteria are met before it makes a recommendation.

- 3.13 Historically statutory management has been applied to companies or groups of companies which have problems of such an extraordinary nature that the ordinary insolvency regime under the Companies Act cannot deal adequately with them (for example, because of the size, complexity, or importance of the corporations' activities).

- 3.14 Statutory management cuts across the rights of the corporations' creditors far more extensively than do ordinary insolvency regimes. The liquidation of the company is only one of the possible options for a statutory manager. The aim of statutory management is to freeze the position of the corporation so as to preserve the interests of members, creditors and the public, and to resolve the difficulties of the corporation. Extensive moratorium provisions apply which preclude creditors, including secured creditors, from exercising rights and powers against the corporation. The regime contains provisions allowing the statutory manager to suspend obligations and terminate certain contracts.

3.15 The statutory management regime is rarely used – it has been applied to only 8 groups of corporations since 1989.

4. Summary of commercial issues

- 4.1 Directors of companies in liquidation can be exposed to personal liability for insolvent or reckless trading and for breaches of duty and other defaults. Although actions for insolvent or reckless trading in theory can be taken before liquidation, in practical terms because directors are generally in control of the company up to liquidation these actions are only taken by the liquidator after the company goes into liquidation.
- 4.2 Relatively few actions are taken against directors for insolvent trading.
- 4.3 One reason why such actions are not commonplace is that they are expensive to run and can become complex, for example, because insolvency of the company at various times needs to be proved by expert evidence.
- 4.4 However, external litigation funding sources are becoming increasingly available to insolvency practitioners who have minimal or no funds in the administration. This can increase the threat to directors.
- 4.5 The Courts have generally been realistic in the retrospective review of the conduct of directors. They understand that business involves risk, and they are prepared to give directors some latitude when determining at what point in time insolvent or reckless trading began.
- 4.6 At the same time, the Courts have shown little tolerance for passive directors who leave the hard work to others and claim that they did not know what was happening.
- 4.7 There are recent examples of the Registrar of Companies (the Government body responsible for administering and enforcing the Companies Act) prosecuting high profile directors where companies have failed.
- 4.8 The Registrar of Companies can also take steps to disqualify directors, although this action usually takes place well after the liquidation has concluded.
- 4.9 As a result of a change in late 2007 to the procedure for setting aside insolvent transactions and voidable charges (the onus is now on the liquidator to commence proceedings to set aside a transaction if a creditor has objected to a setting aside notice – previously the creditor had to apply to Court for an order that the transaction should not be set aside), and some appellate Court decisions in 2015 and 2016 interpreting the insolvent transaction provisions and the defences available to creditors, the number of applications by liquidators have substantially reduced. This is primarily because of current uncertainty as to whether, if a liquidator's application to set aside is unsuccessful, the Court will order costs against the liquidator who may not have funds in the liquidation to meet that order.
- 4.10 After the liquidator's remuneration and secured creditors and priority creditors (for example employees) are paid, returns to unsecured creditors are often minimal or (if the company's assets have been completely depleted) non-existent.

The information provided in this country chapter is correct as at 21/12/2016

POLAND

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 Identification and definition of directors

Polish law provides for the existence of the following commercial companies: registered partnership (*spółka jawna*), professional partnership (*spółka partnerska*), limited partnership (*spółka komandytowa*), limited joint-stock partnership (*spółka komandytowo-akcyjna*), limited liability company (*spółka z ograniczoną odpowiedzialnością*) and joint-stock company (*spółka akcyjna*). Their formation, structure, operation, dissolution, fusion, division and transformation are governed by the Commercial Companies Code of 2000, as amended (CCC). This chapter focuses on a limited liability company and joint-stock company, which represent in Poland over 86% of commercial companies and over 97% of commercial companies with foreign capital.¹ In this chapter a “company” will mean these two types of commercial entities.

One of the governing bodies in a company is the management board, which can comprise one or more members. Only a natural person with full capacity to perform acts in law can be a member of the management board. Unless stated differently in the company articles of association or statute, members of the management board of a limited liability company are appointed by resolution of shareholders, whereas members of the management board in a joint-stock company are appointed by decision of the supervisory board.

Principal duties of the management board are to conduct company affairs and represent the company in its in-court and out-of-court activities. Each company management board member is obliged to perform these duties. Polish law does not distinguish between managing and non-managing management board members (so-called “silent” management board members not involved in the day-to-day company management). However, the competences related to the management of company affairs may be divided between board members in the company articles of association or statute.

For the purpose of this chapter, a director and a management board member will be synonymous. Unless clearly indicated in this chapter, we will not consider as directors those individuals who exercise managerial functions within the company enterprise but are not members of the company management board.

1.2 Introduction

Polish law provides for two alternative types of legal proceedings which may be initiated by the company management board or individual directors when the company is in crisis - bankruptcy and restructuring.

Bankruptcy proceedings are initiated when the company becomes insolvent and are governed by the Bankruptcy Act of 2003 (BA). A thoroughly modified version of this act came into force on 1 January 2016. Polish law specifies two different criteria for establishing company insolvency – insufficient liquidity and over-indebtedness. With respect to insufficient liquidity, BA provides that a company is insolvent when it has lost its ability to pay outstanding pecuniary debts. This refers to the company’s actual ability to pay off its due pecuniary debts. The debtor loses this ability when he does not have cash (on hand or in a bank account) in the amount sufficient to settling its due financial liabilities. BA contains a legal presumption to the effect that the debtor loses his ability to pay off his outstanding debts when payment arrears exceed three months. The loss of the ability to repay due debts should be understood as the inability to make good on at least two such obligations. The inability to pay off one debt does not yet make the company insolvent.

¹ Information provided by the Central Statistical Office of Poland as of June 30, 2016.

As mentioned, the company is also insolvent when it carries an excessive debt burden. The debt burden is excessive when the value of company pecuniary debts exceeds the value of company assets for a continuous period exceeding 24 months. The BA contains a legal presumption to the effect that the value of company financial liabilities exceeds the value of company assets when it is shown in the balance sheet (as defined in the Accounting Act of 1994) that liabilities (excluding reserves for commitments and commitments toward related parties) exceed the value of company assets for a period exceeding 24 months. If in the course of this period the value of assets equals or exceeds the value of liabilities (even temporarily), the run of the 24-month period starts again.

According to the BA, bankruptcy proceedings generally conclude with a total liquidation of company assets and deletion of the company from the National Court Register. Company assets may be liquidated by way of a pre-pack sale, sale by the official receiver in the course of the proceedings or liquidation arrangement between creditors during the course of the proceedings.

Instead of submitting a petition for declaration of company bankruptcy in the event of insolvency, company directors may apply for the company to be subject to one of the restructuring procedures. Restructuring procedures are governed by the Restructuring Act of 2015, which entered into force on 1 January 2016. The Act provides for three types of in-court restructuring procedures (*przyspieszone postępowanie układowe* - accelerated arrangement proceedings, *postępowanie układowe* - arrangement proceedings and *postępowanie sanacyjne* - remedial proceedings) and one type of out-of-court procedure, which ends with approval of the arrangement by the restructuring Court (*postępowanie o zatwierdzenie układu* - proceedings for approval of an arrangement). Restructuring procedures are available to insolvent companies and also to companies threatened with insolvency, which is one whose financial situation indicates that it may soon become insolvent.

This chapter focuses on bankruptcy proceedings initiated as a result of company insolvency.

1.3 The twilight period during which transactions are vulnerable to attack

Under Polish law, the twilight period during which transactions are vulnerable to attack is the period in which company transactions are ineffective in relation to the bankruptcy estate or may be found ineffective in a decision issued by the judge-commissioner or the Court. This period may vary in length depending on the transaction.

In principle, the twilight period will be counted backward from the moment of filing a petition for declaration of bankruptcy rather than from the moment that bankruptcy is declared by the bankruptcy Court. However, in the case of certain transactions, the twilight period will be counted forward from the date of the transaction, in which case the date of filing the petition will be irrelevant. In exceptional cases, the twilight period will remain open-ended.

The run of the twilight period impacts the possibility of attacking the transaction.

The following table presents various twilight periods and transaction types that may be vulnerable to attack in their course.

The principles concerning the ineffectiveness of legal transactions performed by the debtor in the

No.	Type of transaction	Twilight period
1	Legal transaction under which the debtor disposes of his assets, if performed gratuitously or for a consideration but with the value of the debtor's performance being drastically in excess of that received by the debtor or of that reserved for the debtor or for a third party (Art. 127 par. 1 BA).	One year before the filing of the bankruptcy petition.
2	In-court settlement, acceptance of claim in Court, and waiver of a claim by the debtor under conditions as in point 1 above (Art. 127 par. 2 BA).	See point 1
3	Security and payment of an unenforceable debt given or made by the debtor (Art. 127 par. 3 BA).	Six months before the filing of the bankruptcy petition.
4	Assignment of a future receivable when the receivable will have arisen subsequent to the declaration of bankruptcy (Art. 128a BA).	Indefinite. Six months before the filing of the bankruptcy petition, if the assignment contract was entered into in writing and its date is certified.
5	Encumbrance established on the debtor's assets (mortgage, pledge, registered pledge or ship's mortgage), if the debtor was not a personal debtor of the secured creditor and the debtor received no benefits in connection with the establishment of the security (Art. 130 par. 1 BA).	One year before the filing of the bankruptcy petition.
6	Encumbrance established on the debtor's assets (mortgage, pledge, registered pledge or ship's mortgage), if the debtor was not a personal debtor of the secured creditor and the debtor received a benefit disproportionately low in relation to the value of the granted security (Art. 130 par. 2 BA).	See point 5
7	Encumbrances referred to in points 5 and 6 above, if they secure debts of the creditors referred to in points 8-11 below (regardless of the value of the benefit received by the debtor) (Art. 130 par. 3 BA).	See point 5
8	Legal transaction performed for a consideration with the debtor's spouse, a relative by blood or by affinity in the direct line, a relative by blood or affinity in the collateral line up to the second degree, a person cohabitating or maintaining a common household with the debtor, an adoptee or an adoptive parent (Art. 128 par. 1 BA).	Six months before the filing of the bankruptcy petition.
9	Legal transaction performed for a consideration with a company in which the debtor is the sole shareholder and with companies in which persons referred to in point 8 above are management board members or sole shareholders (Art. 128 par. 1a BA).	See point 8
10	Legal transaction performed for a consideration with the debtor's shareholders, representatives or spouses thereof, or with related companies, their shareholders, representatives or spouses thereof (Art. 128 par. 2 BA).	See point 8
11	Legal transaction performed for a consideration with another company, where one of the companies was the controlling company, or where the same company is the controlling company in respect of the debtor and the counter-party in the transaction (Art. 128 par. 3BA).	See point 8

12	Contractual penalties provided for in the event of non-performance or deficient performance of an obligation, if the obligation has been largely performed by the debtor or the contractual penalty is grossly excessive (Art. 130a BA).	Indefinite.
13	Remuneration for work performed by a representative of the debtor, or by the debtor's employee performing tasks falling within the management of debtor's enterprise, or by a person rendering services related to the management of or supervision over the debtor's enterprise, which is drastically higher than average remuneration for the like work or services and is not justified by the work input involved (Art. 129 par. 1 BA). This also applied to benefits due for reasons of termination of employment or of a contract for services relating to the management of the debtor's enterprise (Art. 129 par. 3 BA).	Six months before the filing of the bankruptcy petition.
14	Legal transaction detrimental to company creditors, which means that, as its result, the debtor became insolvent or became insolvent to a greater degree than before the transaction (so-called action Pauliana; Art. 527-534 of the Civil Code of 1964 (CC)).	Five years from the transaction date; however no longer than two years from the date of bankruptcy declaration. The two-year limitation period does not apply if the request to recognize the legal transaction ineffective is submitted by the official receiver as an objection in another Court proceedings.

twilight period shall not apply to:

- The netting performed in payments and securities settlement systems in accordance with BA Article 136² or BA Article 137³ and its result;
- The contract for establishment of a financial security, as referred to in the Act on Certain Financial Securities of 2004, or to the performance of obligations arising from such contract.

1.4 The twilight period during which transactions are liable to give rise to personal liability

Under Polish law, the twilight period may be also the period when transactions are liable to give rise to personal liability of company directors. However, under Polish law, that period is not specified in weeks, months or years. Depending on the transaction, it may begin to run as of the moment when the company becomes a debtor of at least a few creditors or becomes threatened with insolvency.

This issue is discussed in greater detail in the following S 2 of this chapter.

² Art. 136 BA: "In the event of a declaration of bankruptcy issued in respect of a member of the payment system or securities settlement system referred to in Article 22, paragraph 1, subparagraph 4 [payments system or securities settlement system within the meaning of the Act on the Ultimate Nature of Clearings in Payment Systems and Securities Settlement Systems, and the Principles of Supervision of These Systems (2001), being governed by Polish law or the law of another EU Member State], the legal effects of a clearing instruction arising from the introduction of the same in the system, as well as results of netting, shall be incontestable and binding upon third parties if the instruction was entered in the system prior to the declaration of bankruptcy".

³ Art. 137 BA: "Where the clearing order referred to in Article 136 has been entered in the system following the declaration of bankruptcy and is carried out on the business day of the system as defined in Article 80, paragraph 2 [the business day of the system shall be deemed the cycle of effecting orders determined by the rules for functioning of the payments or securities settlement system as defined in the Act referred to in Article 22, paragraph 1, subparagraph 4, during which cycle settlements or clearings are effected and other operations connected therewith take place; said day may begin and end in subsequent calendar days], such day beginning on the date of declaring bankruptcy, the legal effects arising from its entry in such system shall be incontestable and binding upon third parties only in the event that the subject operating the system proves that, at the time that such clearing order became irrevocable according to the rules for functioning of the system, it was not aware and could not have been aware of the declaration of bankruptcy".

QUESTION 2

2. Actions potentially giving rise to liability for directors

- (a) In respect of which acts during the twilight period may a director be held personally liable or which may otherwise have adverse consequences for the director?
- (b) In relation to each act identified in (a) above:
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or 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 Actions potentially giving rise to liability for directors

Here is a selection of acts performed during the twilight period for which a director may be held personally liable:

- 1) Bringing about a situation where enforcement of debts or tax arrears against the company is unsuccessful, which in practice applies to a situation where enforcement was impossible due to the lack of assets (Art. 299.1-2 CCC and Art. 116.1 of the Tax Ordinance Act of 1997, TOA). Article 299 CCC, which concerns civil debts, is applicable only to directors of limited liability companies and not to directors of joint-stock companies.
 - (i) Liability is civil in the case of an unsuccessful enforcement of debts other than tax arrears. In the latter case, such liability is rather administrative; it is determined by an administrative decision of the head of the relevant tax office. Both types of liabilities are compensatory in their nature.
 - (ii) A director can be made personally liable up to all deficit to creditor.
 - (iii) Liability of each particular director is assessed independently from liability of other directors. However, if at least two directors are found liable, their liability is joint and several.

A person may be held liable for civil debts if he was serving as a director of the company at the time when two prerequisites were both present:

- the company was indebted to the creditor (even if the debt was not yet due and payable); and
- the company was insolvent.

In turn, as to liability for tax arrears, directors' liability extends to tax arrears which reached maturity when they were serving on the management board and arrears on account of tax overpayment or refund, or remuneration of tax remitters or tax collectors occurred while the director was serving on the management board (Art. 116.2 TOA).

Bearing this in mind, a claim for damages may be asserted not only against current directors, but also against former directors.

(iv) None.

(v) (a) One can be released from this liability if he can prove that, in particular:

- a petition for declaration of the company’s bankruptcy was filed on time or when the restructuring proceedings were opened or the arrangement with creditors was approved by the restructuring Court within that period; or
- failure to file a petition for declaration of the company’s bankruptcy on time was not the director’s fault; or
- enforcement from company assets was not ineffective or would have been effective were conduct correctly (in the case of civil debts – total ineffectiveness, or, in the case of tax arrears – total or partial ineffectiveness);
- a creditor did not incur any damage as a result of the failure to file for bankruptcy or to open restructuring proceedings or to approve the arrangement with creditors on time (in the case of liability for civil debts); or
- the director can point to company assets that will satisfy creditors to a large extent (in the case of liability for tax arrears).

(b) Case law expresses the opinion that the director’s lack of knowledge about the financial predicament of the managed company, which results exclusively from his omission, cannot serve as a base for releasing the director from compensatory liability. A director should when fulfilling his duties to exercise due diligence expected from a professional character of his activity.⁴

Having said this, the competences related to managing company affairs may be precisely divided between directors in the company articles of association or statute. It is permissible to introduce such a division of competences where specific company affairs (e.g. financial matters) is conducted only by a selected director(s). Such restriction of director’s duties gives grounds for the argument that the scope of director’s liability should be also restricted. However, there is a risk that the effectiveness of such restriction of liability may not be recognized by the Courts.

(c) Directors are not liable for failure to apply for declaration of bankruptcy at a time when enforcement is conducted by the compulsory administration or through a sale of the company enterprise on the basis of the Civil Procedure Code of 1964, when the obligation to submit an application for declaration of bankruptcy arose during the execution.

2) Not filing or not filing on time a petition for declaration of company bankruptcy in the case of its insolvency (Art. 21.3-3a BA).

(i) Civil liability; it is compensatory in its nature.

(ii) A director can be made personally liable up to the total deficit to creditors.

It is presumed in Polish law that damage caused by a failure to file or to file on time a petition for declaration of company bankruptcy covers the amount of unsatisfied claims of the creditors.

(iii) Accordingly please refer to point (1) (iii).

(iv) None.

⁴ For example, the judgment of the Court of Appeals in Łódź dated 27 January 2012, case file no. I ACa 462/11, *Legalis*.

- (v) A director can be released from this liability if he or she can prove that failure to file on time a petition for declaration of company bankruptcy was not his fault. This will happen, for example, when restructuring proceedings were opened or the arrangement with creditors was approved by the restructuring Court within that time.
- See also points 1)(v)(b) and (c) above.
- 3) A failure to comply with the deadline for submitting a petition for declaration of company bankruptcy (Art. 373.1.1 BA and Art. 373.1a-3 BA).
- (i) Liability is civil; its function is repressive / preventive, absence of the compensatory element.
- (ii) See points 1)(ii) and 2)(ii).
- (iii) Each director's liability is assessed independently from liability of other directors. Account is taken of the degree of director's fault and effectiveness of applied measures, particularly reduction of the value of the bankrupt's enterprise and the extent of damages caused to creditors.
- (iv) None.
- (v) A director can try to escape or limit the extent of his liability by demonstrating, for example, that:
- He was not at fault for not filing a petition for declaration of company bankruptcy or for not filing it on time, or the degree of his fault is low;
 - There was only a small reduction in the financial value of the bankrupt's enterprise or none at all, and the extent of damages caused to creditors was small or none at all;
 - The petition was filed on time for opening one of the following restructuring proceedings: accelerated arrangement proceedings, arrangement proceedings or remedial proceedings, and the extent of damages caused to creditors was small.
- 4) A failure to file or to file on time a petition for declaration of company bankruptcy in case of company insolvency (Art. 586 CCC).
- (i) Liability is criminal.
- (ii) Accordingly, in case of civil liability see points 1)(ii) and 2)(ii).
- (iii) (a) Criminal charges can be laid against directors who can be ascribed fault at the time of commitment of the prohibited act. The principle of *nullum crimen sine culpa* applies.
- Criminal liability of each director is assessed independently from liability of other directors. There is no collective liability. Individualization of directors' criminal liability ensues from the fundamental principle of criminal law – the principle of individualization of criminal liability.
- The circumstances affecting the penalty level are also assessed only with respect to the person whom they concern.
- (b) Legal commentators argue that, in practice, the offence of failing to apply for bankruptcy is usually committed by all company directors at once. For individuals who manage company business are required to be aware of the financial predicament of the company they manage and of its short- and medium-term financial liquidity.⁵
- (iv) None.

⁵ D. Czura-Kalinowska: A Commentary to Art. 586.8 [in:] Z. Jara (ed.), The Commercial Companies' Code, Commentary, Warsaw 2016, *Legalis*.

- (v) (a) Although, as noted above, in practice, the offence of failing to apply for bankruptcy is usually committed by all company directors at once, the period in which a person serves as a company director cannot be automatically linked with the commission of a prohibited act of failing to submit a petition for declaration of company bankruptcy. Indeed, the director will not be liable if he or she cannot be assigned blame at the time of the offence. This crime is an intentional offence⁶, so the misconduct is wilful; the offender can operate both with direct and potential intention (then he or she behaves with the awareness of and taking into account the risk that there may be a violation of a specific legal interest and occurrence of a specific effect).

For example, there may be situations where the director could not submit a petition for declaration of bankruptcy for reasons relating to him personally (i.e. he was sick or absent for a long time due to other reasons and could not participate in the work of the management board), or did not know the actual status of company finances, or has been misled as to the company's financial situation, etc., and that is why he or she was not aware of the company's insolvency.⁷ However, in practice, such situations are exceptional.

- (b) The Director may also seek to demonstrate that social harmfulness of the committed offence is negligible and thus try to break free from liability. In assessing the degree of social harmfulness the Court takes into account the type and nature of the infringed right, the size of the committed or threatened damage, the manner and circumstances of the offence, the importance of duties violated by the perpetrator as well as the format of the intention, the motivation of the offender, the type of the violated rules of prudence and the degree of their violation.

In assessing the degree of social harmfulness of the offence committed by a director (i.e. his failure to submit or to submit on time a petition for declaration of company bankruptcy in case of its insolvency), it will be particularly important to assess the degree of violation of the financial interests of company creditors.

- (c) General principles of Polish criminal law provide for situations in which the Court may apply extraordinary mitigation of punishment, conditionally suspend it or waive it altogether.

The Director may also seek mild punishment by citing the many past years of faultless performance of his duties or attempts to repair the damage after the commission of the offence.

- 5) Bringing about company bankruptcy or insolvency intentionally when the company has at least several creditors (Art. 308 in connection with Art. 301.2 of the Criminal Code of 1997, Cr.C).

A director's wilful misconduct occurs, for example, when he takes intentional action leading to the company's loss of liquidity or intentionally neglects his duties leading to the company's loss of liquidity through his inaction.

- (i) Liability is criminal.
- (ii) The director may be faced with additional civil (compensatory) liability for the act in question. The requirement to redress the damage may be also adjudged by a criminal Court (Art. 46 Cr.C).

If several directors are liable for damage caused by a tort, their liability is joint and several (Art. 441.1 CC).

- (iii) See point 4)(iii)(a).

- (iv) None.

⁶ Art. 9.1Cr.C: "A prohibited act is committed with intent when the offender wants to commit it, namely where there is a desire to commit it or an acceptance of the foreseen possibility of committing the act."

⁷ The judgment of the Supreme Administrative Court dated 21 December 2010, case I FSK 36/10.

- (v) (a) A director may be able to elude liability by demonstrating that he or she cannot be assigned blame at the time of the offence. This crime is an intentional offence, so the misconduct is wilful; the offender can operate both with direct and potential intention (then he or she behaves with the awareness of and taking into account the risk that there may be a violation of a specific legal interest and occurrence of a specific effect).
 - (b) See point 4)(v)(b-c).
 - (c) A director may also seek a waiver from or a milder punishment by voluntary compensation of all the damage caused or at least its significant part. The criminal Court may then apply an extraordinary mitigation of the punishment or waive the punishment altogether.
- 6) Bringing about the bankruptcy or insolvency of the company which is a debtor to at least several creditors through recklessness, in particular by squandering assets, incurring liabilities or concluding transactions in evident violation of the principles of proper management (Art. 308 in connection with Art. 301.3 Cr.C).

This regulation may be a source of a risk that directors' actions will be penalized, despite the fact that at the time of taking them the directors believed them to be rational and not exceeding the boundaries of economic risk.⁸

- (i) Liability is criminal.
 - (ii) See point 5)(ii).
 - (iii) See point 4)(iii)(a).
 - (iv) None.
 - (v) (a) A director may be able to elude liability by demonstrating that he or she cannot be assigned blame at the time of the offence. This crime is an unintentional offence.⁹ Moreover, as indicated directly in the discussed rule, this offence involves acting recklessly, as opposed to acting negligently, to which this rule does not apply. In jurisprudence, recklessness is understood as conscious carelessness.¹⁰ The perpetrator foresees the possibility of the given effect, but wrongly believes that it will not happen.
 - (b) See points 4)(v)(b-c) and 5)(v)(c).
- 7) Company insolvency or deteriorating financial standing as a result of director's intentional action or gross negligence (Art. 374.2 BA).
- (i) See point 3)(i) above.
 - (ii) See points 1)(ii) and 2)(ii).
 - (iii) See point 3)(iii) above.

In case law, gross negligence means failure to maintain minimal (elementary) rules of proper behaviour in a given situation. To assign this type of guilt to the director, he or she must behave in a particular situation in a way that differs drastically from the standard of minimum diligence.¹¹ Gross negligence arises if the level of objectionable conduct is particularly high.¹²

- (iv) None.

⁸ J. Potulski: Commentary to Art. 301, point 17, [in:] R. Stefański (ed.), The Criminal Code. Commentary, Warsaw 2016, *Legalis*.

⁹ Art. 9.2 Cr.C: A prohibited act is committed without intent when the offender does not intend to commit it but does so because of a failure to exercise due care under the circumstances, even though the possibility of committing the prohibited act was or could have been foreseen.

¹⁰ The Supreme Court in its judgment of 30 October 2014, case II KK 59/14.

¹¹ The Supreme Court in its judgment of 10 March 2004, case IV CK 151/03; the Supreme Court in its judgment of 26 January 2006, case VCSK 90/05.

¹² The Court of Appeals in Katowice in its judgment of 15 September 2005, case I ACa 255/05.

- (v) A director may be able to elude liability by demonstrating that he or she cannot be assigned blame. Moreover, as indicated directly in the discussed rule, this defence requires proving the absence of intentional conduct or gross negligence.
- 8) In case of the risk of company insolvency or bankruptcy, repaying or securing only some creditors when all creditors cannot be satisfied and thereby acting to the detriment of others (Art. 308 in connection with Art. 302.1 Cr.C).
 - (i) Liability is criminal.
 - (ii) See point 5)(ii).
 - (iii) See point 4)(iii)(a).
 - (iv) None.
 - (v) See points 4)(v)(b-c), 5)(v)(a) and 5)(v)(c).
 - 9) Giving or promising material benefit to a creditor in return for actions detrimental to other creditors in connection with bankruptcy or restructuring proceedings taking place in Court (Art. 308 in connection with Art. 302.2 Cr.C). This is a corruption offence.
 - (i) Liability is criminal.
 - (ii) See point 5)(ii).
 - (iii) See point 4)(iii)(a).
 - (iv) None.
 - (v) See points 4)(v)(b-c), 5)(v)(a) and 5)(v)(c). The offender may be acting solely with direct intention of acting to the detriment of other creditors.
 - 10) Frustrating or curtailing the satisfaction of a company creditor - in the event of threatened company insolvency or bankruptcy - by removing, concealing, disposing of, donating, destroying, actually or apparently charges or damaging company assets (Art. 308 in connection with Art. 300.1 Cr.C).
 - (i) Liability is criminal.
 - (ii) See point 5)(ii).
 - (iii) See point 4)(iii)(a).
 - (iv) None.
 - (v) See points 4)(v)(b-c), 5)(v)(a) and 5)(v)(c).
 - 11) Frustrating or limiting the satisfaction of several creditors by legally creating a new corporate entity and transferring company assets thereto (Art. 308 in connection with Art. 301.1 Cr.C).
 - (i) Liability is criminal.
 - (ii) See point 5)(ii).
 - (iii) See point 4)(iii)(a).
 - (iv) None.
 - (v) See points 4)(v)(b-c), 5)(v)(a) and 5)(v)(c).

Concerning the remedies available in respect of the foregoing acts, please see S 6 of this chapter.

2.2 Liability for activities not closely related to the twilight period

Polish law also provides for the liability of directors with respect to a number of activities that are not closely related to the twilight period. Here are some examples:

- 1) Damage of the company inflicted by actions contrary to law or provisions of the company articles of association or statute (civil liability; Art. 293.1 and Art. 483.1 CCC). That director can be held responsible who can be attributed the culpable act or omission. Liability of directors for the proper and lawful conducting of company affairs and its representation is based on a good manager or conscientious entrepreneur criterion. Its essence is a specific obligation to act in the best interests of the company and exercise due diligence in directing the company. The criterion of due diligence has a qualified dimension, since a director should, when fulfilling his obligations, exercise due diligence ensuing from the professional character of his activity. This means that greater vigilance and precision in realizing entrusted tasks is required from persons who run the company.

It should be noted that, at the ordinary meeting of shareholders held within six months after the end of the financial year, directors have the right to obtain a resolution of shareholders stating that the company which they manage does not raise any claims against them on account of conducting company affairs and administering company assets in the past financial year. Obtaining such acknowledgement of the fulfilment of duties, according to some commentators and case law, relieves directors of liability towards the company concerning the past financial year, unless the facts and documents on the basis of which the acknowledgement was granted are later challenged and no new facts or evidence relating to director's liability are invoked.

However, the acknowledgement of the fulfilment of duties does not protect, among others, against a shareholder's legal action initiated in defence of company interests (*actio pro socio*) and accountability to the company in the event of its bankruptcy (since at this point an official receiver may pursue the claim) (Art. 296 and Art. 487 CCC).

- 2) Abuse by a director of the granted rights (competences) or his failure to fulfil an obligation, which leads to the company suffering a loss (both civil and criminal liability is possible; the latter may leave the director exposed to a penalty of imprisonment from three months to 10 years; Art. 296 par.1 Cr.C).
- 3) Abuse by a director of the granted rights (competences) or his failure to fulfil an obligation, which causes an immediate danger to the company suffering significant damage; it may result in both civil and criminal liability (the director is exposed to a penalty of imprisonment for up to three years, or, if he/she has acted for the purpose of gaining a financial benefit, up to eight years; Art. 296.1a Cr.C).
- 4) Causing material damage to the company by failing to document business activities or by documenting it in a dishonest or untrue manner, particularly by destroying, removing, concealing, altering or falsifying documents regarding such activities may lead to both civil and criminal liability (the director is exposed to a fine, penalty of restriction of liberty or imprisonment for up to five years; Art. 303.1 Cr.C).
- 5) Frustrating or curtailing the satisfaction of a company creditor to prevent execution of a ruling issued by a Court or another state administration authority by removing, concealing, disposing of, donating, destroying, actually or apparently charges or damaging company assets which are seized or threatened with seizure, or removing the signs of seizure may result in both civil and criminal liability (the director is exposed to a penalty of imprisonment from three months to five years; Art. 308 in connection with Art. 300.2 Cr.C).
- 6) Failure to notify the proper entity (e.g. the financing bank) in breach of the obligation of the appearance of a situation which could cause the withdrawal or reduction of the amount of granted financial support or on the possibility of further use of the payment instrument may amount to both civil and criminal liability (the director is exposed to a penalty of imprisonment from three months to five years; Art. 297.2 Cr.C).

These examples of directors' liability do not consume directors' potential additional civil liability under the general rules of Polish civil law towards the company, shareholders, creditors or other third parties (e.g. liability in tort).

QUESTION 3

3. Other persons involved with the company’s affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company’s activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?

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

Persons responsible for the company’s activities during the twilight period can be, next to directors as such, shadow directors, supervisory board members, audit committee members, proxies, attorneys, company liquidators and other persons who under legal provisions, a decision of the appropriate authority or Court, a contract or actual performance, manages the company’s affairs.

3.2 Acts that other persons may be held liable

No.	Actions	Persons liable other than directors	Differences in directors’ and those persons’ liability
1	Bringing about a situation where the execution of debts or tax arrears against the company is ineffective, which in practical terms applies to a situation when execution was impossible due to the lack of assets (Art. 299.1-2 CCC and Art. 116.1 TOA).	Liquidators, except court-appointed liquidators. Article 299 CCC concerns civil-law debts and applies only to liquidators of a limited liability company; joint-stock company liquidators do not fall under this article.	Legal provisions clearly indicate that the liquidator is liable for company tax arrears created only during liquidation (Art. 116b TOA).
2	Non-filing or not filing on time a petition for declaration of company bankruptcy in case of its insolvency.	Liability under Art. 21.3-3a BA: liquidator. Liability under Art. 373.1.1 and Art. 373.1a-3 BA: - liquidator; - shadow director who has substantially contributed to the non-failure of the petition for declaration of bankruptcy within the statutory time limit. Liability under Art. 586 CCC: liquidator. See also point 3 (b)	None None None

3	Intentionally causing bankruptcy or insolvency of the company which is a debtor to at least several creditors (Art. 308 in connection with Art. 301.2 Cr.C)	<p>(a) Anyone who, pursuant to legal provisions, a decision of the appropriate authority or Court, a contract or actual performance, manages the company's affairs.</p> <p>In jurisprudence, the person dealing with other people's financial affairs is the one whose duties and competences include both: (i) care for keeping the entrusted property away from harm, destruction or loss and deterioration of entrusting person's financial interests, and (ii) the use of that property in the process of management to enlarge it or increase in value.</p> <p>Case law also indicates that dealing with other people's financial affairs includes any behaviour that involves solving issues associated with these affairs, cooperating in finding solutions or influencing the outcome, and so it involves disposing of property and performing legal actions relating to property or financial affairs, even if only once.</p> <p>Who will bear liability depends on the specific facts of the case. For example, liability can be borne by shadow directors, supervisory board members, audit committee members, proxies, attorneys, liquidators, etc.</p> <p>(b) Moreover, according to the general rules of Polish criminal law, liability may be expanded on those who:</p> <ul style="list-style-type: none"> - directing the commitment of an offence by another person or using another person's dependency instruct him to perform an offence; - wishing another person to commit a crime, urges that person to commit it; - with the intent that another person commits a crime, facilitates its commitment with his behaviour, in particular by providing a tool, a means of transport, advice or information; responsible for aiding and abetting is also the person who, contrary to the particular legal obligation to prevent an offense, facilitates with his inaction its commitment by someone else. 	None
4	Recklessly bringing about the bankruptcy or insolvency of a company which is a debtor to at least several creditors, in particular by squandering assets, incurring liabilities or concluding transactions evidently contrary to the principles of proper management (Art. 308 in connection with Art. 301.3 Cr.C)	See point 3	None
5	Company insolvency or deterioration of company financial standing as a result of intentional action or gross negligence (Art. 374.2 BA)	Shadow director and liquidator.	None

¹³ The Supreme Court in its decision of 27 April 2001, casel KZP 7/01; the Appeals Court in Pozna in its judgment of 7 February 2013, case II AKa 291/12.

¹⁴ The Appeals Court in Pozna in its judgment of 7 February 2013, case II AKa 291/12.

6	In case of the risk of company insolvency or bankruptcy, repaying or securing only some creditors when they cannot all be satisfied and thereby acting to the detriment of others (Art. 308 in connection with Art. 302.1 Cr.C).	See point 3	None
7	Giving or promising material benefit to a creditor in return for actions detrimental to other creditors in connection with bankruptcy or restructuring in-court proceedings (Art. 308 in connection with Art. 302.2 Cr.C)	See point 3	None
8	Frustrating or curtailing the satisfaction of company creditor –when the company is threatened with insolvency or bankruptcy – by removing, concealing, disposing of, donating, destroying, actually or seemingly charges or damaging company assets (Art. 308 in connection with Art. 300.1 Cr.C)	See point 3	None
9	Frustrating or limiting the satisfaction of several creditors by legally creating a new corporate entity and transferring company assets thereto (Art. 308 in connection with Art. 301.1 Cr.C)	See point 3	None

3.3 Extent of liability

Those other persons can be made personally liable for losses and the deficit on the same basis as directors in the scope referred to in S 3.2 of this chapter.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company’s affairs properly incur further credit during the twilight period?

4.1 Summary of heads of challenge

The basis on which transactions with the company may be set aside in the twilight period are presented in the table in S 4.2 of this chapter in the column titled “Type of transaction”.

4.2 Defences available to a parties

No.	Type of transaction	Examples of potential defences
1	A legal transaction under which a debtor disposes of his assets, if performed gratuitously or for a consideration but with the value of the debtor’s performance being drastically in excess of that received by the debtor or of that reserved for the debtor or for a third party (Art. 127.1 BA).	It may be raised that the value of the debtor’s performance has not been drastically in excess of that received by the debtor or of that reserved for the debtor or for a third party. When comparing the value of benefits of the bankrupt and the third party one needs to refer to their market value and supply and demand on that market. Glaring disparity of benefits should be assessed on the case-by-case basis. Case law indicates that the point of reference for this assessment should be the average prices, rates, fees, etc. used in trade when performing the same or similar legal actions. ¹⁵
2	In-court settlement, acceptance of the claim in Court and waiver of the claim made by a debtor under conditions as in point 1 above (Art. 127.2 BA).	See point 1.
3	Security and payment of an unenforceable debt given or made by the debtor (Art. 127.3 BA).	It can be argued that the security has been granted jointly with the rise of liability (time and functional connection). The provision of Art. 127.3 BA applies only in situations in which the secured debt already existed. Moreover, the person who received the payment or security may by way of a Court action or objection request recognition of these actions to be effective, if at the time of their execution he/she did not know of the existence of grounds for declaration of the debtor’s bankruptcy.
4	The assignment of a future receivable where the receivable will have arisen subsequent to the declaration of bankruptcy (Art. 128a.1 BA).	Concluding an agreement for assignment of the receivable – in writing and with a certified date. If the agreement for assignment of the receivable was concluded not later than six months before the filing of the bankruptcy petition in this form, Art. 128a.1 BA is not applied.

¹⁵ The Court of Appeals in Białystok in its judgment of 20 November 2014, case I ACa 507/14.

		Another form of defence would be by demonstrating that the issue is not about a future receivable and that it was created before the announcement of company bankruptcy.
5	An encumbrance established on the debtor's assets (a mortgage, pledge, registered pledge or ship's mortgage), if the debtor was not a personal debtor of the secured creditor and the debtor received no benefit whatsoever in connection with the establishment of the security (Art. 130.1 BA).	Argumentation showing that the bankrupt received a benefit in connection with the establishment of the encumbrance. See point 6.
6	An encumbrance established on the debtor's assets (a mortgage, pledge, registered pledge or ship's mortgage), if the debtor was not a personal debtor of the secured creditor and the debtor received a benefit disproportionately low in relation to the value of the security given (Art. 130.2 BA).	Argumentation showing that the bankrupt received a benefit in connection with the establishment of the encumbrance and that it is not disproportionately low in relation to the value of the security given.
7	Encumbrances referred to in points 5 and 6 above, if they secure debts of the creditors referred to in points 8-11 below (regardless of the value of a benefit received by the debtor) (Art. 130.3 BA).	A possible defence by demonstrating that the encumbrance was established to the benefit of persons who do not meet the requirements of Art. 130.3 BA.
8	A legal transaction performed for a consideration with a debtor's spouse, a relative by blood or by affinity in the direct line, a relative by blood or affinity in the collateral line up to the second degree, a person cohabitating with the debtor, maintaining a common household therewith, or with an adoptee or an adoptive parent (Art. 128.1 BA).	A possible defence by demonstrating that a party to the transaction does not belong to the group of entities listed in Art. 128.1 BA.
9	A legal transaction performed for a consideration with a company in which the debtor is the sole shareholder and with companies in which persons referred to in point 8 above are management board members or sole shareholders (Art. 128.1a BA).	See point 8.
10	A legal transaction performed for a consideration with the debtor's shareholders, representatives or their spouses, as well as with related companies, their shareholders, representatives or their spouses (Art. 128.2 BA).	See point 8.
11	A legal transaction performed for a consideration with another company, where one of the companies is the controlling company, or where the same company is the controlling company with respect to the debtor and the other party to the transaction (Art. 128.3 BA).	See point 8.
12	Contractual penalties in the event of non-performance or deficient performance of an obligation, if the obligation has been largely performed by the debtor or if the contractual penalty is grossly excessive (Art. 130a BA).	Argumentation proving that the bankrupt has not performed the obligation in full or in a considerable part, or – possibly – that the given contractual penalty complies with market standards or is not grossly excessive.

<p>13</p>	<p>Remuneration for work performed by a representative of the debtor, or by the debtor's employee performing tasks falling within the management of debtor's enterprise, or by a person rendering services related to the management of or supervision over the debtor's enterprise, which is drastically higher than the average remuneration for such work or services and is not justified by the amount of work input involved (Art. 129 par. 1 BA). This also applies to benefits due for termination of employment or service contract related to the management of the debtor's enterprise (Art. 129.3 BA).</p>	<p>A possible defence by demonstrating that this remuneration is market standard for this type of work or service and that it certainly does not grossly exceeds the average remuneration. Moreover, one may argue that this amount of remuneration is justified by the type, scope or intensity of performed work.</p>
<p>14</p>	<p>A legal transaction as a result of which a third party has obtained financial benefit, detrimental to the company's creditors, which means that as a result of that transaction the debtor became insolvent or became insolvent in a greater degree than before the transaction (so-called action Pauliana - fraudulent conveyance; Art. 527-534 CC).</p> <p>The provisions of these articles also apply accordingly in the case when future creditors have been harmed.</p>	<p>A third party who has obtained financial benefit as a result of the debtor's legal action may free himself from the compensation claim by the creditor requesting the recognition of the action as ineffective if he/she satisfies that creditor or indicates to him the debtor's property sufficient to for the creditor to get satisfaction.</p> <p>One may also argue in defence that the debtor did not act with the awareness of harming creditors. If, however, we are dealing with a donation and at the time of the donation the debtor was insolvent, it is presumed that he acted with the awareness of harming creditors. The same applies to cases where the debtor became insolvent as a result of the donation. Another argument that can be raised is that the third party did not know that the legal action would be harmful to creditors and was not able to find that out even when exercising due diligence.</p> <p>If future creditors were harmed when the third party obtained financial benefit against consideration, it is sufficient to demonstrate a lack of knowledge of the third party.</p> <p>However, one should bear in mind that, if as a result of legal action, a material benefit was obtained by a person remaining in close relationship with the debtor, it will be presumed that the person knew that the debtor acted with the awareness of harming creditors. The same applies to a businessperson remaining with the debtor in regular economic relations.</p> <p>The presumptions are rebuttable.</p> <p>If as a result of legal action a third party has obtained financial benefit free of charge, the creditor may request that the action be deemed ineffective, even if that party did not know and would have not found out when exercising due diligence that the debtor acted with the awareness of harming creditors.</p> <p>Another possible defence is to argue that the debtor did not become insolvent as a result of the legal action, and if he was already insolvent, his insolvency did not deepen.</p>

4.3 Credit during the twilight period

According to Polish law, directors conducting company affairs are obliged to act in the company's best interest. If the company is insolvent or threatened with insolvency, directors are additionally obliged to look also after the general interests of company creditors. The assumption of further liabilities during the twilight period must be then viewed by directors from the perspective of the company's and creditors' interests, particularly from the standpoint of the effects of incurring a further debt on the company's financial liquidity, the extent of company indebtedness and the ratio of creditors' satisfaction.

The Polish regulations penalize the actions of directors who lead their company to bankruptcy or insolvency, or who worsen the company's financial standing, particularly by incurring liabilities, by intentional or reckless actions, or by gross negligence. These actions may also serve as the basis for directors' liability for damages. All these risks may serve as a guideline for directors during the twilight period when deciding whether to contract further debt on behalf of the company.

One of the reasons for declaring bankruptcy may be the company's excessive debt, namely when the company's financial liabilities exceed the value of its assets and this state continues without interruption for a period exceeding 24 months. As a result, the assumption of additional liabilities in the twilight period may become an independent source of company insolvency or may deepen the already existing state of insolvency.

Under the Bankruptcy Act of 2003, liabilities to shareholders for loans or other actions which have similar effects to the company within the past five years, together with interest, are not taken into consideration when determining over-indebtedness as the basis for declaring company insolvency. This exclusion, however, does not apply to liabilities to other lenders.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Action brought against directors and other persons

No.	Actions which may be a source of liability	Locus standi
1	Bringing about a situation where the execution of debts and tax arrears against the company is unsuccessful, which in practical terms applies to a situation where the execution is ineffective due to the lack of assets (Art. 299.1-2 CCC and Art. 116.1 TOA).	The creditor whose execution against the company was unsuccessful and the head of the tax office with jurisdiction over the company.
2	A failure to file or to file on time the petition for declaration of company bankruptcy when the company is insolvent	<p>(a) Art. 21.3-3a BA: anyone who suffers damage as a result of a failure to file a bankruptcy petition on time, in particular creditors who have not been fully satisfied from the company bankruptcy estate.</p> <p>(b) Art. 373.1.1 BA and Art. 373.1a-3 BA: creditor, temporary Court supervisor, compulsory administrator, official receiver, public prosecutor, President of the Office of Competition and Consumer Protection, and President of the Financial Supervision Authority.</p>

		<p>(c) Art. 586 CCC: It is an offence prosecuted <i>ex officio</i> by a public authority, primarily the prosecutor's office and the police.</p> <p>However, anyone who becomes aware of the commitment of a crime prosecuted <i>ex officio</i> (e.g. an office holder) has the civic duty to notify the public authorities thereof. If the suspicion of a commitment of a crime is justified, an investigation or inquiry is initiated on this basis.</p>
3	Intentionally bringing about the bankruptcy or insolvency of a company which is a debtor to at least several creditors (Art. 308 in connection with Art. 301.2 Cr.C)	See point 2 (c)
4	Recklessly bringing about the bankruptcy or insolvency of a company which is a debtor to at least several creditors, in particular by squandering assets, incurring liabilities or concluding transactions evidently contrary to the principles of proper management (Art. 308 in connection with Art. 301.3 Cr.C)	See point 2 (c)
5	Company insolvency or deterioration of company financial standing as a result of intentional action or gross negligence (Art. 374.2 BA)	See point 2 (b)
6	In case of the risk of company insolvency or bankruptcy, repaying or securing only some creditors when not all can be satisfied, and thereby acting to the detriment of others (Art. 308 in connection with Art. 302.1 Cr.C).	See point 2 (c)
7	Granting or promising material benefit to a creditor in return for actions detrimental to other creditors in connection with bankruptcy or in-court restructuring proceedings (Art. 308 in connection with Art. 302.2 Cr.C)	See point 2 (c)
8	Frustrating or curtailing satisfaction of a company creditor – when the company is threatened with insolvency or bankruptcy – by removing, concealing, disposing of, donating, destroying, actually or seemingly charges or damaging company assets (Art. 308 in connection with Art. 300.1 Cr.C)	<p>This offence is prosecuted upon private request. Every harmed creditor can apply for prosecution of the offender to the public authorities.</p> <p>However, if the State Treasury is the harmed party, then the offender is prosecuted <i>ex officio</i> by the public authorities, primarily the prosecutor's office or the police.</p>
9	Frustrating or limiting the satisfaction of several creditors by legally creating a new corporate entity and transferring company assets thereto (Art. 308 in connection with Art. 301.1 Cr.C)	See point 2 (c)

QUESTION 6

6 Remedies: orders available to the domestic Court

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

6.1 The chart below discusses in detail the remedies that are available.

No.	Actions or transactions	Remedies available
1	<p>Bringing about a situation where the execution of debts and tax arrears against the company is unsuccessful, which in practical terms applies to a situation where the execution is ineffective due to the lack of assets (Art. 299.1-2 CCC and Art. 116.1 TOA).</p> <p>Art. 299 CCC concerning civil-law debts is applicable only to directors of limited liability companies, not to directors of joint-stock companies.</p>	<p>Liability for the company's debts and tax arrears. The liable individual person is responsible with all his assets jointly and severally with the company.</p>
2	<p>A failure to file or to file on time the petition for declaration of company bankruptcy when the company is insolvent.</p>	<p>(a) Art. 21.3-3a BA: liability for damages. It is presumed under the law that the damage caused by a failure to file or to file on time a petition for declaration of company bankruptcy covers the amount of unsatisfied receivables which creditors have towards the company.</p> <p>(b) Art. 373.1.1 BA and Art.373.1a-3 BA: the Court may adjudicate the deprivation of a person, for a period from one to 10 years, of the right to carry on economic activity on their own account or in the form of a civil-law partnership, and to perform the function of: a supervisory board member, audit committee member, representative (including director) or attorney of a natural person pursuing economic activity to the extent of such activity, a commercial company or partnership, State enterprise, cooperative, foundation or association.</p> <p>(c) (i) Art. 586 CCC: the person is exposed to a fine, restriction of freedom or imprisonment up to one year.</p> <p>(ii) The criminal Court may also decide to disqualify the person from holding specific positions (in particular that of a director in a company) from one to 15 years if he or she has abused the position when committing the offence or has shown that certain essential interests protected by law would be threatened if he or she continued in the present position (Art. 41.1 Cr.C).</p> <p>(iii) Additionally, as mentioned earlier, the person may also face civil liability of compensatory character for the act in question. The requirement to redress damage may be also adjudged by a criminal Court (Art. 46 Cr.C).</p>

3	Intentionally bringing about the bankruptcy or insolvency of a company which is a debtor to at least several creditors (Art. 308 in connection with Art. 301.2 Cr.C).	The person is exposed to penalty of imprisonment from three months to five years. See points 2 (c) (ii) and (iii)
4	Recklessly bringing about the bankruptcy or insolvency of a company which is a debtor to at least several creditors, in particular by squandering assets, incurring liabilities or concluding transactions evidently contrary to the principles of proper management (Art. 308 in connection with Art. 301.3 Cr.C).	The person is exposed to a fine, penalty of restriction of liberty or imprisonment for up to two years. See points 2 (c) (ii) and (iii)
5	Company insolvency or deterioration of company financial standing as a result of intentional action or gross negligence (Art. 374.2 BA).	See point 2 (b)
6	In case of the risk of company insolvency or bankruptcy, repaying or securing only some creditors when not all can be satisfied, and thereby acting to the detriment of others (Art. 308 in connection with Art. 302.1 Cr.C).	The person is exposed to a fine, penalty of restriction of liberty or imprisonment for up to two years. See points 2 (c) (ii) and (iii)
7	Granting or promising material benefit to a creditor in return for actions detrimental to other creditors in connection with bankruptcy or in-court restructuring proceedings (Art. 308 in connection with Art. 302.2 Cr.C).	The person is exposed to a penalty of imprisonment for up to three years. See points 2 (c) (ii) and (iii)
8	Frustrating or curtailing satisfaction of a company creditor – when the company is threatened with insolvency or bankruptcy – by removing, concealing, disposing of, donating, destroying, actually or seemingly charges or damaging company assets (Art. 308 in connection with Art. 300.1 Cr.C).	The person is exposed to a penalty of imprisonment of up to three years; if frustrating or curtailing satisfaction applies to many creditors, the person is exposed to a penalty of imprisonment from six months to eight years. See points 2 (c) (ii) and (iii)
9	Frustrating or limiting the satisfaction of several creditors by legally creating a new corporate entity and transferring company assets thereto (Art. 308 in connection with Art. 301.1 Cr.C).	The person is exposed to a penalty of imprisonment from three months to five years. See points 2 (c) (ii) and (iii)
10	Legal transaction, in-court settlement, acceptance of a claim in Court and waiver of a claim by the debtor under which the debtor disposed of his assets, if performed gratuitously or for a consideration but with the value of the debtor's performance being drastically in excess of that received by the debtor or of that reserved for the debtor or for a third party (Art. 127 par. 1-2 BA).	(a) Ineffectiveness toward the bankruptcy estate <i>ex officio</i> . The effects of these transactions made in the twilight period do not apply to securities established before the date of the declaration of bankruptcy in connection with the financial futures, financial instrument lending or sale and repurchase of financial instruments made under contracts entered into in fulfilment of the framework contract. (b) If the activity is ineffective by virtue of the law, assets which as a result of this activity have vanished from the bankrupt's estate or have not been transferred thereto will be returned to the bankruptcy estate, and if the return in nature is impossible, an equivalent in money will be paid into the bankruptcy estate.

		<p>With the consent of the judge-commissioner, the other party to this activity may be released from the obligation to transfer to the bankruptcy estate that which has vanished from the bankrupt's assets as a result of that activity by paying the difference between the market value of the debtor's benefit on the date of the agreement and the value of the benefit received by the debtor.</p> <p>Consideration of a third party is refunded to that party if it is in the bankruptcy estate separately from other assets or if it enriches the bankruptcy estate. If this consideration is not refundable, the third party may assert claims thereto under bankruptcy proceedings.</p>
11	A security and the payment of an unenforceable debt given or made by the debtor (Art. 127.3 BA).	See point 10
12	An assignment of a future receivable where the receivable will have arisen subsequent to the declaration of bankruptcy (Art. 128a.1 BA).	See point 10
13	Encumbrance established on the debtor's assets (mortgage, pledge, registered pledge or ship's mortgage), if the debtor was not a personal debtor of the secured creditor and the debtor received no benefit whatsoever in connection with the establishment of the security (Art. 130.1 BA).	<p>Ineffectiveness towards the bankruptcy estate in the event of a decision of the judge commissioner (adopted at the request of the official receiver).</p> <p>See point 10 (b)</p>
14	Encumbrance established on the debtor's assets (mortgage, pledge, registered pledge or ship's mortgage), if the debtor was not a personal debtor of the secured creditor and the debtor received a benefit disproportionately low in relation to the value of the security given (Art. 130.2 BA).	See points 13 and 10 (b)
15	Encumbrances referred to in points 13 and 14, if they secure debts of the creditors referred to in points 16-19 (regardless of the value of a benefit received by the debtor) (Art. 130.3 BA).	See points 13 and 10 (b)
16	A legal transaction performed for a consideration with a debtor's spouse, a relative by blood or by affinity in the direct line, a relative by blood or affinity in the collateral line up to the second degree, a person cohabitating with the debtor, a person maintaining a common household with the debtor, an adoptee or an adoptive parent (Art. 128 par. 1 BA).	<p>Ineffectiveness towards the bankruptcy estate in the event of a decision of the judge commissioner (adopted <i>ex officio</i> or at the request of the official receiver).</p> <p>See point 10 (b)</p>
17	A legal transaction performed for a consideration with a company where the debtor is the sole shareholder and with companies where persons referred to in point 16 above are management board members or sole shareholders (Art. 128.1a BA).	See points 16 and 10 (b)

18	A legal transaction performed for a consideration with a debtor's shareholders, representatives or their spouses, and with related companies, their shareholders, representatives or their spouses (Art. 128.2 BA).	See points 16 and 10 (b)
19	A legal transaction performed for a consideration with another company, where one of the companies is the controlling company, or where the same company is the controlling company with respect to the debtor and the other party to the transaction (Art. 128.3 BA).	See points 16 and 10 (b)
20	Contractual penalties provided for in the event of non-performance or deficient performance of an obligation, if the obligation has been largely performed by the debtor or the contractual penalty is grossly excessive (Art. 130a BA).	Ineffectiveness toward the bankruptcy estate (in whole or in part) in the event of a decision of the judge commissioner (adopted at the request of the official receiver). See point 10 (b)
21	Remuneration for work performed by a representative of the debtor or by the debtor's employee performing tasks falling within the management of the debtor's enterprise, or by a person rendering services related to the management of or supervision over the debtor's enterprise, which is drastically higher than the average remuneration for such work or services and is not justified by the amount of work involved (Art. 129.1BA). This also applied to benefits due for termination of employment or a service contract related to the management of the debtor's enterprise (Art. 129.3 BA).	Ineffectiveness toward the bankruptcy estate (in whole or in part) in the event of a decision of the judge commissioner (adopted <i>ex officio</i> or at the request of the official receiver). See point 10 (b)
22	A legal transaction as a result of which a third party has obtained financial benefit, detrimental to the company's creditors, which means that as a result of that transaction the debtor became insolvent or became insolvent in a greater degree than before the transaction (so-called action Pauliana - fraudulent conveyance; Art. 527-534 CC). The provisions of these articles also apply accordingly in the case when future creditors have been harmed.	The creditor may request the Court to declare the transaction ineffective towards him. A creditor with respect to whom the debtor's legal action was deemed ineffective can with priority over other creditors claim satisfaction from items, which as a result of the action deemed ineffective left the debtor's estate or did not transfer to it. A third party who has obtained financial benefit as a result of the debtor's legal action conducted to the detriment of creditors may be released from the compensation claim of the creditor requesting the recognition of the action as ineffective if he satisfies that creditor or indicates thereto debtor's assets sufficient to satisfy him. In case of a bankruptcy declaration, the afore-mentioned right to request the Court to declare the transaction ineffective is held only by the official receiver appointed for the bankrupt.

Criminal Courts impose fines in terms of daily rates by defining the number of daily rates to be levied and the level of each rate; the lowest number of daily rates is 10 and the highest is 540. When setting the daily rate, the Court considers the offender's income, personal, family and financial situation and earning capacity; the daily rate may not be lower than PLN 10 or higher than PLN 2000. The Court may also impose a fine in addition to the penalty of restriction of freedom if the offender committed the deed to gain a material benefit or gained a material benefit as a result of the deed (Art. 33 Cr.C).

In turn, the penalty of restriction of freedom may consist of performing unpaid supervised community work (from 20 to 40 hours a month) or deduction of 10% to 25% from the individual's wage each month for a Court-specified social cause (in the period for which the deduction was adjudged, the convicted offender must not terminate his employment without the Court's consent). The Court may adjudge these duties and the deduction jointly or separately. When serving the penalty of restriction of freedom, the sentenced offender may not change his place of permanent residence without the Court's consent and is obligated to provide explanations as to the course of serving the sentence.

QUESTION 7

7. Duty to co-operate

- (a) **To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder's investigation into the company's affairs?**
- (b) **Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

7.1 Duty to co-operate

Following the submission of a bankruptcy petition, the bankruptcy Court can secure the assets of the debtor company either at creditor request or *ex officio* (Art. 36 BA). This may happen, for example, through the appointment of a temporary Court supervisor (Art. 38.1 BA). In such case, the directors or liquidators are obliged to cooperate with the temporary Court supervisor in managing company business. After the appointment of a temporary Court supervisor, the directors and liquidators are authorized to perform only the functions of ordinary management. Consent of the temporary Court supervisor is necessary to carry out activities exceeding the scope of ordinary management (Art. 38a BA).

If it is necessary to achieve the objectives of bankruptcy proceedings, the bankruptcy Court may at the stage of proceedings for a declaration of bankruptcy suspend enforcement proceedings and annul the seizure of the bankrupt company's bank accounts. All dispositions made with respect to these bank accounts require in this situation the approval of the temporary Court supervisor (Art. 39.1-2 BA).

As soon as company bankruptcy is declared, its directors and liquidators are obliged to identify and release to the official receiver all company assets and documents. This applies in particular to the accounting records and all correspondence, both exchanged with authorities and suppliers or customers, including electronic data. The directors and liquidators should confirm implementation of this obligation in a written statement submitted to the judge-commissioner (Art. 57.1 BA). This obligation extends to employees and other persons who have these in their possession.

In the course of bankruptcy proceedings, the directors and liquidators are also required to provide the judge-commissioner and the official receiver with all explanations concerning company assets (Art. 57.2 BA). This applies in particular to information and documents that will allow the official receiver to perform all the reporting obligations incumbent upon the bankrupt company (Art. 169.1-3 BA). This obligation extends to company employees and other persons in possession of such information.

The directors or liquidators are also required to submit - within a time limit specified by the official receiver - declarations regarding claims filed in bankruptcy proceedings. Only claims ultimately recognized on the list of claims will be entitled to receive dividends. The position of the bankrupt company is a mandatory element of the list of claims.

After the termination or discontinuance of bankruptcy proceedings, an extract from the list of claims approved by the judge-commissioner serves as a writ of execution against the bankrupt company. If the directors or liquidators of the company did not recognize a claim reported in the bankruptcy proceedings and if no final and binding Court ruling has been subsequently issued in its regard, the bankrupt company may request the Court to determine that the claim included on the list of claims does not exist or exists in a lower amount. After appending an enforcement order to the extract from the list of claims, that objection may be raised by the bankrupt company in a legal action for deprivation of enforceability of the enforcement order (Art. 264.1-3 BA).

As of the date when the decision on termination or discontinuance of bankruptcy proceedings becomes final and binding, the bankrupt regains his right to manage his assets and dispose of their components. The official receiver immediately releases the bankrupt's assets, accounting books, correspondence and documents to the bankrupt, and the directors or liquidators of the bankrupt company are obliged to take them back (Art. 364 and Art. 368 BA).

7.2 Sanctions for breach of duty

The lack of consent of the temporary Court supervisor to carrying out activities exceeding the scope of ordinary management is subject to the sanction of invalidity. Consent may be granted prior to the activity, along with the activity or within 30 days thereafter (Art. 38a BA).

When the directors or liquidators of the debtor company fail to heed the instructions of the temporary Court supervisor and when it is feared that they will hide company assets or otherwise act to the detriment of creditors, the Court may apply other methods of securing these assets, for example establish a compulsory administration (Art. 40.1 BA).

If the directors or liquidators fail to meet the obligations related to the identification and release of company assets and documents, the judge-commissioner may restrict their freedom of travel by prohibiting them from leaving Poland without prior authorization (Art. 57.3-4 BA).

If the directors or liquidators go into hiding or conceal company assets, engage in acts designed to conceal assets or encumber assets with fictitious liabilities or otherwise obstruct the determination of the composition of the bankruptcy estate or fail to fulfil their other obligations, the judge-commissioner may employ measures of personal coercion against them (Art. 58.1-2 BA) including fine and arrest.

The judge-commissioner may impose a single fine of not more than PLN 10,000. This limit ceases to bind the judge-commissioner when two successive fines prove ineffective. The total sum of fines in the same case cannot exceed PLN 1,000,000 (Art. 1052 of the Civil Procedure Code of 1964 - CPC). The directors or liquidators pay imposed fines from their personal assets.

When imposing a fine, the judge-commissioner decides at the same time - in the event of its non-payment - on the conversion of the fine into arrest. One-day of arrest equals an unpaid fine ranging between PLN 50 and PLN 1500. The aggregate duration of arrest in the same case cannot exceed six months (Art. 1053 § 1 CPC).

Arrest consists in placing the debtor in premises designed for this purpose, separately from persons imprisoned as a result of criminal and administrative proceedings. If possible, the directors or liquidators should be gainfully employed while in arrest. His income should cover first and foremost the cost of his arrest (Art. 1056 § 1 CPC). If this fails, the cost of arrest should be covered from the bankruptcy estate.

The judge-commissioner repeals personal coercive measures when there is no longer any need to apply them (Art. 58.3 BA). Fines not paid by that time will be redeemed (Art. 1052 CPC). If a detained director or liquidator reports his readiness to perform the given act, the judge-commissioner should decide on his release from arrest (Art. 1054 § 1 CPC).

The judge-commissioner's decision to restrict the freedom to travel or to impose personal coercive measures is appealable (Art. 57.5 and Art. 58.4 BA).

In addition, directors, liquidators and other persons may forfeit for a period from one to 10 years the right to carry on business activity on their own account or in the form of a civil law partnership, and to perform the function of a supervisory board member, audit committee member, representative (including director) or attorney of a natural person pursuing economic activity to the extent of such activity, a commercial company or partnership, state enterprise, cooperative society, foundation or association, in a situation where:

- (a) after declaration of bankruptcy they did not release or indicate assets, accounting records, correspondence or other documents of the bankrupt, including electronic data; or
- (b) after declaration of bankruptcy they concealed, destroyed or encumbered assets which formed part of the bankruptcy estate; or
- (c) in the course of bankruptcy proceedings they did not fulfil other duties or in another manner rendered the proceedings difficult (Art. 373.2-4 BA).

In assessing the above prohibition the bankruptcy Court takes into account the degree of guilt and the effects of performed actions, in particular a reduction of the economic value of the bankrupt's enterprise and the measure of detriment to the creditors (Art. 373.2 BA).

Should the directors or liquidators impede the official receiver from taking over the assets of the bankrupt company, a Court bailiff can establish the official receiver in possession of the bankrupt's assets on the basis of a Court ruling declaring bankruptcy or a ruling on appointment of an official receiver. The costs will be jointly and severally borne by the directors or liquidators who impeded the takeover of the assets by the official receiver (Art. 174.1-2 BA). This also applies to company employees or other persons who impeded the takeover.

Acts in law undertaken by company directors after the declaration of company bankruptcy related to assets included in the bankruptcy estate and subject to release to the official receiver are deemed invalid (Art. 77.1 BA).

If as of the day when the ruling on termination or discontinuance of the bankruptcy proceedings becomes valid the company directors or liquidators do not collect the books, correspondence or documents within the time limit fixed by the trustee, the trustee will entrust them for safekeeping at the expense of the bankrupt. In the absence of assets needed to cover these costs, the Court may award the cost of storage to company directors or liquidators (Art. 365.1-3 BA).

In turn, if the company directors or liquidators will not collect company assets within the time limit fixed by the official receiver, the Court will order liquidation of assets and determine its manner. The directors or liquidators may be ordered to pay the cost of liquidation (Art. 366.2 BA in connection with Art. 365.3 BA).

7.3 Applicable human rights laws

With regard to the duty to co-operate specified in S 7.1 of this chapter, the judge-commissioner may at the request of the official receiver take evidence from hearing the directors or liquidators of the bankrupt company. This may happen in a sitting and one will draw up the minutes of the hearing or the judge-commissioner will take written statements from persons so heard, including a form with signatures certified by a notary (Art. 217.1-2 BA and Art. 218 BA).

However, persons testifying can refuse to answer questions put to them, particularly if the testimony could expose them to criminal liability or severe and immediate pecuniary damage (Art. 261 CPC in connection with Art. 229 BA). Before the hearing, these persons are informed of their right to refuse to give testimony (Art. 266.1 CPC in connection with Art. 229 BA).

Poland belongs to the Council of Europe since 1991, and since 1993 - when it was ratified in Poland - the European Convention on Human Rights applies here, including its Article 6, which guarantees the right to a fair trial. Standards provided for in Article 6 of the Convention find their counterparts in Polish law, in particular in the Constitution of Poland of 1997 and in the procedures of civil and criminal proceedings.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation period

See S 8.2 below of this chapter in the column named “Limitation periods”.

8.2 Appeals

No.	Actions or transactions	Limitation periods	Rights of appeal
1	<p>Bringing about a situation where enforcement of debts and tax arrears against the company is unsuccessful, which in practical terms applies to a situation where enforcement is impossible due to the lack of assets (Art. 299.1-2 CCC and Art. 116.1 TOA).</p> <p>Article 299 CCC concerning civil-law debts applies only to directors of a limited liability company; it does not apply to directors of a joint-stock company.</p>	<p>(a) Art. 299.1-2 CCC: This claim is barred after a period of three years from the date on which the harmed creditor learned of the damage and the person liable for it. However, this term cannot be longer than ten years from the date on which the harmful event occurred (i.e. the date on which the creditor learned about the ineffectiveness of enforcement conducted against the company).¹⁶</p> <p>If the damage resulted from the crime referred to in Art. 586 CCC, the claim for damages is barred after a period of twenty years from the date of the offense, regardless of when the harmed creditor learned of the damage and the person liable for it.¹⁷</p>	<p>(a) Art. 299.1-2 CCC: The judgment can be appealed to the Court of second instance. The deadline to appeal is 14 days from the date of receipt of the judgment along with its justification.</p> <p>In addition, a final and binding judgment of the second instance Court can be subject to a last-resort appeal to the Supreme Court. The deadline for submission of a last-resort appeal is two months from the date of delivery of the judgment along with its justification to the appellant.</p> <p>Last-resort appeals are inadmissible in matters concerning property rights where the value of the subject of the appeal is lower than PLN 50,000.</p> <p>Last-resort appeals can be based on the following grounds:</p> <ul style="list-style-type: none"> – violation of substantive law by way of its erroneous interpretation or incorrect application; – violation of procedural provisions – if the transgression could have a material impact on the resolution of the case. <p>Last-resort appeals cannot be based on charges related to the establishment of facts or assessment of evidence.</p>

¹⁶ Supreme Court resolution of a panel of seven judges dated 7 November 2008, file ref. III CZP 72/2008.

¹⁷ Supreme Court judgment of 9 April 2015, file ref. V CSK 441/2014; Supreme Court resolution of a panel of seven judges dated 7 November 2008, file ref. III CZP 72/2008.

		<p>(b) Art. 116.1 TOA: The tax liability of a company director cannot be determined if five years have passed since the end of the calendar year in which the tax arrear occurred.</p> <p>Whereas if a decision has been already issued, the liability thereunder is barred if three years have passed since the end of the calendar year in which the decision on the director's tax liability was served.</p>	<p>(b) Art. 116.1 TOA: decisions of the first-instance administrative authority can be appealed to the second instance administrative authority within 14 days of their receipt.</p> <p>Decisions of the second-instance administrative authority can be appealed to the Provincial Administrative Court within 30 days of their receipt.</p> <p>A final and binding judgment of the Provincial Administrative Court can be subject of a last-resort appeal to the Supreme Administrative Court. The time limit for its submission is 30 days from the date of delivery of the judgment along with its justification to the appellant.</p> <p>Last-resort appeals can be based on the following grounds:</p> <ul style="list-style-type: none"> - violation of substantive law by way of its erroneous interpretation or incorrect application; - violation of procedural provisions – if the transgression could have material impact on the resolution of the case. <p>Last-resort appeals cannot be based on charges related to the establishment of facts or assessment of evidence.</p>
2	Not filing or non-timely filing of a petition for company bankruptcy declaration in case of company insolvency.	<p>(a) Art. 21.3-3a BA: see point 1 (a).</p> <p>(b) Art. 373.1.1 and Art. 373.1a-3 BA: The prohibition referred to in the above-mentioned provisions is not adjudged if a proceeding in this matter has not been initiated within one year of the following date:</p> <ul style="list-style-type: none"> - Discontinuance or ending of the bankruptcy proceeding; - Rejection of the petition for declaration of bankruptcy due to the lack of sufficient funds to finance bankruptcy proceedings; - Rejection of the petition 	<p>(a) Art. 21.3-3a BA: see point 1 (a).</p> <p>(b) The judgment can be appealed to the Court of second instance. The deadline to appeal is 14 days from the date of receipt of the judgment along with its justification.</p> <p>In addition, a final and binding judgment of the second instance Court can be subject to a last-resort appeal to the Supreme Court. The time limit for submission of a last-resort appeal is two months from the date of delivery of the judgment along with its justification to the appellant.</p>

		<p>for declaration of bankruptcy due to the fact that the bankrupt's assets are encumbered to a degree not leaving any funds to cover the cost of bankruptcy proceedings.</p> <p>Whereas if a petition for declaration of bankruptcy has not been submitted, the prohibition is not adjudged if proceedings in this matter were not initiated within three years of the date when the state of insolvency ceased to exist or the obligation to file a petition for declaration of bankruptcy by the given person expired.</p>	<p>Last-resort appeals can be based on the following grounds:</p> <ul style="list-style-type: none"> - violation of substantive law by way of its erroneous interpretation or incorrect application; - violation of procedural provisions – if the transgression could have material impact on the resolution of the case. <p>Last-resort appeals cannot be based on charges related to the establishment of facts or assessment of evidence.</p>
		<p>(c) Art. 586 CCC: the punishability of a crime expires if five years have passed since its commitment.</p> <p>If a proceeding was initiated during that period, the punishability of the crime expires in 10 years from the end of that five years' period.</p> <p>If the crime results in harm, the claim for damages is barred after a period of twenty years from the date of the offense, regardless of when the harmed creditor learned of the damage and the person liable for it.</p>	<p>(c) The judgment can be appealed to the Court of second instance. The time limit for submission of an appeal is 14 days counting from the date of receipt of the judgment along with its justification.</p> <p>In addition, a final and binding ruling of the second instance Court can be subject to a last-resort appeal to the Supreme Court.</p> <p>The party which did not appeal the judgment of the first-instance Court is not allowed to submit a last-resort appeal against the second-instance Court ruling to the Supreme Court if the judgment of the first-instance Court was upheld or changed to the party's benefit. This constraint does not apply to procedural infringements listed in Art. 439 of the Criminal Procedure Code (CrPC).</p> <p>The time limit for submission of last-resort appeals is 30 days from the date of delivery of the ruling along with its justification to the appellant.</p> <p>Last-resort appeals can be submitted in cases of flagrant violations of the law, when they could have a major impact on the contents of the ruling.</p>

			<p>Last-resort appeals can be pronounced:</p> <ul style="list-style-type: none"> - To the advantage of the accused, when the accused was sentenced to a term of deprivation of freedom without a conditional suspension of its execution; - To the disadvantage of the accused, when the accused was acquitted or the Court discontinued the proceedings. <p>These constraints do not apply to procedural infringements listed in Art. 439 CrPC.</p> <p>Last-resort appeals cannot be submitted only because the penalty seems disproportionate to the offense.</p>
3	Intentionally causing bankruptcy or insolvency of a company that is a debtor to at least several creditors (Art. 308 in connection with Art. 301.2 Cr.C)	<p>(a) The punishability of the offense ceases if 10 years have elapsed from the time of the consequence of the prohibited act.</p> <p>(b) If proceedings were initiated in the above period, the punishability of the offense ceases 10 years after the end of that period.</p> <p>(c) If the offense resulted in damages, the claim for damages is barred after a period of 20 years from the date of the offense, regardless of when the harmed creditor learned of the damage and the person liable for it.</p>	See point 2 (c).
4	Recklessly causing bankruptcy or insolvency of a company that is a debtor to at least several creditors, in particular by squandering assets, incurring liabilities or concluding transactions in evident violation of the principles of proper management (Art. 308 in connection with Art. 301.3 Cr.C).	<p>(a) The punishability of the offense ceases if five years have elapsed from the time of the consequence of the prohibited act.</p> <p>(b) See point 3 (b)</p> <p>(c) See point 3 (c)</p>	See point 2 (c).
5	Company insolvency or deterioration of company financial standing as a result of intentional action or gross negligence (Art. 374 par. 2 BA).	See point 2 (b)	See point 2 (b).

6	In case of a risk of company insolvency or bankruptcy, repaying or securing only some creditors when they cannot all be satisfied and thereby acting to the detriment of others (Art. 308 in connection with Art. 302.1 Cr.C).	(a) See point 4 (a) (b) See point 3 (b) (c) See point 3 (c)	See point 2 (c).
7	Granting or promising to grant a material benefit to a creditor in return for his actions detrimental to other creditors in connection with bankruptcy or in-court restructuring proceedings (Art. 308 in connection with Art. 302.2 Cr.C).	(a) See point 4 (a) (b) See point 3 (b) (c) See point 3 (c)	See point 2 (c).
8	Frustrating or curtailing the satisfaction of a company creditor - in the event of threatened company insolvency or bankruptcy - by removing, concealing, disposing of, donating, destroying, actually or apparently charging or damaging company assets (Art. 308 in connection with Art. 300.1 Cr.C).	(a) The punishability for an offense subject to private prosecution ceases after one year from the date when the harmed party learned of the person liable for the offense, however not later than after three years from the time of the consequence of the prohibited act. (b) If the offense is subject to public prosecution (<i>ex officio</i>) by the public authorities, its punishability ceases if five years have elapsed from the time of the consequence of the prohibited act. (c) If proceedings were initiated during that period, the punishability of offenses specified in point (b) ceases after ten years, and of offenses specified in point (a) – after five years from the end of that period.	See point 2 (c).
9	Frustrating or limiting the satisfaction of several creditors by creating a new corporate entity based on the legal regulations and transferring company assets thereto (Art. 308 in connection with Art. 301.1 Cr.C).	See point 3	See point 2 (c).
10	Legal transaction, in-court settlement, acceptance of a claim in Court, and waiver of a claim made by a debtor under which he/she has disposed of his assets, if performed gratuitously or for	No time limit (activities are ineffective by the power of law).	See point 1 (a)

	a consideration but with the value of debtor's performance being drastically in excess of that received by the debtor or of that reserved for the debtor or for a third party (Art. 127.1-2 BA).		
11	Security and payment of an unenforceable debt given or made by the debtor (Art. 127.3 BA).	See point 10	See point 1 (a)
12	Assignment of a future receivable where the receivable will have arisen subsequent to the declaration of bankruptcy (Art. 128a.1 BA).	See point 10	See point 1 (a)
13	Encumbrance established on the debtor's assets (be it a mortgage, pledge, registered pledge or ship's mortgage), if the bankrupt was not a personal debtor of the secured creditor and the bankrupt received no benefit in connection with the establishment of the security (Art. 130.1 BA).	No demand for recognition of an act as ineffective can be made upon the elapse of five years from the date of that act or upon the elapse of two years from the date of bankruptcy declaration (depending on which date comes first) (Art. 132.3 BA). The two-year time limit does not apply when the demand for recognition of an act as ineffective is submitted in the form of an objection in the course of other Court proceedings (Art. 132.3 BA).	Judge-commissioner's decisions can be appealed. Appeals are examined by the bankruptcy Court as a Court of second instance. There are no last-resort appeals from second-instance Court rulings.
14	Encumbrance established on the debtor's assets (be it a mortgage, pledge, registered pledge or ship's mortgage), if the bankrupt was not a personal debtor of the secured creditor and the bankrupt received a benefit disproportionately low in relation to the value of the security given (Art. 130.2 BA).	See point 13	See point 13
15	Encumbrances referred to in points 13 and 14 above, if they secure debts of the creditors referred to in points 16-19 below (regardless of the value of a benefit received by the bankrupt) (Art. 130.3 BA).	See point 13	See point 13
16	Legal transactions performed for consideration with the bankrupt's spouse, a relative by blood or by affinity in the direct line, a relative by blood or affinity in the collateral line up to the second degree, a	See point 13	See point 13

	person cohabitating or maintaining a common household with the bankrupt, or with an adoptee or an adoptive parent (Art. 128.1 BA).		
17	Legal transactions performed for consideration with a company in which the bankrupt is the sole shareholder and with companies in which persons referred to in point 16 above are management board members or sole shareholders (Art. 128.1a BA).	See point 13	See point 13
18	Legal transactions performed for consideration with the bankrupt's shareholders, representatives or their spouses, and with related companies, their shareholders, representatives or their spouses (Art. 128.2 BA).	See point 13	See point 13
19	Legal transactions performed for consideration with another company, where one of the companies is the controlling company, or where the same company is the controlling company in respect of the bankrupt and the counter-party to the transaction (Art. 128.3 BA).	See point 13	See point 13
20	Contractual penalties provided for in the event of non-performance or deficient performance of an obligation, if the obligation was largely performed by the bankrupt or the contractual penalty is grossly excessive (Art. 130a BA).	See point 13	See point 13
21	Remuneration for work performed by a representative of the bankrupt, or by the bankrupt's employee performing tasks falling within the management of the bankrupt's enterprise, or by a person rendering services related to the management or supervision of the bankrupt's enterprise, which is drastically higher than average remuneration for the like work or services and is not justified by the work input involved (Art. 129.1 BA).	See point 13	See point 13

	This also applies to benefits due for reasons of termination of employment or of a contract for services relating to the management of the bankrupt's enterprise (Art. 129.3 BA).		
22	<p>Legal transactions as a result of which a third party obtained financial gain, detrimental to company creditors, which means that as a result of that transaction the debtor became insolvent or became insolvent to a greater degree than before the transaction (so-called action Pauliana; Art. 527-534 CC.</p> <p>Civil Code articles listed above are applied accordingly to situations where future creditors have been harmed.</p>	<p>No demand for recognition of an act as ineffective can be made upon the elapse of five years from the date of that act or upon the elapse of two years from the date of bankruptcy declaration (depending on which date comes first).</p> <p>The two-year time limit does not apply when the demand for recognition of an act as ineffective is submitted in the form of an objection in the course of other Court proceedings.</p>	See point 1 (a)

QUESTION 9

9. Foreign corporations

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

9.1 EU corporations (with exception of Danish corporations)

Poland as a Member State of the European Union is bound by the Council Regulation (EC) No 1346 / 2000 of 29 May 2000 on insolvency proceedings (EU Regulation 1346 / 2000).

Based on the EU Regulation 1346 / 2000, Polish Courts may open main and non-main (secondary or territorial) insolvency proceedings of an EU corporation (with exception of Danish corporation). Main proceedings are proceedings taking place in a Member State where the debtor has its "centre of main interests". In turn, non-main proceedings are proceedings taking place in the Member State where the debtor has an "establishment". The effects of non-main proceedings are restricted to the debtor's assets located in the territory of the latter Member State.

In both cases, Polish law as the law of the State of the opening of proceedings will determine the conditions for the opening of these proceedings, their conduct and their closure. It will determine in particular the powers of the respective office holders and the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all the creditors. However, under the EU Regulation 1346 / 2000, the law of the State of the opening of proceedings will not apply where the person who benefited from an act detrimental to all the creditors provides proof that the said act is subject to the law of a Member State other than that of the State of the opening of proceedings, and that law does not allow any means of challenging that act in the relevant case.

Office holders appointed in main insolvency proceedings may exercise in another Member State all the powers conferred on them by Polish law as the law of the State of the opening of proceedings, as long as no other insolvency proceedings have been opened there nor any preservation measure to the contrary has been taken there further to a request for the opening of insolvency proceedings in that State. They may in particular remove the debtor's assets from the territory of the Member State in which they are situated.

Office holders appointed in non-main insolvency proceedings may in any other Member State claim in or out of Court that the moveable property was taken out of Poland – i.e. from the territory of the State of the opening of proceedings – to the territory of that other Member State after the opening of insolvency proceedings. They may also bring action to set aside, which is in the interests of the creditors.

In exercising their powers, office holders must comply with the local laws of the Member State.

On 26th June 2017, EU Regulation 1346 / 2000 will be replaced by Regulation (EU) 2015 / 848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast). However, the above rules will remain essentially unchanged.

9.2 Non-EU corporations and Danish corporations

The UNCITRAL Model Law on Cross-Border Insolvency is implemented in Poland by the Bankruptcy Act 2003.

Under the Bankruptcy Act 2003, Polish Courts can declare bankruptcy of a non-EU or Danish corporation if they have international jurisdiction in these matters. Polish Courts have exclusive jurisdiction over bankruptcy matters if the debtor's centre of main interest is in Poland. Polish Courts will also have jurisdiction if the debtor conducts business or has his registered address or property in Poland. If the jurisdiction of the Polish Court is exclusive, bankruptcy proceedings take on the form of main bankruptcy proceedings. In other cases, bankruptcy proceedings have the form of territorial or secondary proceedings. In each of these cases, when a Polish Court declares bankruptcy of a non-EU or Danish corporation, it is governed by Polish bankruptcy law, also in terms of the ineffectiveness of the bankrupt's actions and the right to challenge them when they pertain to assets being a part of the bankruptcy estate located in Poland.

The Bankruptcy Act 2003 enables foreign office holders to also seek recognition in Poland of their foreign insolvency proceedings opened in a non-EU state or in Denmark. A judgement opening foreign bankruptcy proceedings may be recognized in Poland if it relates to a matter that does not belong to the exclusive jurisdiction of Polish Courts and the recognition is not contrary to fundamental principles of law in Poland. The recognition of a judgment to open foreign bankruptcy proceedings results by the force of law in a recognition of the decisions concerning the appointment of a foreign office holder issued in its course. If a judgment to initiate bankruptcy proceedings in a non-EU state or Denmark is recognized in Poland, the effects of announcing bankruptcy on the debtor's assets located in Poland and liabilities that have arisen or are to be executed in Poland are governed by Polish bankruptcy law. The same applies to the issue of ineffectiveness of the bankrupt's actions concerning assets being a part of the bankruptcy estate located in Poland and to challenging these actions.

The recognition of a judgment to open foreign bankruptcy proceedings does not conflict with the Polish Court opening bankruptcy proceedings. However, if a judgment on opening main foreign bankruptcy proceedings is recognized, then bankruptcy proceedings opened in Poland become secondary bankruptcy proceedings. If a ruling on opening territorial foreign bankruptcy proceedings is recognized, bankruptcy proceedings opened in Poland are conducted on general terms.

9.3 Exposure of foreigners to criminal liability

Polish criminal law applies to foreigners (e.g. directors of foreign corporations) who commit an offence on Polish territory.

Moreover, the Polish criminal law provisions also apply to foreigners who commit abroad an offense against the interests of Poland, Polish citizen, Polish legal person or Polish organizational unit without legal personality. The Polish criminal law applies also in the event of a foreigner committing a different type of offence abroad, if the offense is punishable under Polish criminal law by more than two years' imprisonment and the offender is present on the Polish territory and if there is no decision to extradite him.

The condition for liability for an act committed abroad is the recognition of such act as a crime also by the law in force at the place where it was committed. However, notwithstanding the provisions in force at the place of the offense, Polish criminal law still applies to foreigners if, for example, they commit an offence against essential Polish economic interests or an offense which generated private financial gain on Polish territory – even if indirectly.

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?

In Poland directors' and officers' insurance (D&O insurance) does not belong to the group of compulsory insurances and it is a relatively new product on the Polish insurance market. However, leading insurance companies offer it.

In principle, the scope of D&O insurance, guaranteed sum, the duties of the insurance company, policyholder and insuring party, the terms of the insurer's liability, and other matters concerning the insurance are governed by the general terms and conditions of D&O insurance offered by the particular insurer. However, the individual insurance contract may also be concluded through negotiations, so some provisions of general terms and conditions of D&O insurance can be replaced and new ones added therein to meet the specific needs of the insured party. The extent of coverage of D&O insurance can be shaped quite freely according to the adopted variant of insurance and additional provisions negotiated with the insurance company. However, the broader the extent of protection, the higher the premium.

D&O insurance is usually concluded by the company as a policyholder. Depending on the scope and variant of insurance the insured parties are among others directors, members of the supervisory board, members of the audit committee, proxies, liquidators, hired company managers, employees entrusted with the above-mentioned duties as attorneys, or individual employees or non-employees entrusted with the power of attorney to maintain accounting books. In addition, insurance companies offer D&O insurance covering claims addressed to the spouse of an insured party. D&O insurance that expand insurance coverage on the company itself are also popular, inasmuch as the company has to pay damages on behalf of the insured party and suffered other related costs.

D&O insurance most commonly covers:

- liability of directors and other insured parties for losses caused to the company and other third parties (including shareholders) by an act or omission involving non-performance or inadequate performance of duties connected with their positioning the company;
- liability of directors for company debts, including tax arrears; and
- liability of directors for civil law or administrative penalties and fines.

The insurer usually also covers justified and documented by the insured party costs, such as legal and experts fees, the costs of the mediation, arbitration and litigation, PR consultant's fees, costs of reputation recovery in connection with the reported claims, or psychologist and psychiatrist's fees.

As in any insurance contract, D&O insurance policies also contains insurer's exclusions from liability for losses. Most common are exclusions from liability for losses caused:

- as a result of intentional acts or omissions;
- through gross negligence;
- in order to obtain personal benefit; and
- as a result of crime.

In addition, under the general terms and conditions of D&O insurance the insurer is not liable usually for:

- fines and compensations of a criminal nature;
- personal injury including death, bodily injury or health disorder, and lost profits due to bodily injury or health disorder; and
- property damage, such as loss, destruction or damage of property, including lost profits due to loss, destruction or damage of property.

This chapter is based on the legal situation as of 01/07/2016

The views expressed in this article do not represent the official standpoint of Wardyński & Partners.

RUSSIA

QUESTION 1

1. Directors and the start and duration of the twilight period

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

1.1 Introduction

Most of the legislation relevant to the insolvency of corporate entities in Russia is contained in Federal Law No. 127-FZ on Insolvency (Bankruptcy) of 26 October 2002 (the Insolvency Law).

Insolvency of banks and credit organisations and bankruptcy of individuals are subject to special rules, and these entities and individuals are outside the scope of this note.

The Insolvency Law was subject to significant amendments in the middle of 2009 and thereafter which, among other things, significantly developed the concept of vulnerable transactions and set out in greater detail the grounds, the procedure and consequences of their challenge. In addition, such amendments introduced the concept of “controlling persons” (which includes the chief executive officer and arguably members of the board of directors of the company) and expanded the grounds giving rise to liability of directors and other controlling persons for actions during the period preceding the bankruptcy of a company.

Provisions regarding some areas of insolvency and liability of directors and officers and third parties are also included in the Civil Code of the Russian Federation (the Civil Code); the Criminal Code of the Russian Federation (the Criminal Code); the Administrative Offences Code of the Russian Federation (the Administrative Offences Code); the *Arbitrazh* Procedure Code and in Federal Law of the Russian Federation No. 208-FZ on Joint Stock Companies of 26 December 1995 (the JSC Law) and Federal Law of the Russian Federation No. 14-FZ on Limited Liability Companies of 8 February 1998 (the LLC Law).

Bankruptcy cases in Russia are heard by *arbitrazh* (state commercial) Courts located in the area where the debtor is registered which, for ease of reference, we refer to as bankruptcy Courts.

1.2 Brief description of insolvency procedures in Russia

According to the Insolvency Law, insolvency proceedings consist of one or more of the following stages:

- (a) Supervision (*nablyudeniyе*), a preliminary compulsory stage of insolvency proceedings intended to conduct a financial audit with the purpose of determining whether the debtor may be restored to solvency, securing its assets, drawing up an initial register of creditors' claims and convening the first creditors' meeting.
- (b) Financial rehabilitation / recovery (*finansovoye ozdorovleniye*), a non-compulsory stage designed to offer the debtor the chance to obtain an extension of time to meet its liabilities with the help of financial support from a third party.
- (c) External management (*vneshneye upravleniye*), a non-compulsory stage aimed at collecting debts, making an inventory of assets, and preparing and carrying out a plan for restoring solvency.
- (d) Liquidation (*konkursnoye proizvodstvo*), i.e. winding-up.
- (e) Entry into a voluntary arrangement (*mirovoye soglasheniye*), which does not constitute a separate stage of the insolvency proceedings, but rather the successful outcome of any of the other stages.

Russian bankruptcy laws focus primarily on various procedures to protect the rights of creditors in the course of insolvency proceedings and attempt to make the debtor solvent again. Although seven years on from the introduction of the amendments to the Insolvency Law, the concept of the liability of directors and others involved in the management of the company is far from being sufficiently and clearly regulated. That said, there have been cases where the Courts have held such persons liable under the Insolvency Law.

1.3 Twilight period(s)

1.3.1 Definition of directors

For the purposes of the Insolvency Law, the term “director” (rukovoditel dolzhnika) includes the chief executive officer (the CEO), the head of the collective management body and other persons entitled to act on behalf of a company without a power of attorney, such as a liquidator (a Director). The Insolvency Law also sets out certain cases where other persons, including members of the board of directors (supervisory board),¹ may be held liable for losses caused by their violation of the Insolvency Law.²

1.3.2 Determining the twilight period

It is generally accepted that the twilight period refers to a period which begins when a company’s solvency is in doubt and the company satisfies the relevant insolvency test and ends with the commencement of the formal insolvency proceedings. During the twilight period, a Director (primarily the CEO) should act cautiously in order to avoid becoming personally liable for the debts incurred as a result of transactions entered into or performed during this period if the company subsequently goes into a formal bankruptcy process.

As regards Russian insolvency law, there is a three-year look-back period during which certain transactions entered into or performed by a debtor may be susceptible to attack (for grounds of challenge and other details see paragraphs 1.4 and 4).

However, as a matter of the Insolvency Law, it is not always necessary for a successful challenge of such transactions to show that at the moment of their conclusion or performance the debtor showed signs of bankruptcy, or that as a result of the performance of such transactions the debtor became insolvent. Furthermore, in order to challenge a vulnerable transaction, it is not necessary that, at the moment of the entry into such a transaction, the CEO or any other controlling person (as defined in paragraph 1.3.6 below) of the debtor knew or should have known that the debtor showed signs of being insolvent or otherwise satisfied the insolvency test, or that there was no reasonable prospect of avoiding insolvent liquidation.

The signs of bankruptcy are mentioned by law along with other qualifying challenges and in certain cases may extend the vulnerability periods or ease the burden of proof when transactions are being challenged.

Moreover, Russian law does not directly correlate the personal liability of a director or any other controlling person with their knowledge or belief that, at the moment of conclusion or performance of a vulnerable transaction, the debtor may have shown signs of being insolvent. Only in the case of liability of controlling persons is the loss caused to creditors, as a result of the instructions of the persons controlling the debtor, taken into account and the level of liability may be affected by the actual loss suffered by creditors as a result of following such instructions. At the same time, according to recent amendments to the concept of liability, in order to impose personal liability on a controlling person it is necessary to prove that the instructions of that controlling person resulted in the debtor’s insolvency and in certain cases such connection between the cause and effect is presumed unless proved otherwise (see paragraph 1.3.6 for details).

Under the Insolvency Law, one of the twilight periods during which a Director may be exposed to personal liability is deemed to begin when the company meets certain criteria set out in the Insolvency Law and ends with the filing of a bankruptcy petition (see paragraph 1.3.5 for details – “twilight period for failing to file”). This twilight period entails certain duties on the part of the Director, which are discussed in paragraphs 1.3.3 and 1.3.5 below.

¹ Under Russian law, the terms “board of directors” and “supervisory board” are synonymous.

² Article 10(1) of the Insolvency Law.

1.3.3 Duty of a Director to inform the shareholders / participants³ that the debtor is showing signs of bankruptcy

Under the Insolvency Law the company is deemed to show “signs of being insolvent” if it is not able to satisfy the monetary claims of its creditors (provided that the debt is overdue for at least three months from the date it was due to be paid).

If a company shows signs of being insolvent:⁴

- (i) the Director must inform those who are authorised to convene a shareholders’ / participants’ meeting of the company (such as the board of directors) that the company shows signs of being insolvent within 10 days from the date when the Director became aware or ought to have become aware of the signs of insolvency;
- (ii) shareholders of the company are required by law to take measures to restore the debtor’s solvency.

The above steps are referred to as “bankruptcy prevention” measures, but they essentially aim to prevent the commencement of formal insolvency proceedings.

A Director may incur administrative penalties for failure to perform the above duty, including a fine or disqualification for up to two years.⁵

1.3.4 Duty of shareholders

As mentioned in paragraph 1.3.3 above, if the company encounters financial problems, the shareholders of the company are formally obliged to take measures to make the debtor solvent again. However, the Insolvency Law does not specify which measures need to be undertaken. According to the Insolvency Law, these measures may be undertaken not only by shareholders of the company but also, with the agreement of the debtor, by its creditors or third parties.⁶

The only measure expressly envisaged by the Insolvency Law is rehabilitation prior to Court proceedings (*sanatsiya*). Rehabilitation to restore the debtor’s solvency requires the injection of sufficient financial assistance to the debtor to satisfy its monetary obligations, including claims for wages and severance payments to employees, mandatory payments (e.g. taxes). In the event that financial assistance is provided, the debtor or other persons may assume obligations for the benefit of the providers of such financial assistance.

1.3.5 Duty to file a bankruptcy petition – twilight period for failing to file

The Insolvency Law provides for the obligation of a Director of the debtor to petition a bankruptcy Court for commencement of insolvency proceedings within one month of it becoming evident that:⁷

- (a) the settlement of claims of one or more creditors will result in the debtor being unable to perform its payment obligations, including mandatory payments,⁸ to other creditors;
- (b) the shareholders (or those authorised by them) take a decision to file such a petition;
- (c) the enforcement of claims against the debtor’s assets will make it significantly difficult or impossible for the debtor to continue operations;
- (d) the debtor (i) ceases to pay any part of its debts as they fall due on account of insufficiency of funds (“inability to pay”) or (ii) has assets insufficient in value to discharge its monetary liabilities (“insufficiency of assets”);
- (e) the company owes unpaid wages and severance payments in the amounts due under the labour law, which are overdue by at least three months by reason of insufficiency of funds;

³ In this chapter “shareholders” include founders and participants of a company.

⁴ Article 30 of the Insolvency Law.

⁵ Article 14.13(6) of the Administrative Offences Code.

⁶ Article 30 of the Insolvency Law.

⁷ Article 9 of the Insolvency Law.

⁸ Debts owed to the state or otherwise to the Russian Federation.

(f) in the course of a solvent liquidation of the debtor, either of the tests referred to in (d) above is met (in which case a bankruptcy petition must be filed by the liquidation commission with a bankruptcy Court within ten days of such test being met); or

(g) in other cases provided by the insolvency law.⁹

Failure to file the petition results in a secondary liability for persons with the duty to file for insolvency. Such secondary liability covers new debts arising after the expiration of the period envisaged for filing a bankruptcy petition.¹⁰

The bankruptcy petition can also be filed by a creditor, an employee (including a former one) in respect of unpaid wages and severance payments or by authorised government agencies with respect to mandatory payments owed to state or municipal budgets.

A creditor (other than a bank) may petition for the debtor's bankruptcy if the amount of a debt is not less than RUB300,000¹¹ (approximately US\$4,600),¹² is overdue by at least three months¹³ and the unpaid debt has been confirmed by a Court judgment which has entered into force.

According to the 2015 amendments to the Insolvency Law, a bank creditor may petition for the debtor's bankruptcy from the date when the debtor shows signs of being insolvent without needing to confirm its claim by a Court decision, but subject to a mandatory public notification procedure to ensure that the debtor and other creditors are aware of the creditor's intention to initiate insolvency proceedings.¹⁴

In the case of a bankruptcy petition by an authorised government agency (with respect to mandatory payments), the 30-day period runs from the date on which such agency took a decision to seize the debtor's assets to satisfy the mandatory payments or the date when a Court decision to recover mandatory payments entered into force, as the case may be, before a bankruptcy petition may be filed.

1.3.6 Liability of controlling persons: another twilight period

Another twilight period was introduced in mid-2009 when the concept of personal liability of controlling persons was incorporated into the Insolvency Law ("twilight period for controlling persons"). According to the Insolvency Law, a controlling person in relation to a debtor is a person that has:

- a) the right to issue instructions that are binding on the debtor; or
- b) the ability to determine the actions of the debtor (by virtue of being a relative or in-law relative of the debtor, holding an official status or otherwise), including:
 - (i) by compelling a Director or members of the management bodies (e.g. board of directors) of the debtor to take certain actions; or
 - (ii) by otherwise having a controlling influence on a Director or members of the management bodies of the debtor.

Specifically, a controlling person in relation to a debtor may be a member of the liquidation commission, a person who under a power of attorney may perform transactions in the name of the debtor, or a person who has the right to dispose of 50% or more of a joint stock company's voting shares or 50% or more of the participation interests in the charter capital of a limited liability company, or a CEO (Controlling Persons).

Controlling Persons could jointly and severally bear secondary liability for monetary claims of creditors against, and mandatory payment due from, the debtor when:

⁹ Article 224 of the Insolvency Law.

¹⁰ Article 10(2) of the Insolvency Law.

¹¹ Article 6(2) of the Insolvency Law.

¹² Here and further below an exchange rate of RUB65 to US\$1 is being referred to.

¹³ Article 33(2) of the Insolvency Law.

¹⁴ Articles 7(1) and 7(2) of the Insolvency Law.

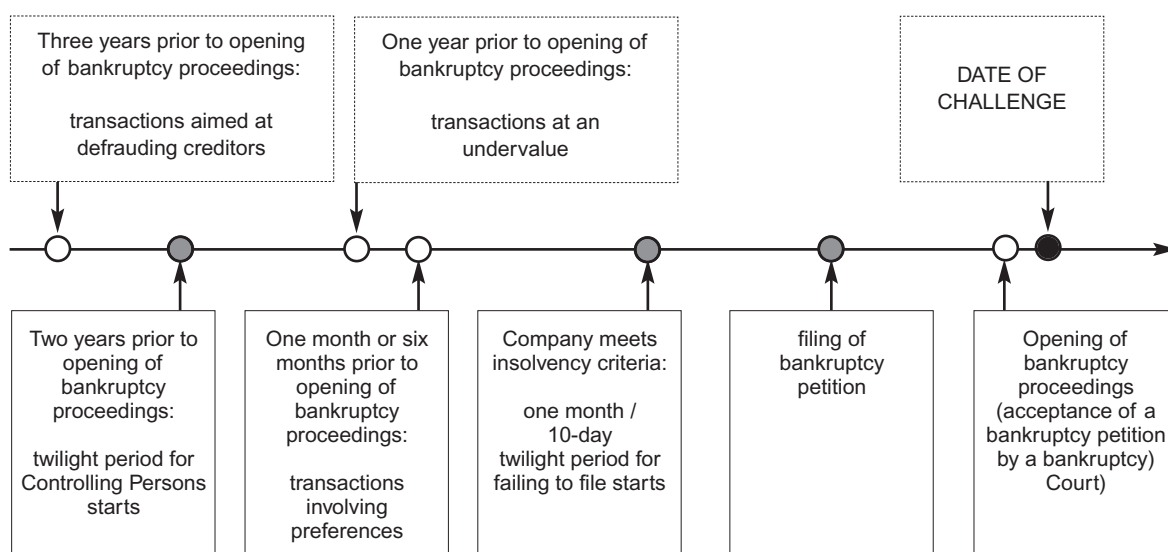
- a) the insolvent debtor was declared insolvent as a result of actions of, or a failure to act by the Controlling Persons. Such cause and effect is presumed, among other things, if
 - (i) a suspicious or preferential transaction was entered into and approved by such person and such transaction resulted in causing “harm to creditors’ rights” (i.e. a decrease in the value or the size of the debtor’s assets and / or an increase in the claims against the debtor, as well as other consequences of the debtor’s acts or transactions resulting in it becoming impossible for the creditors to have debts due from the debtor paid (in part or in full) from the debtor’s assets); or
 - (ii) the claims of creditors of the third order of priority¹⁵ arising as a result of a criminal, administrative or tax offence committed by a debtor or its CEO and confirmed by a decision on holding them liable which is entered into force exceed by value 50% of the total registered creditors’ claims as of the date of the closure of the register of creditors’ claims;¹⁶ and
- (b) the bankruptcy estate is insufficient to satisfy the creditors’ claims in full.¹⁷

The twilight period to trigger the above liability is set two¹⁸ years preceding the commencement of insolvency proceedings during which such Controlling Persons were entitled to give binding instructions to the debtor or were able to determine the actions of the debtor.¹⁹

1.4 Challenging transactions in bankruptcy

According to Russian law, transactions entered into by the debtor prior to the commencement of insolvency proceedings may be challenged on various grounds (see paragraph 4).

This can be illustrated by the following diagram (which also includes other twilight periods applicable in the course of a company’s insolvency that are described in this note):



¹⁵ Claims of creditors of the third order of priority include claims of the most creditors under commercial transactions and contracts to the extent their claims cannot be discharged from the assets of the debtor securing the respective claims.

¹⁶ This assumption applies with respect to claims on damages submitted after 1 September 2016.

¹⁷ Article 10(4) of the Insolvency Law.

¹⁸ Following recent amendments, with respect to claims to hold a Controlling Person liable submitted after 1 September 2016 a three-year period prior to the commencement of insolvency proceedings will apply.

¹⁹ Article 2 of the Insolvency Law.

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 the director?
- (b) In relation to each act identified in (a) above:
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement?
 - (iv) Is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director? and
 - (v) What defences, if any, will be available in relation to each offence?

2.1 Overview

All the governing bodies of a company which fall within the definition of "Director" in paragraph 1.3.1 above are subject to the same scope of civil liability.²⁰ Russian law does not distinguish between executive and non-executive directors when setting out directors' obligations or liabilities.

All members of the board of directors (supervisory board) are elected by the general shareholders' meeting and have similar responsibilities. The members of the board of directors elect the chairman of the board of directors by a majority vote. However, as a matter of Russian law, the chairman of the board of directors is not subject to a higher level of liability than the other members of the board of directors. The concept of an "independent director"²¹ has been introduced in the JSC Law for the purposes of approving "interested party" transactions²² for companies that have more than 1,000 shareholders. No additional responsibilities are envisaged for "independent" directors.

Members of the management board may also serve on the board of directors. However, they may not occupy more than 25% of the seats on the board of directors and may not hold the position of chairman of the board of directors. Russian law does not provide for any special or additional liability of members of the management board, irrespective of whether they also serve on the board of directors or not.

2.2 Civil liability of controlling persons

According to the Insolvency Law, Controlling Persons may be liable in the amount insufficient to satisfy the creditors' claims (including current claims, claims included in the register of creditors and those filed after the closure of the register) arising as a result of insufficiency of the debtor's assets (please also see paragraph 1.3.6 above).

²⁰ Article 53.1 of the Civil Code; Art. 71 of the JSC Law; Art. 44 of the LLC Law.

²¹ An "independent" director within the meaning of Art. 83 (2) of the JSC Law is a member of a company's board of directors (supervisory board) who is not and has not been for one year preceding adoption of the resolution in question:

- the person exercising the functions of the company's individual executive body, including its manager, a member of its collegiate executive body or a member of a management body of its management company;
- a person whose spouse, parents, children, full or half brothers or sisters, adoptive parents or adopted children is / are on those management bodies of the company or the company's management company or is / are the company's manager; and
- an affiliate of the company, except as a member of the company's board of directors (supervisory board).

²² In brief, an "interested party" transaction is a transaction where any of: a member of the board of directors of a company, the CEO of a company, a member of the management board of a company or a shareholder which alone or jointly with his affiliates holds at least 20% of the voting shares of a company, or a person who has authority to issue instructions that are binding upon the company has an interest in that company entering into the relevant transaction and performing its obligations under such transaction. What constitutes an "interest" is further described in the JSC Law and the LLC Law. Under Russian law, 'interested party' transactions are subject to special corporate approvals. It should be noted that there is a difference between the "interested party" transaction envisaged by the JSC Law and the LLC Law and a "transaction with an interested person" envisaged by the Insolvency Law.

As a defence, Controlling Persons may prove that they were not at fault or acted in good faith and reasonably in the interests of the debtor in which case they may be exempt from liability. Furthermore, a bankruptcy Court may reduce the liability of a Controlling Person if such person proves that the amount of harm caused by him to creditors was significantly lower than the amount claimed by a creditor from such a Controlling Person.²³

Recent amendments to the concept of liability of Controlling Persons and the recent Court practice mean that in order to establish liability against a Controlling Person, it needs to be proved that the performance by the debtor of the instructions given by a Controlling Person caused the debtor's insolvency.

2.3 Civil liability of directors

2.3.1 General principles

A person who represents the entity by virtue of law or foundation documents (i.e. the CEO) as well as the members of a company's board of directors and management board must act in good faith and reasonably and in the interests of the company. Unless otherwise provided by the law or by specific agreement, directors have an obligation to compensate the company for the losses caused by them.²⁴

The CEO and members of the various company boards are jointly and severally liable to the company for any damages incurred by the company which arise as a result of their improper actions or inaction for which they are at fault (with the exception of those members of the boards who voted against the resolution that caused damages to the company or, acting in good faith, did not vote).²⁵ Any agreement to exonerate or limit the liability of the Directors for actions carried out in bad faith (for public companies – for actions which are carried out in bad faith and are unreasonable) is void.²⁶

For the CEO and a member of various boards to be liable, damages must be incurred by the company as a result of the CEO's or the board member's acting (or failure to act) unreasonably or not in good faith when exercising his rights and fulfilling his obligations. The claimant is required to prove that a director was not acting in good faith and / or was acting unreasonably and this resulted in losses to the company. In addition, a director may be held liable if it is proved that in exercising rights and performing obligations his actions (failure to act) did not comply with the usual terms of business or were not within the scope of normal business (commercial) risks.²⁷

A person is deemed to be at fault if under that degree of care and circumspection which was required of that person according to the nature of the obligation and the conditions in the course of business, such a person did not take all possible measures for the proper performance of the obligation.²⁸ The damages are to be compensated in full, including any loss of profit.

According to clarifications provided to the RF Supreme *Arbitrazh* Court²⁹ applicable to CEOs, liquidators and bankruptcy administrators, actions (omission to act) in bad faith on the part of a Director are deemed to be proven, inter alia, where the Director:³⁰

- 1) has acted where there is a conflict between his personal interests (or the interests of the Director's affiliates) and the interests of the legal entity, except in cases where the conflict of interest is disclosed;
- 2) has concealed information from the shareholders about a transaction that he performed (including where, in breach of the law or the charter or internal documents, information about the transaction was not included in the financial statements);

²³ Article 10(4) of the Insolvency Law.

²⁴ Article 53 of the Civil Code.

²⁵ Article 53.1 of the Civil Code.

²⁶ Article 53.1(5) of the Civil Code.

²⁷ Article 53.1 of the Civil Code.

²⁸ Article 401 of the Civil Code.

²⁹ Up to 2014 the RF Supreme Arbitrazh Court was the highest judicial body for disputes considered by arbitrazh (state commercial) Courts. The RF Supreme Arbitrazh Court's powers were transferred to the RF Supreme Court in 2014 and the RF Supreme Court is the highest judicial body for disputes considered by Courts of general jurisdiction and arbitrazh (state commercial) Courts.

³⁰ Decree of the Plenum of the RF Supreme Arbitrazh Court dated 30 July 2013 No. 62 On Payment of Damages by Members of a Legal Entity's Management Bodies.

- 3) has performed a transaction without the approval of the relevant management bodies of the company which is required by law or the charter;
- 4) withholds and avoids handing over documents relating to circumstances which give rise to adverse consequences for the company after his powers are terminated;
- 5) was aware or ought to have been aware that his actions (omission to act) at the time they were performed were counter to the company's interests, e.g. where the Director performed a transaction (voted in favour of its approval) on terms known to be disadvantageous to the company or with a counterparty known to be unable to perform the respective obligation (shell companies, etc.).

Unreasonable actions (omission to act) on the part of a Director are deemed to be proven, *inter alia*, where the Director:

- 1) has made a decision without taking into account information known to him that is of relevance in the given circumstances;
- 2) before making a decision failed to take steps to obtain information necessary and sufficient to do so which are customarily taken in regular business practice in similar situations, e.g. if it is proved that under the circumstances a reasonable Director would have postponed making the decision until additional information was obtained; and
- 3) has performed a transaction without complying with the internal procedures usually required or in place at the given company for the performance of similar transactions (e.g. co-ordination with the legal department, accounting department, etc.).

A Court cannot dismiss in its entirety a claim seeking that a Director compensates a company for its losses solely on the basis that the amount of the losses cannot be established with a reasonable degree of reliability. In such cases the amount of losses recoverable is determined by the Court taking into account all the circumstances in the case and based on the principle of fairness and commensurability of liability.

In addition, according to recent amendments, persons who are able to determine the actions of the CEO and members of a company's boards (e.g. a beneficiary of a company) have a similar duty to act in good faith and reasonably and in the best interests of the company and may also be held liable for losses caused to the company which arise as a result of their failings.

2.3.2 Defence

Directors who voted against the resolution that caused harm to the company or who, acting in good faith, abstained from voting are exonerated from liability.³¹ The CEO may provide explanations regarding his actions (omission to act) and cite the reasons for the losses (e.g. unfavourable market conditions, bad faith on the part of a counterparty, employee or representative of the company, unlawful actions by third parties, *force majeure*, etc.) and submit the relevant evidence.

2.3.3 Liability for insolvency of a company

In addition to the liability of Controlling Persons, which is regulated by the insolvency law (described in paragraph 1.3.6), Russian law establishes the following rules on liability.

(a) The Limited Liability Company Law (LLC Law)

Under the LLC Law, if the insolvency of a limited liability company is occasioned by its participants or other persons who have the right to give mandatory instructions binding the company or otherwise determine the actions of that limited liability company, such persons may bear secondary liability for the obligations of that company in the case of insufficiency of assets of the company.³²

³¹ Article 53.1(2) of the Civil Code.

³² Article 3 of the LLC Law.

(b) The Joint Stock Company Law (JSC Law)

In contrast with the LLC Law, the JSC Law contains provisions that appear to restrict considerably the scope of potential liability to which persons who have the right to determine the actions of a company may be exposed in case of its insolvency. Namely, the JSC Law imposes a restricted standard of potential liability to those situations where such persons “have used their right to give binding instructions to the company or otherwise exercise control over the company with intent that the company takes an action and knowing in advance that such action would result in the company’s insolvency (bankruptcy).”³³

According to Court practice, the general rules on holding the CEO, a shareholder / participant and members of a company’s boards liable under the JSC Law and LLC Law are not applied in isolation to the concept of liability of Controlling Persons of the Insolvency Law and the latter concept may trigger liability of Controlling Persons without invoking the provisions of the respective JSC and LLC law.

2.4 General criminal liability of directors

2.4.1 General principles

Given that violations prohibited by the criminal legislation are most likely to occur in the context of day-to-day management of the company, the CEO of the company is the person most likely to incur criminal liability. Nevertheless, the members of the board of directors and other collective management bodies can also be subject to criminal liability as individuals performing management functions at a company.

As a matter of Russian criminal law, criminal liability may only be imposed on individuals. Legal entities are not subject to criminal liability but may be subject to administrative liability.

Below is a summary of the main provisions of Russian criminal law generally applicable to the Directors of a company.³⁴ These provisions apply during twilight periods as well. The Directors of a company may be subject to liability for the crimes referred to below if they are found guilty of such by a Court.

Russian law also provides special grounds for criminal liability for actions associated with a company’s insolvency. These are set out in paragraph 2.6 below.

2.4.2 Criminal liability for abuse of power

The Criminal Code³⁵ provides that a Director who uses his position in violation of the law and counter to the interests of the respective company and causes damage to the company, faces penalties that include a fine, compulsory community service, disqualification from holding certain posts or from engaging in certain activities, and imprisonment. If the Director’s actions have infringed only the interests of the company itself (and the company is not a state or municipal enterprise), then prosecution of the person can be initiated only by the CEO of the company or with his consent.

2.4.3 Criminal liability for commercial bribery

A Director may be subject to criminal liability for accepting a bribe (including money, securities, other assets or illegal use of services) from a third party in exchange for performing actions (or omitting to act) for the benefit of the third party in connection with the position held by that Director.³⁶

A Director may also be held criminally liable for giving a bribe to a person who performs management functions at a company or providing services to such a person in exchange for that person’s performing actions (or omitting to act) for the benefit of the Director in connection with the position held by that person.³⁷

³³ Article 3 of the JSC Law.

³⁴ The crimes described further in the text do not constitute an exhaustive list of the grounds for criminal liability of Directors.

³⁵ Article 201 of the Criminal Code.

³⁶ Articles 204(3) and 204(4) of the Criminal Code.

³⁷ Article 204(1) of the Criminal Code.

If the above actions (or omissions) on the part of a Director have infringed only the interests of the company itself (and the company is not a state or municipal enterprise), then prosecution of the person can be initiated only by the CEO of the company or with his consent.³⁸ The penalties include a fine, disqualification from holding certain posts or from engaging in certain activities, and imprisonment.

2.4.4 Criminal liability for fraud

The Directors may be liable for fraud, i.e. theft of the property of another person (including a company) or acquisition of title to the property of another person (including a company) through deceit or breach of trust, including fraud committed by a person exercising the powers vested in him by virtue of his office and fraud associated with deliberate breach of contract in the sphere of business activity.³⁹ Penalties for fraud include a fine, custodial restraint, compulsory community service, and imprisonment.

2.4.5 Criminal liability for money laundering or other legalisation relating to property which has been unlawfully obtained

The performance of financial operations and transactions with money and other property which has been unlawfully obtained (money laundering) is subject to a fine or, in certain cases, imprisonment. The same actions involving substantial amounts are punishable by, among other things, imprisonment together with possible confiscation of assets.⁴⁰

2.4.6 Criminal liability for unlawful business activity

A Director may be held liable if due to his fault the company engages in business activity without a licence or registration or does so in violation of the registration or licensing requirements.⁴¹ The penalties include a fine, compulsory community service or imprisonment.

2.4.7 Criminal liability for illegally obtaining and disclosing confidential information relating to commercial, tax or banking matters

The Criminal Code⁴² provides for criminal liability for the illegal collection, disclosure or use of confidential information relating to commercial, tax or banking matters without the consent of the owner of such information by a person who has knowledge of or becomes aware of such information while being employed by the company. The penalties include a fine together with disqualification from holding certain posts or from engaging in certain activities, or imprisonment.

2.5 General administrative liability of directors

Although the general nature of administrative and criminal offences is similar, these offences should be differentiated. The fundamental difference is the scope of the damage caused by an offence. While the Administrative Offences Code does not specify the amount or scope of the damages caused by an offence, it contains a provision that an offence qualifies as an administrative one if it does not involve an act subject to a criminal sanction. The Criminal Code provides that unlawful actions during insolvency proceedings (paragraph 2.6.1 below) which have caused substantial damage may result in criminal liability. The degree of damage is, therefore, the main distinctive criterion.

Below is a summary of the main provisions of the Administrative Offences Code that apply to company Directors. Russian law also provides special grounds for administrative liability for actions associated with a company's insolvency. These are set out in paragraph 2.6 below.

³⁸ See footnote 25 above.

³⁹ Article 159(1) and (3) and Art. 159.4(1) of the Criminal Code.

⁴⁰ Articles 174, 174.1 and Art. 104.1 of the Criminal Code.

⁴¹ Article 171 of the Criminal Code.

⁴² Article 183 of the Criminal Code.

2.5.1 Administrative liability for unlawful remuneration on behalf of a company

The Administrative Offences Code envisages administrative liability for unlawfully giving, offering or promising a bribe on behalf of or in the interests of a company to a person performing management functions at a company, a foreign official or an international public official, in exchange for their performing actions (or omitting to act) in the interests of that company to the benefit of the company in connection with the position held by that person.⁴³ However, it is the company that can be held liable for this offence rather than the Director, who normally would be subject to a criminal penalty for the bribe.

2.5.2 Administrative liability for money laundering

There is administrative liability for violation of the anti-money laundering legislation with regard to the organisation and / or exercise of internal control, including violation of the rules involving failure to provide information to the relevant authorised body concerning operations that are subject to mandatory control.⁴⁴ The Directors may be subject to administrative liability under the respective article mainly in the form of a fine.

2.5.3 Administrative liability for business activity without a licence or registration

A Director may be held liable, among other things, if the company engages in business activity in breach of the requirements and conditions set out in the respective licence.⁴⁵ The basic sanction for this offence is an administrative fine.

2.5.4 Administrative liability for breach of labour law

The Administrative Offences Code also envisages administrative liability for the Directors for violation of the Russian labour legislation.⁴⁶ The basic sanction for these offences is a fine.

2.6 Criminal and administrative liability for illegal actions before and during insolvency proceedings

2.6.1 Criminal liability

The Criminal Code imposes criminal liability for certain actions (or omissions / failure to act) in anticipation of insolvency and also for certain actions taken during the insolvency of a company.

In particular, the Criminal Code imposes criminal liability for the following:

- (a) deliberate insolvency,⁴⁷ i.e. deliberate actions (or omission to act) by the CEO or a shareholder of a company rendering it impossible for the company to satisfy its creditors' claims in respect of monetary obligations in full and / or to fulfil the duty to make mandatory payments;
- (b) fictitious insolvency,⁴⁸ i.e. public statements made by the CEO or a shareholder of a company which are known to be false regarding the supposed insolvency of the company;
- (c) unlawful actions during insolvency proceedings,⁴⁹ which fall under three categories:
 - (i) concealing property, property rights or liabilities; withholding information about property, including its size, location or any other information about property, property rights or liabilities; transferring property to others, alienating or destroying property and concealing, destroying or falsifying accounting documents, if such actions are taken when the company has shown signs of being insolvent;

⁴³ Article 19.28 of the Administrative Offences Code.

⁴⁴ Article 15.27 of the Administrative Offences Code.

⁴⁵ Article 14.1 of the Administrative Offences Code.

⁴⁶ See, for example, Arts. 5.27, 5.27.1 and 5.28 of the Administrative Offences Code.

⁴⁷ Article 196 of the Criminal Code.

⁴⁸ Article 197 of the Criminal Code.

⁴⁹ Article 195 of the Criminal Code

- (ii) the unlawful satisfaction of claims of certain creditors out of the company's property by the CEO or a shareholder of the company in the knowledge that this will be to the detriment of the other creditors, if such actions are taken when the company has shown signs of being insolvent.

The Criminal Code does not contain any definition of “unlawful satisfaction”. There is a strong argument that this term should be interpreted to mean satisfaction of creditors' claims in violation of the order of priority established by the Insolvency Law. However, there is also another interpretation, according to which “unlawful satisfaction” is a payment made in violation of the law (e.g. a payment made from an account that has been attached or a payment made under an invalid transaction).

The signs of being insolvent are described in paragraph 1.3.3 above.

- (iii) unlawful actions meant to impede the activity of an insolvency administrator, including evading the transfer of documents necessary for him to perform his duties, where the CEO's power to manage the debtor has been granted by an insolvency administrator appointed by a Court.

For the above actions to constitute a crime, “substantial damage” must be caused (i.e. in amount exceeding RUB1.5 million).

With respect to fraudulent and deliberate insolvency, the Criminal Codes imply that there must be a direct intent in committing such offences.

Sanctions for the criminal offences mentioned above include a fine, compulsory community service, compelled labour, correctional labour, custodial restraint or imprisonment.

2.6.2 Administrative liability

The actions that constitute an administrative offence are similar to those set out in paragraph 2.6.1 above. However, a criterion for determining whether a crime or an administrative offence has been committed is the degree of damage (paragraph 2.5 above). When an act causes damage of more than RUB1.5 million, it may constitute a crime, if less – an administrative offence.

In addition to the acts mentioned in paragraphs 1.3.3 - 1.3.6 above, the Administrative Offences Code imposes liability for the following offences associated with bankruptcy:⁵⁰

- (a) deliberate insolvency (as defined in paragraph 2.6.1(a));
- (b) fictitious insolvency (as defined in paragraph 2.6.1(b));
- (c) unlawful actions during insolvency proceedings (as defined in paragraph 2.6.1(c));
- (d) acceptance by a creditor of unlawful satisfaction from an insolvent debtor, where the creditor is aware of the preferential treatment and the likelihood that it is to the detriment of other creditors, if such actions are taken when the debtor has shown signs of being insolvent; and
- (e) non-performance of a legally binding judgment imposing secondary liability on Controlling Persons for the debtor's obligations, where such non-performance does not constitute a crime (see also paragraph 1.3.6).

Liability for the above offences can take the form of an administrative fine and / or disqualification as a Director (please see also paragraph 6.2 for details).

Penalties for civil, criminal and administrative offences connected with insolvency are further described in paragraph 6.

⁵⁰ Articles 14.12 and 14.13 of the Administrative Offences Code.

2.7 Defences in criminal and administrative proceedings

Russian criminal and administrative law does not provide for any special defences related to insolvency proceedings or potential claims against Directors or creditors. However, both the Criminal Code and the Administrative Offences Code set out a list of general defences (i.e. circumstances in which criminal or administrative liability cannot be imposed, such as extreme necessity or insanity). However, these defences are unlikely to apply to bankruptcy-related crimes or offences.

The Administrative Offences Code does envisage that if an administrative offence is insignificant (i.e. actions or omissions which, although formally containing signs of an administrative offence, do not constitute a material violation of legally protected public legal relations given the nature of the offence, the offender's role, the extent of the harm and the gravity of the consequences), the Director may be exonerated from administrative liability.⁵¹

QUESTION 3

3. **Other persons involved in a company's affairs who may be held liable for their actions during the twilight period**
- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
 - (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
 - (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 Overview

Under Russian law, there are three categories of persons that may be held liable for the debts of an insolvent entity:

- (a) persons required to file for insolvency (namely, the CEO and the members of the liquidation committee (the liquidator) of the debtor, in the cases referred to in paragraph 1.3.5);
- (b) Controlling Persons (paragraphs 1.3.6 and 2.2 above); and
- (c) the parent company.

3.2 Liability of a parent company

Under Russian law,⁵² a company that is able to determine the activities of another company (the subsidiary) is considered to be a parent company of such subsidiary. This ability to control can derive from the parent company's shareholding in the subsidiary, or a provision in the subsidiary's charter, or an agreement entered into between the parent company and the subsidiary. If the insolvency of the subsidiary has been caused by its parent company, the latter can be held secondarily liable for the subsidiary's debts.

A parent company would also qualify as a Controlling Person as discussed in paragraph 1.3.6 above.

⁵¹ Article 2.9 of the Administrative Offences Code.

⁵² Article 67.3 of the Civil Code.

Although the Civil Code does not specify a twilight period during which a subsidiary's debts must have arisen if its parent company is to be liable for them, in our view, if a claim to hold a parent company secondarily liable is filed in an insolvency case against its subsidiary, the two-year⁵³ twilight period mentioned in paragraph 1.3.6 above should apply.

The JSC Law provides that if a parent company has caused its subsidiary to become insolvent, the latter bears secondary liability for the debts of its subsidiary only if the parent company deliberately exercised its right (enshrined in the charter of the subsidiary or in an agreement with the subsidiary) or its ability to issue instructions binding on the subsidiary in the knowledge that doing so would result in the subsidiary's insolvency. Such liability is limited to situations where the parent company has actual knowledge that the subsidiary's insolvency would ensue.

The LLC Law contains a similar provision, namely that if the insolvency of a subsidiary is caused by its parent company, the latter bears secondary liability for the debts of the subsidiary if the latter's assets are insufficient to pay its debts.

The Civil Code does not enshrine specific grounds or degrees of fault sufficient to trigger the above rules. As a rule, a person will be liable in the conduct of business unless they can prove that due performance was rendered impossible by *force majeure*, that is, extraordinary circumstances that could not be prevented under the prevailing conditions (such circumstances do not include, in particular, a breach of duties by a counterparty of the debtor, the lack of availability of goods needed for performance and the debtor's having insufficient funds).⁵⁴

In addition, according to recent amendments to the Civil Code, persons who have an actual ability to determine the actions of Directors may also be held liable for losses caused to a company due to their fault. Such persons also qualify as Controlling Persons as discussed in paragraph 1.3.6 above.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Overview

Russian law provides for a number of specific grounds on which transactions entered into during suspect periods prior to the opening of insolvency proceedings may be challenged.

According to the applicable Insolvency Law, the following types of transactions can be challenged in the bankruptcy Court:

- (a) so called "suspicious" transactions, which include: (i) transactions at an undervalue; and (ii) transaction aimed at defrauding creditors; and
- (b) preferential transactions.

⁵³ With respect to claims to hold a Controlling Person liable submitted after 1 September 2016, a three-year twilight period respectively should apply.

⁵⁴ Article 67.3 and Article 401 of the Civil Code.

As a rule, such transactions can be challenged only at the stage of external administration (if any) or winding up, and only by:

- the insolvency administrator on behalf of a debtor, either at the bankruptcy administrator's own discretion or when requested to do so by the creditors' meeting or committee; and
- a representative of, or any person authorised by, the creditors' meeting or committee, but only if the insolvency administrator fails to bring a claim for invalidation of the transaction within the time limits set by the creditors' meeting or committee; or
- a creditor or a government agency, the value of the registered claim of which exceeds 10% of the total claims included in the register of creditors' claims (disregarding the value of the claims of the creditor whose transaction is being challenged or its affiliates).

Assets that are recovered under such transactions that are set aside are to be returned to the bankruptcy estate (see paragraph 6.1).

Under the above provisions of the Insolvency Law, actions which have the following effects may also be challenged:

- (1) actions directed at performing obligations arising under civil, labour, family, tax, customs and procedural law and other legislative provisions;
- (2) agreements, orders for payments and payments made in accordance with labour law;
- (3) actions directed at fulfilling judgments and other acts of state bodies.

Transactions entered into during the twilight period may also be challenged under the provisions of the Civil Code, the LLC Law and the JSC Law. However, it is arguable whether the actions mentioned above can be challenged separately from the underlying transactions.

4.1.1 Transactions at an undervalue

These are transactions where the consideration received or to be received by a debtor is "inadequate" (i.e. where the market value of the transferred assets is significantly higher than the consideration received or to be received taking into account the circumstances of the transaction, including where the price or other terms of such transaction are materially less favourable than those of comparable transactions concluded in comparable circumstances).

Such transactions may be challenged if entered into or performed within one year preceding, or at any time after, the opening of insolvency proceedings.

4.1.2 Transactions aimed at defrauding creditors

Transactions are treated as aimed at defrauding creditors if the following conditions are all satisfied:

- (i) the purpose was to prejudice the property rights of creditors (such purpose is presumed if at the time of entry into the transaction, or as a result of the entry into the transaction, the debtor was or became unable to pay its debts or the liabilities of a debtor exceeded the value of its assets and, among other things, (a) no consideration was paid to the debtor; or (b) the transaction was with an "interested party"; or (c) the value of disposed property or assumed obligations equals 20% or more of the balance sheet value of the debtor's assets; "interested parties" include, among others, the CEO of the debtor and its directors as well as affiliates and companies comprising the so-called "group of entities" to which the debtor is attributable); and
- (ii) such transaction resulted in "harm to creditors" (e.g. resulted in a decrease in the value or the size of the debtor's assets or an increase in the value of claims against the debtor or other consequences that entail or could entail the inability of creditors to satisfy their claims from the debtor's assets); and

- (iii) the counterparty knew or should have known of the above purpose at the time of entry into such transaction (among other things, it is presumed that the counterparty knew of such purpose if it was an “interested party” or it knew or should have known of the signs of the debtor’s inability to pay or insufficiency of the debtor’s assets).

Transactions aimed at defrauding creditors may be challenged if they are entered into or performed within three years preceding, or at any time after, the opening of the insolvency proceedings.

4.1.3 Preferential transactions

These are transactions that result or may result in preferential satisfaction of a particular creditor over other creditors, including but not limited to one of the following transactions:

- (i) granting of security or guarantees for pre-existing indebtedness;
- (ii) transactions that may alter the ranking of creditors’ claims which arose before the entry into of such transaction;
- (iii) transactions that will or may result in the satisfaction of not matured claims of creditors where the debtor has failed to satisfy its matured claims; or
- (iv) transactions that prioritise or may prioritise the claims of a creditor which arose before the entry into of such transaction when compared to the ranking of its claims according to the statutory ranking of creditors in insolvency.

Preferential transactions may be challenged if entered into or performed within one month preceding, or at any time after, the opening of insolvency proceedings. However, preferential transactions falling simultaneously within (i) and (ii) above, or falling within any of the above where the counterparty knew of the debtor’s inability to pay or that the debtor’s liabilities exceeded the value of its assets, are subject to a six-month suspect period. A counterparty that is an “interested party” is presumed (unless proved otherwise) to have such knowledge.

4.2 Defences available to a counterparty to protect vulnerable transactions

The insolvency law specifies certain transactions that cannot be challenged:

- (i) transactions concluded on an organised trading platform on the basis of a bid addressed to an unlimited number of trading members as well as acts comprising performance of such transactions cannot be challenged on any of the above grounds;
- (ii) transactions entered into in the ordinary course of business if the value of assets disposed of or obligations incurred does not exceed 1% of the balance sheet value of the debtor’s assets; such transactions cannot be challenged as transactions at an undervalue or as preferential transactions;
- (iii) transactions where the debtor received adequate consideration; such transactions can, however, be challenged as a transaction aimed at defrauding creditors;
- (iv) discharge of payment obligations under facility or loan agreements with banks as lenders (which should arguably include foreign banks) and discharge of mandatory claims cannot be challenged as preferential transactions if:
 - such discharge was made as scheduled payments according to the terms of the financing agreements or as provided by law; and
 - when such obligations were discharged, the debtor had no other mature monetary obligations of which the respective creditor was aware.⁵⁵

⁵⁵ This carve-out in the provided wording applies to transactions challenged after 1 September 2016.

4.3 Further risks in dealing with a company during the twilight period

Two key issues regularly arise when considering the question of the duties of Directors and others during the twilight period. First, how safe is it for Directors or others involved in a company's affairs to obtain further loans and, second, can an independent third party rely on the validity of transactions entered into with a company (guarantees and other forms of security in particular) in each case during the twilight period?

When an independent third party is dealing with an insolvent company (e.g. when the third party intends to provide a loan to the insolvent company), the third party should take into account the risk that the insolvent company's transactions may be set aside under the general provisions discussed above.

It should also be noted that recently a mechanism similar to English law representations and warranties was introduced in the Civil Code. For instance, a creditor could seek representations concerning the financial standing of the debtor under Article 431.2 of the Civil Code. However, due to its novelty and the lack of relevant judicial practice at this stage, it is difficult to make any reliable assessment of its applicability in insolvency.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

(i) A claim to have Controlling Persons (including parent companies) held secondarily liable in a bankruptcy case (see paragraph 1.3.6) may be filed by

- an insolvency administrator appointed for the winding-up stage.

An insolvency administrator appointed for the winding-up stage is entitled to file a claim, either at his own discretion or if so requested by a decision of the creditors' meeting or creditors' committee.

- the registered creditors, state bodies, employees, former employees and representatives of the employees, in the cases provided by the Insolvency Law (e.g. a failure to file a bankruptcy petition where there is an obligation to do so (see paragraph 1.3.5)).⁵⁶
- an insolvency administrator appointed for the liquidation stage (at his own discretion or if requested by the decision of the creditors' meeting or creditors' committee); the registered creditors and agencies have the right until completion of the liquidation stage of insolvency to bring an action against the relevant persons to make them liable for the relevant debts. The same rules apply in cases of failure to file a bankruptcy petition where such obligation is mandatory (see paragraph 1.3.5).

(ii) A claim for damages against Directors on the basis of the general principles of liability for losses caused by them to the company itself (paragraph 2.3.1) may be filed by -

- the company itself;⁵⁷
- a shareholder holding at least 1% of the company's ordinary shares, where the company is a JSC;⁵⁸
- a participant (shareholder) of a company that is an LLC.⁵⁹

⁵⁶ Article 10(5) of the Insolvency Law.

⁵⁷ Article 53.1 of the Civil Code.

⁵⁸ Article 71(5) of the JSC Law.

⁵⁹ Article 44(5) of the LLC Law.

- (iii) Administrative and criminal proceedings may be initiated on the basis of an application submitted by any persons (although, the application cannot be anonymous).

Specifically, the Administrative Offences Code provides that where unlawful actions are committed during a company's bankruptcy, administrative proceedings may be initiated based on an application filed by any person, including persons involved in the bankruptcy case, the debtor's management bodies and the relevant self-regulated organisation of insolvency administrators (although the application cannot be anonymous).⁶⁰

Arbitrazh (state commercial) Courts have jurisdiction to impose administrative liability on persons for the majority of the offences associated with insolvency (paragraph 2.6.2).

Criminal proceedings in relation to abuse of power (paragraph 2.4.2) and commercial bribery (paragraph 2.4.3) may be initiated by the CEO (or with his consent), unless the illegal actions of the respective Director infringed only the interests of the company (and the company is not a state or municipal enterprise). Courts of general jurisdiction hear all criminal cases.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

6.1 Invalidation of transactions and restitution

As a general rule, everything recovered as a result of a transaction being successfully challenged on the grounds set out in the Insolvency Law (and referred to in paragraph 4), or on general grounds provided by the Civil Code, will be clawed back, and all assets disposed of by the debtor under such transactions are to be returned to the bankruptcy estate. In turn, the debtor's counterparties will have a claim against the debtor for the value of the property returned and will generally rank *pari passu* with other unsecured creditors of the debtor.

However, in the case of (i) preferential transactions that are subject to the six-month suspect period, and (ii) transactions aimed at defrauding creditors, the counterparty's claim will in each case rank below the claims of unsecured creditors. In the absence of unlawful conduct or fault on the part of a creditor in performing the contested transaction such liability cannot be imposed on the creditor, and its reinstated claim will be subject to satisfaction on the general grounds set out in the Insolvency Law (i.e. *pari passu* with other unsecured creditors). In particular, according to the general rule, such liability cannot be imposed on a creditor that has received a payment in non-cash form from the debtor, including before it matures (provided that the payment was not made early at the insistence of the creditor itself, in the knowledge that the debtor is insolvent).

A Court may decide not to invalidate a transaction if the value of the property acquired by the debtor under the contested transaction exceeds the value of that which could be returned to the bankruptcy estate as a result of the transaction being reversed, or if the acquirer under the invalid transaction has returned everything obtained to the bankruptcy estate. Therefore, if a person acquires property under a transaction and believes that the grounds for invalidity of transactions set out in the Insolvency Law may apply to that transaction, then after any insolvency proceeding is instituted against the debtor that person is entitled to return the property to the debtor or pay the price for it, having notified the debtor of such return. In that case the person returning the property is entitled to bring a claim against the debtor on the grounds set out in the Insolvency Law (e.g. the person is entitled to apply to the bankruptcy Court to have its claim included on the register of creditors' claims. The rules applicable to such an application will depend on the grounds upon which the underlying transaction could be challenged).

⁶⁰ Article 28.1 of the Administrative Offences Code.

6.2 Administrative fine and disqualification

The Administrative Offences Code envisages, among other things, a warning, an administrative fine and disqualification as the most common types of penalties applicable to Directors. Specifically, for offences relating to insolvency, a CEO may be subject to an administrative fine of up to RUB100,000 (approximately US\$1,500) or disqualification for up to three years (paragraph 2.6.2).

Disqualification entails depriving an individual of the right to, among other things, occupy any management post in the executive body of a legal entity or a seat on the board of directors or management (supervisory) board, or engage in business activity that involves management of a legal entity. The duration of the sanction can range from six months to three years. Information on all disqualified persons is kept in a special register. Legal entities are under an obligation, before offering a contract for a management position, to verify with the body responsible for keeping the register that the candidate has not been disqualified.⁶¹

6.3 Imprisonment and fine

The Criminal Code envisages a variety of remedies, including a fine, disqualification from holding certain posts or from engaging in certain activities, compulsory community service, compelled labour, arrest and imprisonment. When determining punishment, the nature and degree of danger posed to society by the offence and the offender's character are taken into account, including any mitigating or aggravating circumstances, and also the impact of the punishment on the rehabilitation of the convicted person and on his family.

In relation to crimes associated with insolvency, the Criminal Code provides the following remedies:

- (1) Deliberate insolvency (Paragraph 2.6.1 (a)) – a fine of up to RUB 500,000 (approx. USD 7,700) or an amount equal to the salary or other income of the convicted person for a period of one to three years, or correctional labour for a period of up to five years, or imprisonment for up to six years with a fine of up to RUB200,000 (approximately US\$3,000) or in an amount equal to the salary or other income of the convicted person for a period of up to 18 months or without the same.
- (2) Fictitious insolvency (paragraph 2.6.1 (b)) – a fine of up to RUB300,000 (approximately US\$4,600) or an amount equal to the salary or other income of the convicted person for a period of one to two years, or correctional labour for a period of up to five years, or imprisonment for up to six years with a fine of up to RUB80,000 (approximately US\$1,200), or an amount equal to the salary or other income of the convicted person for a period of up to six months or without the same.
- (3) Unlawful actions during insolvency proceedings -
 - (i) concealing property (paragraph 2.6.1 (c) (i)) – a fine of up to RUB500,000 (approximately US\$7,700) or an amount equal to the salary or other income of the convicted person for a period of one to three years, or custodial restraint for a period of up to two years, or compelled labour for a period of up to three years, or arrest for a period of up to six months, or imprisonment for up to three years with a fine of up to RUB200,000 (approximately US\$3,000) or in an amount equal to the salary or other income of the convicted person for a period of up to 18 months or without the same;
 - (ii) unlawful satisfaction of claims of certain creditors (paragraph 2.6.1 (c) (ii)) – a fine of up to RUB300,000 (approximately US\$4,600) or an amount equal to the salary or other income of the convicted person for a period of up to two years, or custodial restraint for a period of up to one year, or compelled labour for a period of up to one year, or arrest for a period of up to four months, or imprisonment for up to one year with a fine of up to RUB80,000 (approximately US\$1,200) or in an amount equal to the salary or other income of the convicted person for a period of up to six months or without the same; and

⁶¹ Article 32.11(2) of the Administrative Offences Code.

- (iii) unlawful actions directed at impeding the activity of a bankruptcy administrator (paragraph 2.6.1 (c) (iii)) – a fine of up to RUB200,000 (approximately US\$3,000) or in an amount equal to the salary or other income of the convicted person for a period of up to 18 months, or compulsory community service of up to 480 hours, or correctional labour for a period of up to two years, or compelled labour for a period of up to three years, or arrest for a period of up to six months, or imprisonment for up to three years.

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 the insolvency office-holder's investigation into the company's affairs?**
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?**

The duty to co-operate with an insolvency administrator is established in a number of provisions of the insolvency law.

The insolvency law imposes an express duty on the CEO⁶² to disclose information to an insolvency administrator appointed by a bankruptcy Court at the first stage of insolvency (supervision), where the CEO remains in place but with limited powers, and also at the liquidation stage. In particular, within 15 business days after the appointment of an insolvency administrator in the course of a supervision stage, the CEO must provide the insolvency administrator and a bankruptcy Court with the list of all the debtor's assets and make available the accounting and other documents reflecting business operations of the debtor for the period of three years prior to the commencement of the supervision stage of insolvency.⁶³ In addition, on a monthly basis, the CEO must inform the insolvency administrator of any changes in the debtor's assets.

In the course of financial rehabilitation, the insolvency administrator is entitled to request information from the debtor's management bodies that remain in place and exercise their powers subject to the limitations established by the insolvency law.⁶⁴

At the liquidation stage the CEO and previously appointed insolvency administrators must procure, within three days of the appointment of the liquidation administrator, that the latter is provided with the accounting documents of the debtor, among other things.⁶⁵ Similar obligations exist when an external administrator is appointed.⁶⁶

At the initial stages of bankruptcy, such as supervision and financial recovery, the appointment of the insolvency administrator does not constitute grounds for the CEO's dismissal or termination of the powers of other management bodies of the debtor. They continue to exercise their powers subject to the limitations established by the Insolvency Law. Therefore, the duty to co-operate with the insolvency administrator may be inferred from a number of provisions of the Insolvency Law. At the later stages of external management and liquidation, the insolvency administrator replaces all other governing bodies of the debtor. At this stage, the co-operation of the CEO becomes to a considerable extent obsolete and therefore, at the liquidation stage, the CEO, along with the previously appointed insolvency administrator, is obliged to provide all necessary financial and other documentation to the liquidation administrator.

⁶² For the purposes of this paragraph, the term "CEO" also includes the chairman of the management board of the debtor and other persons acting on behalf of the debtor without a power of attorney.

⁶³ Article 64(3)(2) of the Insolvency Law.

⁶⁴ Articles 66(2) and 83(4) of the Insolvency Law.

⁶⁵ Article 126(2) of the Insolvency Law.

⁶⁶ Article 94(1) of the Insolvency Law.

In addition, the Insolvency Law envisages personal secondary liability of the CEO for outstanding obligations of the debtor in situations where: (i) the accounting or other reporting documentation of the debtor that is required to be produced and maintained by Russian law proves to be missing, or the relevant information on the assets of the debtor proves to be incomplete or untrue, in each case as of the date of instigation of the supervision stage or declaration of the debtor's insolvency; and (ii) such situation results in significant difficulties for conducting bankruptcy proceedings, including making an inventory and realisation of the debtor's assets. For the purposes of holding the CEO liable in case of missing accounting and reporting information and any misstatement thereof as provided above according to recent amendments to the legislation the CEO is presumed as causing the company to be declared insolvent. Also, as mentioned in paragraphs 2.6.1 (c (i)) and 2.6.2, criminal and administrative liability may also be imposed.

It should be noted that if an administrative case or a criminal investigation is launched against the CEO, there are no specific defences available to him. However, a CEO enjoys privilege against self-incrimination by virtue of Article 6 of the European Convention of Human Rights, Article 51(1) of the Constitution of the Russian Federation and similar provisions of the Criminal Procedure Code of the Russian Federation and the Administrative Offences Code.

QUESTION 8

8. Appeals and limitation periods

- (a) What limitation period, if any, applies to the actions referred to above?
- (b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation periods for civil claims

Limitation periods for civil claims are as follows:

- (1) Actions against directors in connection with the failure to file a bankruptcy petition when such filing is mandatory and actions in connection with the liability of Controlling Persons where instructions given by such persons and performed by the debtor resulted in harm to creditors, may be brought within one year when the relevant claimant knew or should have known of the grounds for holding the controlling persons liable, but not later than three years after the date when the debtor was recognised bankrupt and in any case before the completion of the liquidation stage of the insolvency proceedings of the debtor.⁶⁷ Based on Court practice, the limitation period runs from the date when the sale of the debtor's assets constituting the bankruptcy estate is completed during the liquidation stage (only from this moment can the exact amount of liability of directors be determined).
- (2) For challenging transactions on the grounds envisaged by the Insolvency Law and triggered by the initiation of insolvency proceedings, the limitation period is one year. It begins to run from the date when the insolvency administrator initially appointed becomes aware or ought to have become aware of the grounds to challenge the transactions provided for in the Insolvency Law.

As follows from Court practice, the introduction of external management or a declaration that a debtor is insolvent does not on its own trigger the commencement of the limitation period. When considering, however, whether an insolvency administrator was aware of grounds to challenge a transaction or not, the extent to which the administrator, acting reasonably and with due care and circumspection, could have established such grounds is taken into account. In particular, a reasonable insolvency administrator appointed upon the commencement of an insolvency proceeding would promptly request all information that he would need in order to properly fulfil his duties, including information that could help identify transactions that could be challenged (including accounting documents concerning the three year period prior to commencement of the bankruptcy case, documents relating to transactions such as the disposal of the debtor's assets and documents relating to the company's bank accounts, including the transactions performed in those accounts, etc.).

⁶⁷ Article 10(5) of the Insolvency Law.

8.2 Appealing the decisions of lower Courts

The following possibilities are available to appeal a judicial decision of *arbitrazh* (state commercial Courts):

- appeals in an *arbitrazh* Court of appeal;
- appeals in *cassation* Court;
- second” *cassation* appeal before the Commercial Disputes Bench of the Supreme Court;
- supervisory review by the Presidium of the Supreme Court; and
- review in light of new or newly discovered circumstances.

As a rule, judgments can be appealed in the appellate Courts up to one month after the judgment is reached. However, rulings rendered in relation to claims to have a debtor’s Controlling Persons held liable; or to have a debtor’s transactions declared invalid and / or to have the consequences of invalidity applied to a transaction; and rulings dismissing an application to have a debtor’s transaction declared invalid must be appealed in an *arbitrazh* Court of appeal no later than 10 days after the date they are rendered.

Appellate decrees can be challenged in the *cassation* Courts by filing an appeal up to two months after the respective judgment or appellate Court decree comes into force.

Cassation Court decrees may be further appealed by filing a “second” *cassation* appeal with the Supreme Court up to two months after the date when the contested judicial act (e.g. decree of the district *arbitrazh* Court) came into force.

An application for supervisory review by the Presidium of the Supreme Court should be filed within three months after the date when the contested judicial act came into force.

An application seeking review of a judicial act in the light of new or newly discovered circumstances must be filed within three months after the new or newly discovered circumstances arise. Such applications are to be filed with the Court that made the relevant judgment and must be resolved within one month after they are filed. If the Court accepts the case for review, the judicial act is cancelled and the case is resolved in the usual way.

8.3 Limitation period for administrative offences

The Administrative Offences Code establishes a general two-month limitation period for administrative offences. Where the remedy for an administrative offence is disqualification (e.g. for fictitious or deliberate insolvency if there are no signs of a criminal offence (paragraph 2.6.2)), a one-year limitation period applies. The limitation period starts running from the date the offence was committed.

8.4 Appealing decisions in respect of administrative liability

Under the Administrative Offences Code, decisions rendered with respect to administrative offences can be appealed up to 10 days after the date they are served or a copy of the relevant decision is received by the defendant. An appeal may be submitted to the official body that issued the decision or directly to the Court.⁶⁸ Once the appeal has been considered by the Court, the possibilities for further appeal apply; procedure and time limits for appeal are set out in the RF Code on Administrative Proceedings and depend on a number of aspects, e.g. which Court’s decision is appealed.

8.5 Limitation period for criminal offences

The Criminal Code envisages limitation periods ranging from two years for petty crimes to up to 15 years for serious crimes.⁶⁹

Under Russian criminal legislation, unlawful actions during bankruptcy (paragraph 2.6.1(c)) are considered petty crimes, therefore the limitation period for such crimes is two years. Deliberate and fraudulent insolvencies are considered grave crimes, and accordingly the limitation period applicable to them is 10 years.

⁶⁸ Article 30.3 of the Administrative Offences Code.

⁶⁹ Article 78 of the Criminal Code.

As a general rule, the limitation period is calculated from the day the crime is committed. For continuing (*dlyasheesia*) crimes (such as unlawful business activity), the limitation period is calculated from the day when the criminal activity was stopped or precluded. The limitation period for continuous (*prodolzhaemoe*) crimes (i.e. crimes consisting of several criminal acts, such as commercial bribery, money laundering and fraud) starts from the date of the last criminal act: under Russian criminal law the limitation period does not depend on whether the crime is concealed or not. However, there is a possibility to have the limitation period suspended, e.g. if offenders evade being prosecuted or sentenced.⁷⁰ Also, under Russian law, the date from which the limitation period starts running also depends on category of crime (e.g. in Court practice and legal doctrine there is a position that the limitation period for a petty crime starts running from the date when the negative consequences occurred rather than from the date when an act was committed).

8.6 Appealing decisions in respect of criminal liability

An appeal against a sentence or other judgment of the Court of first instance may be lodged within 10 days from the day that the sentence is handed down or other judgment of the Court is rendered (a convict in custody may lodge an appeal within the same period from the day that he is given a copy of the sentence, ruling or decree). Further appeals may also be made to the Courts of appeal and the RF Supreme Court.

QUESTION 9

9. Foreign corporations

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

The Insolvency Law applies to all commercial legal entities that may be declared insolvent under Russian law, i.e. legal entities registered in Russia. The Insolvency Law also states that the relations involving foreign creditors are subject to the provisions of the Insolvency Law, except as otherwise envisaged by international treaty to which the Russian Federation is a party. Also, the Insolvency Law applies to foreign entities that are parties to transactions that may be challenged under the Insolvency Law (paragraph 4).

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?

Neither the insolvency law nor any other legislation provides for an obligation to insure the directors' liabilities in the case of insolvency. However the JSC Law, the LLC Law and the insolvency law gives rise to a potential liability in respect of the CEO, members of the board of directors and the management board for certain damages.⁷¹ Therefore, as with any other legal liability risk, most of such risks can be insured.

⁷⁰ Article 78 of the Criminal Code.

⁷¹ Article 71 of the JSC Law; Art. of the LLC Law; Art. 10 of the Insolvency Law.

The insurance contract can be concluded by the company or by an individual who is the CEO, member of the board of directors or member of the management board of the company. There are arguments (driven mostly by tax reasons) that in cases where the director's liability is insured by the company, the relevant director's identity should be reflected in the insurance contract between such company and the insurer.

It is not possible to get insurance to cover criminal prosecution or criminal liability in Russia. However, the following risks relating to insolvency may be insured:

- (1) any violation of management duties, negligence, failure to act, error or director's misrepresentation or inaccurate statements;
- (2) any actions of the director in the course of performance of his official duties;
- (3) violation of conditions relating to the powers of directors envisaged by law.

As a general rule, the insurance policy may provide for the following compensation:

- (a) compensation in respect of damages awarded by a Court decision;
- (b) compensation in respect of damages agreed in an out-of-Court settlement; and
- (c) compensation in respect of necessary and reasonable expenses to conduct the defence.

As a rule, claims for compensation of losses against a director can be brought within the term of the insurance contract in question or, if it is expressly provided by the insurance contract this period could be extended beyond the initial term of the insurance policy.

Losses caused to a company by the CEO, members of the board of directors or the management board are reimbursed by the insurance company within the limits specified in the insurance contract.

If the insurance compensation is insufficient to cover all losses caused to a company, such a director will be responsible for the shortfall.

If a company has already been reimbursed for its losses through other remedies, including recovery of damages from the party that directly caused such losses (e.g. an employee or contract partner), then a director shall not be held responsible for reimbursement of the losses.

Programmes insuring the liability risk of management bodies of commercial entities are offered in Russia by a number of insurance companies.

The information provided in this country chapter is correct as at 01/09/2016

SINGAPORE

QUESTION 1

1 The directors and the start and duration of the twilight period

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

1.1 Persons considered as directors of the company

- (a) In the ordinary course, the term “director” simply refers to a person formally appointed as a director of a company and named in the register of directors maintained by the company and the registrar of companies.¹
- (b) Note, however, that the definition of “director” under Singapore law includes more than just formally appointed directors and includes “*de facto* directors” and “shadow directors.” This is elaborated upon under Question 3 below.

1.2 Duration of the twilight period

1.2.1 In relation to clawback provisions

- (a) There are two key issues to be considered in determining whether the twilight period has commenced in relation to clawback provisions.² Note that each of these clawback provisions will be discussed in more detail at Question 4 below.
- (b) First, it is necessary to determine whether the company was “insolvent” at the time (or as a result) of the relevant transaction. In this regard, the company will be deemed to be insolvent if it is unable to pay its debts, which may be established by proving:
- (i) balance sheet insolvency, i.e. the company’s liabilities exceed the value of its assets;³ and / or
 - (ii) cash-flow insolvency, i.e. the company becomes unable to pay its debts as they fall due.⁴
- (c) Second, it is necessary to determine the time period between the commencement of the formal insolvency process and the time of entry into the transactions. For these purposes, a formal insolvency process commences on the date on which an application for a judicial management order is made⁵ or on the date of the making of a winding up application.⁶ In addition, the vulnerability periods relating to Singapore law clawbacks, being periods prior to the commencement of the formal insolvency process, are as follows:
- (i) transactions at an undervalue – five years;
 - (ii) unfair preferences – six months, or two years if the preferred person is an associate of the debtor;
 - (iii) voidable floating charges – six months;
 - (iv) extortionate credit transactions – three years;

¹ Sections 4(1) and 173(1) Companies Act (Cap. 50) (CA).

² Note that each of these clawback provisions will be discussed in more detail at Question 4 below.

³ Section 254(2)(c) CA. See also s. 10(4) Bankruptcy Act (Cap. 20) (BA).

⁴ Section 254(2)(c) CA.

⁵ Section 227T(2) CA.

⁶ Section 329(2) CA.

- (v) transactions defrauding creditors – the standard limitation period of six years will apply which, in the case of fraud, runs from the time the fraud is discovered.

1.2.2 In relation to insolvent trading

Specifically, in relation to insolvent trading, it is important to consider the good faith of the director, that is, whether the director had, at the time the debt was contracted, reasonable or probable grounds of expectation, after taking into consideration all other liabilities, that the company would be able to pay the debt.

1.2.3 In relation to breach of director’s duties

Specifically, in relation to the director’s duties, it is important to consider when the company is insolvent or even in a “parlous financial position.” In the event that a company is in either of the aforementioned conditions, the directors have a fiduciary duty to take into account the interests of the company’s creditors when exercising their decision-making powers.⁷ Note that this issue will be discussed in more detail at Question 2 below.

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 the director?**
- (b) In relation to each act identified in (a) above: -**
 - (i) Is the director’s liability considered to be civil, criminal or both?**
 - (ii) Can a director be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?**
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?**
 - (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 Breach of director’s duties

2.1.1 Statutory duties of directors under S 157 CA

- (a) Section 157 CA codifies certain duties that a director and / or officer owes to the company. In particular:
 - (i) a director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office;⁸ and
 - (ii) an officer or agent of a company shall not make improper use of his position as an officer or agent of the company or any information acquired by virtue of his position as an officer or agent of the company to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the company.⁹

⁷ Note that this issue will be discussed in more detail at Question 2 below.

⁸ Section 157(1) CA. See *Cheam Tat Pang v PP* [1996] 1 SLR(R) 161; *Kea Holdings Pte Ltd v Gan Boon Hock* [2000] 2 SLR(R) 333; *Lim Weng Kee v PP* [2002] 2 SLR(R) 848; *Townsing Henry George v Jenton Overseas Investment Pte Ltd* [2007] 2 SLR(R) 597.

⁹ Section 157(2) CA. See *Haw Par Brothers International Ltd v Chiarapurk Jack* [1991] 1 SLR(R) 425.

- (b) Liability for breach of this duty is civil and criminal. Section 157(3) CA provides that the officer or agent who fails to comply will be liable to account for profits made or for any damage suffered by the company and is guilty of an offence and is liable to either a fine or imprisonment.
- (c) The Court has the discretion to relieve a director and / or officer either wholly or partly from civil liability (but not criminal liability)¹⁰ if they acted honestly and reasonably and it was fair under the circumstances to do so.¹¹ The Court's power to grant relief only applies to excuse directors who have not received the company's property in breach of trust.¹²

2.1.2 Duties of directors under general law

- (a) The statutory duties of directors and / or officers under S 157 CA as set out above are not exhaustive. As specifically provided in S 157(4) CA, the provision is in addition to and not in derogation of any other rule of law. A brief description of the duties of a director under the general law is as follows:
 - (i) a director must exercise his discretion bona fide in what he considers to be in the best interest of the company;¹³
 - (ii) a director must not place himself in a position where his duty and his interest conflict;¹⁴
 - (iii) a director must exercise his powers for the purposes for which those powers are given and not for collateral purposes;¹⁵
 - (iv) a director must possess the duty to be skilful in accordance with the nature of the duty required of his office;
 - (v) a director must exercise a duty of care to the company of which he is a director;¹⁶ and
 - (vi) a director must exercise reasonable diligence in performing the duties of his office¹⁷
- (b) Liability for breach of the duties of directors under general law is civil. A director will be personally liable for any loss suffered by the company as a result of his breach of duty. If the breach relates to self-dealing, the contract will not be enforceable.¹⁸ If the breach relates to transactions with third parties, the transaction may be avoided if the third party knew or ought to have known of the director's breach of duty.¹⁹
- (c) The Court has discretion to relieve a director and / or officer either wholly or partly from civil liability (but not criminal liability)²⁰ if he has acted honestly and reasonably and it is fair under the circumstances to do so.²¹ The Court's power to grant relief only applies to excuse directors who have not received the company's property in breach of trust.²²

¹⁰ In *Re IDEAGLOBAL.COM Ltd* [2000] 3 SLR 100 at [34].

¹¹ Section 391(1) CA.

¹² *Hytech Builders Pte Ltd v Tan Eng Leong* [1995] 2 SLR 795 at 806.

¹³ *Cheong Kim Hock v Lin Securities (Pte) (in liq)* [1992] 1 SLR(R) 497; *ECRC Land Pte Ltd v Ho Wing On Christopher* [2004] 1 SLR(R) 105; *Vita Health Laboratories Pte Ltd v Pang Seng Meng* [2004] 4 SLR 162.

¹⁴ *Chua Boon Chin v JM McCormack* [1979-1980] SLR(R) 121; *DM Divers Technics Pte Ltd v Tee Chin Hock* [2004] 4 SLR(R) 424. This common-law rule is further reinforced by s. 156(1) CA which requires a director to declare any interest in a proposed transaction or arrangement. These disclosures are to be made to the board of directors. Default of the requirements under s. 156 CA is an offence punishable by fine and imprisonment under s. 156(15) CA.

¹⁵ *Eclairs Group Ltd v JKK Oil & Gas Plc* [2015] UKSC 71.

¹⁶ *AWA Ltd v Daniels t/a Deloitte Haskins & Sells* (1992) 7 ACSR 759.

¹⁷ See also s. 157(1) CA. Note that, under s. 157C CA, a director of a company may rely on professional or expert advice given by the employee or a professional adviser, or any other director in discharging his duties, as long as the director acts in good faith, makes proper inquiry where necessary and has no knowledge that such reliance is unwarranted.

¹⁸ *Lim Koei Ing v Pan Asia Shipyard & Engineering Co Pte Ltd* [1995] 1 SLR(R) 15; *Goh Kim Hai Edward v Pacific Can Investment Holdings Ltd* [1996] 1 SLR(R) 540.

¹⁹ *Re David Payne & Co Ltd* [1904] 2 Ch 608; *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246; *Criterion Properties plc v Stratford UK Properties LLC* [2004] 1 WLR 1846.

²⁰ In *Re IDEAGLOBAL.COM Ltd* [2000] 3 SLR 100 at [34].

²¹ Section 391(1) CA.

²² *Hytech Builders Pte Ltd v Tan Eng Leong* [1995] 2 SLR 795 at 806.

2.1.3 Specific duties arising during the twilight period

- (a) If the company is insolvent, or even in a “parlous financial position”, directors have a fiduciary duty to take into account the interests of the company’s creditors when making decisions on behalf of the company.²³ This fiduciary duty requires directors to ensure that the company’s assets are not dissipated or exploited for their own benefit to the prejudice of creditors (i.e. to preserve the company’s assets for distribution to the company’s creditors through the mechanism of insolvency).²⁴
- (b) However, this fiduciary duty to consider the interests of the company’s creditors is strictly speaking owed to the company. There is no duty owed directly to the creditors (as such).²⁵ Hence, individual creditors cannot, without the assistance of insolvency practitioners such as liquidators, directly recover damages from the directors for such breaches of duty.²⁶

2.2 Insolvent trading²⁷

- (a) Personal liability may attach to an officer of a company who was knowingly a party to the contracting of a debt and had, at the time the debt was contracted, no reasonable or probable ground of expectation that the company would be able to pay the debt after taking into consideration all other liabilities.
- (b) Liability is criminal and civil. An officer of the company who is guilty of an offence under this provision is liable to a fine or imprisonment.²⁸ Further, a person who has been convicted of insolvent trading may be ordered by the Court to be personally liable without any limitation of liability for the payment of the whole or any part of the debt.²⁹

2.3 Fraudulent trading³⁰

- (a) Personal liability may attach to any person who was knowingly a party to the carrying on of business of a company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose.³¹
- (b) Liability is criminal and civil. Any person who is guilty of an offence under this provision is liable to a fine or imprisonment.³² Further, the Court may order any person who was knowingly a party to the carrying on of business in this manner to be personally liable, without any limitation, for all or any of the debts or other liabilities of the company as the Court directs.³³

2.4 Fraud in anticipation of winding up³⁴

- (a) Personal liability may attach to a past or present “officer” or a contributory of a company which is being wound up who has, within a 12-month period ending with the commencement of the winding up or after the commencement of the winding up:
 - (i) concealed any part of the company’s property worth SG\$200 or more or concealed any debt due to or from the company;
 - (ii) fraudulently removed any part of the company’s property worth SG\$200 or more;

²³ *Liquidators of Progen Engineering Pte Ltd v Progen Holdings Ltd* [2010] 4 SLR 1089 at [48].

²⁴ The rationale for such a duty is that, when a company is insolvent, the creditors’ interests come to the fore as the company is effectively trading and running the company’s business with the creditors’ money.

²⁵ *Liquidators of Progen Engineering Pte Ltd v Progen Holdings Ltd* [2010] 4 SLR 1089 at [52].

²⁶ The rationale is that, if creditors were allowed to recover directly, it would contravene the collective procedure of insolvency and open a back door to the *pari passu* rule. Allowing creditors and the company to directly recover from directors might also lead to breaches of personal directors’ duties.

²⁷ Sections 339(3) and 340(2) CA.

²⁸ Section 339(3) CA.

²⁹ Section 340(2) CA.

³⁰ Sections 340(1) and 340(5) CA.

³¹ “Fraudulent purpose” connotes the intention to go beyond the bounds of what ordinary decent people engaged in business would regard as honest, or actions deserving real moral blame according to the current notions of fair trading amongst commercial men. See *Liquidator of Leong Seng Hin Piling Pte Ltd v Chan Ah Lek and Others* [2007] 2 SLR 77; *Tang Yoke Kheng (trading as Niklex Supply Co) v Lek Benedict and Others* [2005] 3 SLR 263; *Phang Wah v PP* [2012] SGCA 60.

³² Section 340(5) CA.

³³ Section 340(1) CA.

³⁴ Sections 336(1)(c), 336(1)(g) and 336(1)(h) CA.

- (iii) concealed, destroyed, mutilated or falsified (or has been privy to the concealment, destruction, mutilation or falsification of) any book or paper affecting or relating to the property or affairs of the company;
 - (iv) made or has been privy to the making of any false entry in any book or paper affecting or relating to the property or affairs of the company;
 - (v) fraudulently parted with, altered or made any omission in any document affecting or relating to the property or affairs of the company, or has been privy to such action;
 - (vi) by any false representation or other fraud, obtained any property for or on behalf of the company on credit which the company has not subsequently paid for;
 - (vii) obtained on credit, for or on behalf of the company, under the false pretence that the company is carrying on its business, any property which the company has not subsequently paid for;
 - (viii) pawned, pledged or disposed of any property of the company which has been obtained on credit and not fully paid for, unless such pawning, pledging or disposing was in the ordinary course of business of the company;
 - (ix) attempted to account for any part of the property of the company by fictitious losses or expenses; or
 - (x) been 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.
- (b) If any one of the above-mentioned elements is satisfied, liability is criminal and a person guilty of this offence is liable to a fine or imprisonment.
- (c) The following defences exist under these provisions:
- (i) in relation to (i), (vii) and (viii), it is a good defence that there was no intent to defraud;³⁵ and
 - (ii) in relation to (iii) and (iv), it is a good defence that there was no intent to conceal the state of affairs of the company or to defeat the law.³⁶

2.5 Misconduct in the course of winding up³⁷

- (a) Personal liability may attach to a past or present officer or a contributory of a company which is being wound up if he:
- (i) does not, to the best of his knowledge and belief, fully and truly disclose 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 which are not disposed of in the ordinary course of business;
 - (ii) does not provide to the liquidator (or as directed by the liquidator) all the movable and immovable property of the company in his custody or under his control and which he is required by law to deliver up, or all books and papers in his custody or under his control belonging to the company and which he is required by law to deliver up;
 - (iii) makes any material omission in any statement relating to the affairs of the company;
 - (iv) knowing or believing that a false debt has been proved by any person, fails for a period of one month to inform the liquidator thereof;
 - (v) prevents the production of any book or paper affecting or relating to the property or affairs of the company;

³⁵ Section 336(2) CA.

³⁶ Section 336(2) CA.

³⁷ Sections 336(1)(a), (b), (d), (e), and (f) CA.

- (b) If any one of the above-mentioned elements is satisfied, liability is criminal and a person guilty of this offence is liable to a fine or imprisonment.
- (c) The following defences exist:
 - (i) in relation to (i)-(iii), it is a good defence that there was no intent to defraud;³⁸ and
 - (ii) in relation to (v), it is a good defence that there was no intent to conceal the state of affairs of the company or to defeat the law.³⁹

2.6 Default in complying with requirements relating to statement as to the company's affairs⁴⁰

- (a) Personal liability may attach to a person who defaults in complying with the requirements relating to the submission of a statement as to the company's affairs as at the date of the winding up. The statement of the company's affairs is to be submitted by the directors and secretary of the company and may also be required to be submitted by past or present officers of the company and / or promoters of the company.⁴¹
- (b) Liability is criminal and a person guilty of this offence is liable to a fine or imprisonment or to both and also to a default penalty.⁴²

2.7 Falsification or destruction of company's books⁴³

- (a) Personal liability may attach to every officer or contributory of a company who destroys, mutilates, alters or falsifies any books, papers or securities, or makes or was privy to the making of any false or fraudulent entry in any register or book account of document belonging to the company with intent to defraud or deceive any person.
- (b) Liability is criminal and a person guilty of this offence is liable to a fine or imprisonment.

2.8 Proper accounts not kept⁴⁴

- (a) Personal liability may attach to every officer of a company who is in default where it is shown that proper books of account were not kept by the company throughout the period of two years immediately preceding the commencement of an investigation into or the winding up of the company. Proper books of account shall be deemed not to have been kept if there have not been kept such books or accounts as are necessary to exhibit and explain the transactions entered into and financial position of the trade or business of the company.⁴⁵
- (b) Liability is criminal and a person guilty of this offence is liable to a fine or imprisonment.
- (c) It is a good defence for an officer that he has acted honestly and that, in the circumstances in which the business of the company was carried on, the default was excusable.⁴⁶

2.9 Misfeasance⁴⁷

- (a) Personal liability may attach to any person who has taken part in the formation or promotion of a company, or any past or present liquidator or officer, who has misapplied or retained or become liable or accountable for any money or property of the company or been guilty of any misfeasance or breach of trust or duty in relation to the company. This provision applies to the receipt of any money or property during the two years preceding the commencement of winding up.

³⁸ Section 336(2) CA.

³⁹ Section 336(2) CA.

⁴⁰ Section 270 CA.

⁴¹ See also Question 7.3.

⁴² Section 408 CA states that where a default penalty is provided, a person guilty of the offence shall be (a) guilty of a further offence if the offence continues after he is so convicted or after he has been so dealt with and (b) liable to an additional penalty for each day during which the offence so continues of not more than the amount expressed in the section as the amount of the default penalty or, if the amount is not so expressed, of not more than SG\$200.

⁴³ Section 338 CA.

⁴⁴ Section 339(1) CA.

⁴⁵ Section 339(2) CA.

⁴⁶ Section 339(1) CA.

⁴⁷ Section 341 CA.

- (b) Liability is civil and the Court may on the application of a liquidator or any creditor or contributory compel such person to repay or restore the money or property or any part thereof with interest at such rate as the Court thinks just or to contribute such sum to the assets of the company by way of compensation (as the Court thinks just).⁴⁸

2.10 Disqualification for acts done in the twilight period⁴⁹

- (a) An order disqualifying a person from being a director or in any way, whether directly or indirectly, being concerned in, or taking part in, the management of a company for a period not exceeding five years may be made where:⁵⁰
- (i) the person is or has been director of a company which has at any time gone into liquidation (whether while he was a director or within three years of his ceasing to be a director) and was insolvent at that time; and
 - (ii) that his conduct as director of that company either taken alone or together with his conduct as a director of any other company or companies makes him unfit to be a director of or in any way, whether directly or indirectly, be concerned in, or take part, in the management of a company.
- (b) Liability for acting in breach of a disqualification order is criminal and a person guilty of such an offence will be liable for a fine or imprisonment or to both.
- (c) Note that a person who is subject to a disqualification order may apply for leave of the Court to be concerned in or take part in the management of a company.⁵¹

QUESTION 3

3 Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 Persons other than formally-appointed directors who may be liable

3.1.1 *De facto* and shadow director

- (a) In addition to persons who are formally appointed as directors of a company, the term "director" as defined under Singapore law also includes "*de facto* directors" and "shadow directors".⁵² Persons considered to be *de facto* directors or shadow directors are subject to the usual duties incumbent on a director.

⁴⁸ Section 341(1) CA.

⁴⁹ Section 149(1) CA. For other grounds for disqualification of directors, see also ss. 154 and 155A CA.

⁵⁰ Under s. 149(6)(a) CA, in deciding whether or not to make a disqualification order, the Court shall consider the following matters: (i) whether there has been any misfeasance or breach of any fiduciary or other duty by the director in relation to the company; (ii) whether there has been any misapplication or retention by the director of, or any conduct by the director giving rise to an obligation to account for, any money or other property of the company; and (iii) the extent of the director's responsibility for any failure by the company to comply with ss. 138, 190, 191, 196B, 197, 199 and 201 CA. Further, under s. 149(6)(b) CA, the Court shall consider the following matters notwithstanding that the director has not been convicted or may be criminally liable (i) the extent of the director's responsibility for the causes of the company becoming insolvent; (ii) the extent of the director's responsibility for any failure by the company to supply any goods or services which have been paid for (in whole or in part); (iii) the extent of the director's responsibility for the company entering into any transaction liable to be set aside under s. 259 CA; (iv) whether the causes of the company becoming insolvent are attributable to its carrying on business in a particular industry where the risk of insolvency is generally recognised to be higher.

⁵¹ Section 149(13) CA.

⁵² Section 4(1) CA provides that "director" includes "any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the directors or the majority of the directors of a corporation are accustomed to act and an alternate or substitute director."

- (b) A *de facto* director is a person who acts as a director notwithstanding the fact that he has never been formally appointed as such.⁵³ Such a person is considered a director since S 4(1) CA defines a director to include “any person occupying the position of director of a corporation by whatever name called.”
- (c) A shadow director refers to a person who (in effect) stands behind the scenes and controls the decisions made by the majority of the directors.⁵⁴ Such a person is considered a director since S 4(1) CA defines a director to include “a person in accordance with whose directions or instructions the directors or the majority of the directors of a corporation are accustomed to act.”

3.1.2 Officer

- (a) Liability for certain acts identified in Question 2 above is also capable of being imposed on an “officer” of the company. Under S 4(1) CA, the term “officer”, in relation to a corporation, includes:
 - (i) any director or secretary of the corporation or a person employed in an executive capacity by the corporation;
 - (ii) a receiver and manager of any part of the undertaking of the corporation appointed under a power contained in any instrument; and
 - (iii) any liquidator of a company appointed in a voluntary winding up.
- (b) The term “officer” however does not include:
 - (i) any receiver who is not also a manager;
 - (ii) any receiver and manager appointed by the Court;
 - (iii) any liquidator appointed by the Court or by the creditors; or
 - (iv) a judicial manager appointed by the Court.

3.1.3 Contributory

- (a) In addition, liability for certain acts identified in Question 2 above is also capable of being imposed on a “contributory” of the company. Under S 4(1) CA, the term “contributory”, in relation to a company, means “a person liable to contribute to the assets of the company in the event of its being wound up”, and includes:
 - (i) the holder of fully paid shares in the company; and
 - (ii) prior to the final determination of the persons who are contributories, includes any person alleged to be a contributory.
- (b) Accordingly, although a holder of fully paid shares in a limited liability company does not have to contribute towards the assets of the company on winding up, such a person is nevertheless included in the definition of “contributory”. This includes the past and present members of the company.⁵⁵

⁵³ *Alrich Development Pte Ltd v Rafiq Jumabhoy* [1995] SGCA 53 at [52].

⁵⁴ *Heap Huat Rubber Company Sdn Bhd and Others v Kong Choot Sian and Others* [2004] SGCA 12 at [67].

⁵⁵ Section 250(1) CA.

3.2 Scope and extent of liability

Ref. ⁵⁶	Offence / act	Persons liable	Extent of liability ⁵⁷
2.1	Breach of directors' duties	Directors (including <i>de facto</i> and shadow director)	Same as for director
2.2	Insolvent trading	Officer of the company	Same as for director
2.3	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
2.4	Fraud in anticipation of winding up	Past or present officer or a contributory of a company	Same as for director
2.5	Misconduct in the course of winding up	Past or present officer or a contributory of a company	Same as for director
2.6	Default in complying with requirements relating to statement as to the company's affairs	Director and secretary of the company and may also include officers and / or promoters of the company	Same as for director
2.7	Falsification or destruction of company's books	Officer or contributory of a company	Same as for director
2.8	Proper accounts not kept	Officer of the company	Same as for director
2.9	Misfeasance	Any person who has taken part in the formation or promotion of the company or any past or present liquidator or officer of the company	Same as for director
2.10	Disqualification for acts done in the twilight period	Directors (including <i>de facto</i> and shadow director)	Same as for director

QUESTION 4

4 Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

⁵⁶ The reference in the foregoing column refers to the paragraph number with respect to question 2 above relating to actions potentially giving rise to liability for directors.

⁵⁷ Refer to the responses to question 6 below relating to the remedies available in respect of actions potentially giving rise to liability for directors.

4.1 Transactions at an undervalue⁵⁸

4.1.1 Overview

A liquidator or a judicial manager⁵⁹ may challenge a transaction entered into by a company up to five years before the commencement of a winding up or judicial management of the company which is at an undervalue, if the company was then insolvent or, as a result of the transaction, became insolvent.

4.1.2 Conditions for the setting aside of a transaction at undervalue are

- (a) The company has entered into a transaction which is at an undervalue.
 - (i) (i) A company enters into a transaction at an undervalue if the company makes a gift to a person or the company otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration.⁶⁰
 - (ii) Further, a company enters into a transaction at an undervalue if the company enters into a transaction with a person for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the other person.⁶¹
- (b) The transaction is entered into within the period commencing five years before the date on which an application for winding up or judicial management of the company is made.⁶²
- (c) At the time of the transaction, the company was insolvent⁶³ or as a consequence of the transaction became insolvent.⁶⁴ In this respect, there is a rebuttable presumption that the company was insolvent if the counterparty is the company's 'associate'.⁶⁵

4.1.3 Defences

- (a) The Court will not make an order on the basis that a transaction is at an undervalue if it is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business; and at the time it did so, there were reasonable grounds for believing that the transaction would benefit the company.⁶⁶
- (b) Further, a third party who acquires property from counterparty relevant company is protected if he acquires it in good faith, for value and without notice of the relevant circumstances.⁶⁷ Any benefit deriving from such an interest is also protected. In addition, a third party who receives a benefit from such a transaction is protected if he receives it in good faith, for value and without notice of the relevant circumstances.⁶⁸

4.2 Unfair preference⁶⁹

4.2.1 Overview

A liquidator or a judicial manager⁷⁰ may challenge a transaction entered into by a company within six months or two years (in respect of a transaction with the company's associate) before the commencement of a winding up or judicial management of the company which is an unfair preference, if the company was then insolvent or as a result of the transaction became insolvent.

⁵⁸ Section 98 BA read with s. 329(1) CA.

⁵⁹ Sections 98 BA and 227T(1) CA.

⁶⁰ Section 98(3)(a) BA. See also s. 331 CA.

⁶¹ Section 98(3)(c) BA.

⁶² Section 227T(2) CA.

⁶³ Pursuant to s. 110(4) BA, the company shall be insolvent if (a) it is unable to pay its debts as they fall due; or (b) the value of its assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

⁶⁴ Section 110(2) BA.

⁶⁵ Regulation 5 of Companies (Application of Bankruptcy Act Provisions) Regulations (Cap. 50, RG 3) (CABRA) provides that a company shall be regarded as an associate of another company if (a) the same person has control of both companies, or a person has control of one company and persons who are his associates, or he and persons who are his associates, have control of the other company; or (b) a group of 2 or more persons has control of each company, and such groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person of whom he is an associate.

⁶⁶ Regulation 6 CABRA.

⁶⁷ Section 102(3)(a) BA.

⁶⁸ Section 102(3)(b) BA.

⁶⁹ Section 99 BA read with s. 329(1) CA.

⁷⁰ Sections 99 BA and 227T(1) CA.

4.2.2 Conditions for setting aside an unfair preference

- (a) The company has entered into a transaction which gave a creditor of the company a factual preference.⁷¹ In determining whether a creditor of the company has been factually preferred, the acid test is whether what was done by the company has the effect of disturbing the statutory order of priorities in an insolvent liquidation as measured at the time of the transaction.
- (b) The company was influenced by the desire to prefer that creditor.⁷²
- (i) The test is not whether there is a dominant intention to prefer, but whether the company's decision was influenced by a desire to prefer the creditor.⁷³ The Court will consider the desire (the subjective state of mind) of the company to determine whether it had positively wished to improve the creditor's position in the event of its own insolvent liquidation. It is sufficient that the desire to prefer is one of the factors which influenced the decision to enter into the transaction; it need not be the sole or decisive factor. A transaction which is actuated by proper commercial considerations may not constitute a voidable preference. A genuine belief in the existence of a proper commercial consideration may be sufficient even if, objectively, such a belief might not be sustainable. Exertion of pressure by the creditor does not negate the desire to prefer.⁷⁴
- (ii) The desire to prefer relates to the producing of the effect of a preference and has nothing to do with knowledge of one's own insolvency.⁷⁵ Therefore, in establishing the company's desire to prefer, it is not required that the company have knowledge of insolvency or impending insolvency.
- (iii) The relevant time in determining whether the company had the requisite desire to prefer is the time when the creditor received the preference, and not when it was promised the preference.⁷⁶
- (iv) There is a rebuttable presumption that the company had the desire to prefer if the creditor is the company's associate⁷⁷ (except an employee).⁷⁸ To rebut this presumption, it must be shown that the transaction was not influenced at all by any desire to prefer.⁷⁹
- (c) With respect to an unfair preference to a person who is not an associate of the company, the unfair preference must occur within the period commencing six months before the date on which an application for the winding up or judicial management of the company is made.⁸⁰ With respect to unfair preference to a person who is an associate of the company, the unfair preference must occur within the period commencing two years before the date on which an application for the winding up or judicial management of the company is made.⁸¹
- (d) At the time of the transaction, the company was insolvent or as a result of the transaction became insolvent.⁸² In this respect, there is a rebuttable presumption that the company was insolvent if the counterparty is the company's "associate".⁸³

⁷¹ Section 99(3) BA.

⁷² Section 99(4) BA.

⁷³ *Coöperatieve Centrale Raiffeisen-Boerenleenbank BA (trading as Rabobank International, Singapore Branch) v Jurong Technologies Industrial Corp Ltd (under judicial management)* [2011] 4 SLR 977 at [24], approving Millet J's statement in *Re MC Bacon Ltd* [1990] BCLC 324.

⁷⁴ *Coöperatieve Centrale Raiffeisen-Boerenleenbank BA (trading as Rabobank International, Singapore Branch) v Jurong Technologies Industrial Corp Ltd (under judicial management)* [2011] 4 SLR 977 at [41]. The Singapore Court of Appeal has rejected the argument that there was no desire to prefer because the payment to the creditor which amounts to an unfair preference was given under great pressure by the creditor. The Singapore Court of Appeal noted that the other creditors exerted pressure just as much as that creditor did the same.

⁷⁵ *Coöperatieve Centrale Raiffeisen-Boerenleenbank BA (trading as Rabobank International, Singapore Branch) v Jurong Technologies Industrial Corp Ltd (under judicial management)* [2011] 4 SLR 977 at [31].

⁷⁶ *Coöperatieve Centrale Raiffeisen-Boerenleenbank BA (trading as Rabobank International, Singapore Branch) v Jurong Technologies Industrial Corp Ltd (under judicial management)* [2011] 4 SLR 977 at [34].

⁷⁷ For a definition of "associate", see regs. 5 and 6 of CABRA.

⁷⁸ Section 99(4) BA.

⁷⁹ *Chee Yoh Chuang and Another (as Liquidators of Progen Engineering Pte Ltd (In Liquidation)) v Progen Holdings Ltd* [2010] SGCA 31 at [36]. The Singapore Court of Appeal noted that it is never sufficient, where there is objective evidence of a preferential payment to benefit a related party in the event of an insolvent liquidation, for the directors of the company to simply deny the existence of such a desire.

⁸⁰ Section 101(1)(c) BA and s. 227T(2) CA.

⁸¹ Section 101(1)(b) BA and s. 227T(2) CA.

⁸² Section 110(2) BA.

⁸³ Regulation 5 of Companies (Application of Bankruptcy Act Provisions) Regulation (Cap. 50, RG 3) (CABRA) provides that a company shall be regarded as an associate of another company if (a) the same person has control of both companies, or a person has control of one company and persons who are his associates, or he and persons who are his associates, have control of the other company; or (b) a group of 2 or more persons has control of each company, and such groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person of whom he is an associate.

4.2.3 Defences

- (a) A third party who acquires property from a preferred creditor is protected if he acquires it in good faith, for value and without notice of the relevant facts. Any benefit deriving from such an interest is also protected.⁸⁴
- (b) A third party who receives a benefit from the preference is protected if he receives it in good faith, for value and without notice of the relevant facts.⁸⁵

4.3 Transactions defrauding creditors⁸⁶

4.3.1 Overview

Where a transaction is a conveyance of property (whether real or personal) which was made with the intent to defraud creditors, a person who is prejudiced by the transaction may apply to Court to have the transaction avoided provided that the conveyance was not made to a person for valuable consideration and in good faith.

4.3.2 Conditions for setting aside a transaction defrauding creditors⁸⁷

- (a) The company has entered into a conveyance of property (either personal or real property) with the intent to defraud creditors.
- (b) It is not necessary that the company must be in liquidation or judicial management.

4.3.3 The provision relating to transactions defrauding creditors does not extend to any interest of property disposed of for valuable consideration⁸⁸ and in good faith or upon good consideration and in good faith to any person not having, at the time of disposition, notice of the intent to defraud creditors.⁸⁹

4.4 Transactions entered into in breach of director's duties⁹⁰

Transactions which the directors caused the company to enter into in breach of their duties to the company may be challenged and avoided if the counterparty knew or ought to have known of the director's breach of duties.⁹¹

4.5 Extortionate credit transactions⁹²

4.5.1 Overview

A liquidator or a judicial manager⁹³ may challenge a transaction relating to the provision of credit to a company which is or was extortionate and was entered into within three years before the commencement of a winding up or judicial management of the company.⁹⁴

4.5.2 Conditions for setting aside an extortionate credit transaction

- (a) The company has entered into a transaction for or involving the provision to it of credit which is or was extortionate. A transaction is considered extortionate if, having regard to the risk accepted by the person providing the credit:⁹⁵

⁸⁴ Section 102(3)(a) BA.

⁸⁵ Section 102(3)(b) BA.

⁸⁶ Section 73B Conveyancing and Law of Property Act (Cap. 61) (CLPA).

⁸⁷ Section 73B(1) CLPA.

⁸⁸ In determining whether "valuable consideration" or "good consideration" has been provided, the Court will have regard to the value of the property and assess whether the consideration provided is adequate: see *Wong Ser Wan v Ng Bok Eng Holdings Pte Ltd and another* [2004] 4 SLR(R) 365 at [50] to [56] and [62], affirmed on appeal in *Ng Bok Eng Holdings Pte Ltd and another v Wong Ser Wan* [2005] 4 SLR(R) 561.

⁸⁹ Section 73B(3) CLPA.

⁹⁰ Section 157 CA.

⁹¹ *Re David Payne & Co Ltd* [1904] 2 Ch 608; *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246; *Criterion Properties plc v Stratford UK Properties LLC* [2004] 1 WLR 1846.

⁹² Section 103 BA read with s. 329(1) CA.

⁹³ Section 99 BA grants the locus *standi* solely to "Official Assignee". This implies that the liquidator has the locus *standi* to bring an action under the provision. The judicial manager's power to make such an action is conferred under s. 227T(1) CA.

⁹⁴ Section 103(2) BA.

⁹⁵ Section 103(3) BA.

- (i) 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
 - (ii) it is harsh and unconscionable or substantially unfair.
- (b) The transaction was entered into within three years prior to the date on which an application for winding up or judicial management of the company is made.⁹⁶

4.6 Floating charges for past value⁹⁷

4.6.1 Overview

A liquidator (and possibly a judicial manager)⁹⁸ may challenge a floating charge created in the six months prior to the commencement of a winding up (or a judicial management) unless the chargee proves that the company was solvent immediately after the creation of the charge.⁹⁹

If the company was insolvent immediately after the creation of the charge, the floating charge will be invalid except to the amount of any cash paid to the company contemporaneously with or subsequent to the creation of the charge together with interest on that amount at the rate of 5% per annum.¹⁰⁰

4.6.2 Condition for setting aside a floating charge for past value

- (a) A floating charge is created within six months prior to the date on which an application for the winding up (or judicial management) of a company is made.
- (b) The company was insolvent immediately after the creation of the charge.

4.7 Registerable but unregistered charge¹⁰¹

If a registerable charge¹⁰² is not registered within 30 days after creation, the charge shall be void against the liquidator and any creditor of the company. Note, however, that the Court has the discretion to grant an extension of time to register charges.¹⁰³

4.8 Post-application disposition¹⁰⁴

Any disposition of the property of the company and any transfer of shares or alteration in the status of the members of the company made after the date on which the winding up application was made is void, unless the Court otherwise orders.¹⁰⁵

⁹⁶ Section 103(2) BA.

⁹⁷ Section 330 CA.

⁹⁸ To avail itself of the remedies under this provision, the judicial manager is required to apply to the Court pursuant to s. 227X(b).

⁹⁹ Section 330 CA.

¹⁰⁰ Section 330 CA. If the effect of a payment made to the company is merely to substitute an unsecured debt for a secured debt, then the payment will not be considered in substance a payment to the company and will not be secured by the floating charge: *Re Fairway Magazines Ltd* [1993] BCLC 643 at p 652.

¹⁰¹ Section 131(1) CA.

¹⁰² Pursuant to s. 131(3) CA, the following charges are required to be registered: (a) a charge to secure any issue of debentures; (b) a charge on uncalled share capital of a company; (c) a charge on shares of a subsidiary of a company which are owned by the company; (d) a charge created or evidenced by an instrument which if executed by an individual, would require registration as a bill of sale; (e) a charge on land wherever situated or any interest therein but not including any charge for any rent or other periodical sum issuing out of land; (f) a charge on book debts of the company; (g) a floating charge on the undertaking or property of a company; (h) a charge on calls made but not paid; (i) a charge on a ship or aircraft or any share in a ship or aircraft; or (j) a charge on goodwill, on a patent or a licence under a patent, on a trade mark or a licence to use a trade mark, or on a copyright or a licence under a copyright or on a registered design or a licence to use a registered design.

¹⁰³ Section 137 CA. The Singapore Court of Appeal in *Media Development Authority of Singapore v Sculptor Finance (MD) Ireland Ltd* [2013] SGCA 58 at [33] states that the Court's discretionary jurisdiction to extend time for registration of a charge under s. 137 CA arises only if there is sufficient evidence: (a) that the omission to register the charge was: (i) accidental; (ii) due to inadvertence; (iii) due to some other sufficient cause; (iv) not of a nature to prejudice the position of creditors or shareholders; or (b) that it is just and equitable to grant relief on other grounds. Satisfying one of these limbs is a necessary but insufficient criteria to obtain an extension of time. The applicant must go on to persuade the Court to exercise the discretion in its favour.

¹⁰⁴ Section 259 CA.

¹⁰⁵ The Court's discretion is at large in determining whether or not to validate a disposition of the company's property. In this regard, the basic principle of *pari passu* distribution among creditors would generally be respected (see for example the discussion in *Power Knight Pte Ltd v Natural Fuel Pte Ltd (in compulsory liquidation) and others* [2010] 3 SLR 82).

4.9 Disclaimer of onerous property¹⁰⁶

The liquidator of a company may, with the leave of the Court, disclaim the following property of the company at any time within 12 months of the commencement of winding up or such extended period as is allowed by the Court:¹⁰⁷

- (a) any estate or interest in land which is burdened with onerous covenants;
- (b) shares in corporations;
- (c) unprofitable contracts;¹⁰⁸ or
- (d) any other property that is unsaleable, or not readily saleable, by reason of its binding the possessor thereof to the performance of any onerous act, or to the payment of any sum of money.

Note however that the liquidator is not entitled to use his power of disclaimer to disturb accrued rights and liabilities.¹⁰⁹

QUESTION 5

5 Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Criminal proceedings

5.1.1 An action may be brought by the Public Prosecutor, the Registrar (with the authorisation of the Public Prosecutor),¹¹⁰ a liquidator (with the direction of the Court)¹¹¹ or any other person (with the consent of the Minister)¹¹² against the directors and / or others involved.

Such criminal offences include:

- (a) breach of duties of directors and / or officers under S 157 CA;
- (b) insolvent trading under Ss 339(3) and 340(5) CA;
- (c) fraudulent trading under Ss 340(1) and 340(5) CA;
- (d) fraud in anticipation of winding up under Ss 338(1)(c), 338(1)(g) and 336(h) CA;
- (e) misconduct in the course of winding up under Ss 336(1)(a), (b), (d), (e) and (f) CA;
- (f) default in complying with requirements relating to statement as to the company's affairs under S 270 CA;
- (g) falsification or destruction of company's books under S 338 CA;

¹⁰⁶ Section 332 CA.

¹⁰⁷ Note that if such property has not come to the knowledge of the liquidator within one month after the commencement of the winding up, the power of disclaiming may be exercised at any time within 12 months after he has become aware thereof or such extended period as is allowed by the Court.

¹⁰⁸ A contract is unprofitable for the purposes of s. 332 CA if it imposes on the company continuing financial obligations which may be regarded as detrimental to the creditor, which presumably means that the contract confers no sufficient reciprocal benefit. A contract is however not unprofitable merely because the company could have made or could make a better bargain. Contracts which will delay the winding up of the company's affairs because they are to be performed over a substantial period of time and will involve expenditure that may not be recovered are unprofitable. See *Transmetro Corporation Ltd v Real Investments Pty Ltd & Anor* [1999] 17 ACLC 1314; *Re SSSL Realisations (2002) Ltd (In Liquidation) & Anor* [2007] 1 BCLC 29.

¹⁰⁹ *Re Bastable* [1901] 2 KB 518.

¹¹⁰ Section 409(1) CA.

¹¹¹ Section 342(1) CA.

¹¹² Section 409(1) CA.

- (h) proper accounts not kept under S 339(1) CA; and
- (i) disqualification for acts done in the twilight period under sections 149(1) and 154 CA.

5.2 Civil proceedings

- 5.2.1 In relation to civil proceedings, a liquidator¹¹³ or a judicial manager¹¹⁴ primarily has the ability to bring actions against directors and other persons when a company goes into liquidation or judicial management. However, in certain situations, the law allows a wider range of persons to bring an action to recover funds in the interests of the creditors.
- 5.2.2 The table below sets out the parties who may initiate an action against the directors and others in connection with certain situations.

Ref. ¹¹⁵	Offence / act	Who may bring action against directors / other persons
2.1	Breach of directors' duties	Liquidator, judicial manager or shareholders ¹¹⁶
2.2	Insolvent trading	Liquidator or any creditor or contributory of the company ¹¹⁷
2.3	Fraudulent trading	Liquidator or any creditor or contributory of the company ¹¹⁸
2.9	Misfeasance	Liquidator or any creditor or contributory of the company ¹¹⁹

¹¹³ Section 272(2)(a) CA.

¹¹⁴ Section 227G(4) CA read with para. (e) of the Eleventh Schedule CA.

¹¹⁵ The reference in the foregoing column refers to the paragraph number with respect to question 2 above relating to actions potentially giving rise to liability for directors.

¹¹⁶ Through the derivative action under s. 216A CA.

¹¹⁷ Section 340(2) CA.

¹¹⁸ Section 340(1) CA.

¹¹⁹ Section 341(1) CA.

QUESTION 6

6 Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

Ref. ¹²⁰	Offence / act	Remedy available
2.1	Breach of directors' duties	(a) For duties at general law, directors are personally liable for any loss suffered by the company as a result of their breach of duty. If the breach relates to self-dealing, the contract will not be enforceable. ¹²¹ If the breach relates to transaction with third parties, the transaction may be avoided if the third party knew or ought to have known of the director's breach of duty. ¹²² (b) For duties under S 157 CA, directors are liable to the company for any profit made by him or for any damage suffered by the company as a result of the breach; and liable on conviction to a fine not exceeding SG\$5,000 or to imprisonment for a term not exceeding 12 months. ¹²³
2.2	Insolvent trading	(a) Criminal liability to a fine not exceeding SG\$2,000 or to imprisonment of a term not exceeding three months. ¹²⁴ (b) Personal liability without any limitation of liability for the payment of the whole or any part of the debt. ¹²⁵
2.3	Fraudulent trading	(a) Criminal liability to a fine not exceeding SG\$15,000 or to imprisonment for a term not exceeding seven years or to both. ¹²⁶ (b) Personal liability, without limitation, for knowing parties for all or any of the debts or other liabilities of the company as the Court directs. ¹²⁷
2.4	Fraud in anticipation of winding up	Criminal liability to pay a fine not exceeding SG\$10,000 or to imprisonment of a term not exceeding two years. ¹²⁸
2.5	Misconduct in the course of winding up	Criminal liability to pay a fine not exceeding SG\$10,000 or to imprisonment of a term not exceeding two years. ¹²⁹

¹²⁰ The reference in the foregoing column refers to the paragraph number with respect to questions 2 and 4 above relating to actions giving rise to liability for directors and transactions during the twilight period.

¹²¹ *Lim Koei Ing v Pan Asia Shipyard & Engineering Co Pte Ltd* [1995] 1 SLR(R) 15; *Goh Kim Hai Edward v Pacific Can Investment Holdings Ltd* [1996] 1 SLR(R) 540.

¹²² *Re David Payne & Co Ltd* [1904] 2 Ch 608; *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246; *Criterion Properties plc v Stratford UK Properties LLC* [2004] 1 WLR 1846.

¹²³ Section 157(3) CA.

¹²⁴ Section 339(3) CA.

¹²⁵ Section 340(2) CA.

¹²⁶ Section 340(5) CA.

¹²⁷ Section 340(1) CA.

¹²⁸ Section 336(1) CA.

¹²⁹ Section 336(1) CA.

Ref. ¹²⁰	Offence / act	Remedy available
2.6	Default in complying with requirements relating to statement as to the company's affairs	Criminal liability to pay a fine not exceeding SG\$5,000 or to imprisonment of a term not exceeding 12 months or to both and also to a default penalty. ¹³⁰
2.7	Falsification or destruction of company's books	Criminal liability to pay a fine not exceeding SG\$10,000 or to imprisonment of a term not exceeding two years. ¹³¹
2.8	Proper accounts not kept	Criminal liability to pay a fine not exceeding SG\$5,000 or to imprisonment of a term not exceeding 12 months. ¹³²
2.9	Misfeasance	Repay or restore the money or property or any part thereof with interest at such rate as the court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misfeasance as the court thinks just. ¹³³
2.10	Disqualification for acts done in the twilight period	Disqualification from being a director or in any way, whether directly or indirectly, being concerned in, or taking part in, the management of a company during a period not exceeding five years. ¹³⁴
4.1	Transactions at an undervalue	<p>The Court is entitled to make such order as it thinks fit for restoring the position to what it would have been if the company had not entered into the transaction.¹³⁵ In this regard, the Court may:¹³⁶</p> <ul style="list-style-type: none"> (a) require any property transferred as part of the transaction to be vested in the liquidator; (b) require any property to be so vested if it represents in any person's hands the application of the proceeds of sale of property so transferred or of money so transferred; (c) release or discharge (in whole or in part) of any security given by the company; (d) require any person to pay, in respect of benefits received by him from the company, such sums to the liquidator as the Court may direct; (e) provide for any surety or guarantor whose obligations to any person were released or discharged (in whole or in part) under the transaction to be under such new or revived obligations to that person 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 the security or charge to have the same priority as a security or charge released or discharged (in whole or in part) under or by the transaction; and / or

¹³⁰ Section 270 CA.

¹³¹ Section 338 CA.

¹³² Section 339(1) CA.

¹³³ Section 341 CA.

¹³⁴ Section 149(1) CA.

¹³⁵ Section 98(2) BA.

¹³⁶ Section 102(1) BA. This is a non-exhaustive list of the orders which the Court may make.

Ref. ¹²⁰	Offence / act	Remedy available
		(g) provide for the extent to which any person whose property is vested by the order in the liquidator, or on whom obligations are imposed by the order, is to be able to provide in the winding up for debts or other liabilities which arose from, or were released or discharged (in whole or in part) under or by the transaction.
4.2	Unfair preference	<p>The court is entitled to make such order as it thinks fit for restoring the position to what it would have been if the company had not given the unfair preference.¹³⁷ In this regard, the court may:¹³⁸</p> <ul style="list-style-type: none"> (a) require any property transferred in connection with the giving of the preference to be vested in the liquidator; (b) require any property to be so vested if it represents in any person's hands the application of the proceeds of sale of property so transferred or of money so transferred; (c) release or discharge (in whole or in part) of any security given by the company; (d) require any person to pay, in respect of benefits received by him from the company, such sums to the liquidator as the court may direct; (e) provide for any surety or guarantor whose obligations to any person were released or discharged (in whole or in part) by the giving of the preference to be under such new or revived obligations to that person 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 the security or charge to have the same priority as a security or charge released or discharged (in whole or in part) under or by the giving of the unfair preference; and / or (g) provide for the extent to which any person whose property is vested by the order in the liquidator, or on whom obligations are imposed by the order, is to be able to provide in the winding up for debts or other liabilities which arose from, or were released or discharged (in whole or in part) under or by the giving of the preference.
4.3	Transactions defrauding creditors	The impugned transaction is voidable. ¹³⁹
4.4	Transactions entered into in breach of director's duties	The impugned transaction is voidable if the counterparty knew or ought to have known of the director's breach of duties. ¹⁴⁰

¹³⁷ Section 99(2) BA.

¹³⁸ Section 102(1) BA. This is a non-exhaustive list of the orders which the Court may make.

¹³⁹ Section 73B(1) CLPA.

¹⁴⁰ *Re David Payne & Co Ltd* [1904] 2 Ch 608; *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246; *Criterion Properties plc v Stratford UK Properties LLC* [2004] 1 WLR 1846.

Ref. ¹²⁰	Offence / act	Remedy available
4.5	Extortionate credit transactions	The Court may order one or more of the following: ¹⁴¹ (a) provision setting aside the whole or part of any obligation created by the transaction; (b) provision varying the terms of the transaction or varying the terms on which any security for the purposes of the transaction is held; (c) provision requiring any person who is or was party to the transaction to pay to the liquidator any sums paid to that person; (d) provision requiring any person to surrender to the liquidator any property held by him as security for the purposes of the transaction; and / or (e) provision directing accounts to be taken between any persons.
4.6	Floating charges for past value	The Court can declare that the floating charge is invalid in whole or in part. ¹⁴²
4.7	Registerable but unregistered charge	The charge will be void against the liquidator and the other secured creditors. ¹⁴³
4.8	Post-application disposition	The impugned transaction is void unless the Court otherwise orders. ¹⁴⁴

QUESTION 7

7 Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Obligation to co-operate and provide information

7.1.1 In a winding up process

- (a) There is an obligation on every person who is a past or present officer or a contributory of a company to fully and truly disclose to the liquidator all the movable and immovable property of the company, and how and to whom and for what consideration and when the company disposed of any part thereof (except such part as has been disposed of in the ordinary way of the business of the company) to the best of the person’s knowledge and belief.¹⁴⁵
- (b) Any person who does not so disclose to the liquidator is guilty of an offence and is liable upon conviction to a fine not exceeding SG\$10,000 or to imprisonment for a term not exceeding two years.¹⁴⁶

¹⁴¹ Section 103(4) BA.

¹⁴² Section 330 CA.

¹⁴³ Section 131(1) CA.

¹⁴⁴ Section 259 CA.

¹⁴⁵ Section 336(1)(a) CA.

¹⁴⁶ Section 336(1) CA.

7.1.2 In a judicial management process

- (a) The following persons are under an obligation to provide the judicial manager with such information concerning the company and its promotion, formation, business, dealings, affairs or property and attend on the judicial manager at such times as the judicial manager may reasonably require:¹⁴⁷
- (i) those who are or have at any time been officers of the company;
 - (ii) those who have taken part in the formation of the company at any time within one year before the date of the judicial management order; and
 - (iii) those who are in the employment of the company, or have been in its employment, and are, in the judicial manager’s opinion, capable of giving information which he requires.
- (b) If a person, without reasonable excuse, fails to comply with any obligation imposed by this section, he shall be guilty of an offence and shall be liable on conviction to a fine not exceeding SG\$10,000 and also to a default penalty.¹⁴⁸

7.2 Obligation to assist with getting in the company’s property

7.2.1 In a winding up process

- (a) There is an obligation on every person who is a past or present officer or a contributory of a company to deliver up to the liquidator all the movable property, immovable property, books and papers of the company in his custody or under his control and which he is required by law to deliver up.¹⁴⁹
- (b) Any person who does not deliver up such property when directed by the liquidator is guilty of an offence and is liable upon conviction to a fine not exceeding SG\$10,000 or to imprisonment for a term not exceeding two years.¹⁵⁰

7.2.2 In a judicial management process

A contributory or member of the company, any previous receiver and manager of the company’s property, and any trustee, banker, agent or officer of the company who possess or control any property books, papers or records to which the company appears to be entitled to are obligated to pay, deliver, convey, surrender or transfer the property, books, papers or records to the judicial manager.¹⁵¹

7.3 Company’s statement of affairs

7.3.1 In a winding up process

- (a) Persons who are or have been officers of the company or who have taken part in the formation of the company at any time within one year before the date of a winding up order are under the obligation to make a statement of the company’s affairs to be submitted to the liquidator within 14 days of the date of the winding up order or such time as extended by the liquidator or the Court.¹⁵²
- (b) The company’s statement of affairs consists of the particulars of the company’s assets, debts and liabilities, the names and addresses of its creditors, the securities held by the creditors respectively, the dates when the securities are respectively given, and such further information as the liquidator requires.¹⁵³

¹⁴⁷ Section 227V CA.

¹⁴⁸ Section 227V(3) CA.

¹⁴⁹ Section 336(1)(b) CA.

¹⁵⁰ Section 336(1) CA.

¹⁵¹ Section 227U CA.

¹⁵² Section 270(2) CA.

¹⁵³ Section 270(2) CA.

- (c) Any person who does not comply with this provision is guilty of an offence and is liable upon conviction to a fine not exceeding SG\$5,000 or to imprisonment for a term not exceeding 12 months or to both and also to a default penalty.¹⁵⁴

7.3.2 In a judicial management process

- (a) Persons who are or have been officers of the company, who have taken part in the company's formation at any time within one year before the date of the judicial management order and who are or have been employees of the company and are in the judicial manager's opinion capable of giving the information are under an obligation to submit to the judicial manager a statement of the company's statement of affairs within 21 days after receipt of the company notice of the judicial management order, or as extended by the judicial manager but in any event within two months.¹⁵⁵
- (b) The company's statement of affairs consists of particulars of the company's assets, debts and liabilities; the names and addresses of its creditors; the securities held by the creditors respectively; and the dates when the securities were respectively given.¹⁵⁶
- (c) Any person who does not comply is guilty of an offence and is liable upon conviction to a fine not exceeding SG\$10,000 and also to a default penalty.¹⁵⁷

7.4 Examination of officers

7.4.1 In a winding up process

- (a) The Court may summon before it
- (i) any officer of the company;
 - (ii) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; or
 - (iii) any person whom the Court thinks capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company,
- and the Court may examine such person on oath either orally or on written interrogatories and may cause to be made a record of his answers.¹⁵⁸ Any such record may be used in evidence in any legal proceedings against such person.
- (b) Additionally, if the liquidator is of the opinion that a fraud has been committed, or that any material fact has been concealed by any person in the promotion or formation of a company or by any officer in relation to a company since its formation, or that any officer of a company has failed to act honestly or diligently or has been guilty of any impropriety or recklessness in relation to the affairs of the company, the liquidator may apply to Court to put the relevant persons for examination.¹⁵⁹ The persons that may be directed by the Court to be publicly examined include any person:¹⁶⁰
- (i) who was previously an officer of the company, including any banker, solicitor or auditor;
 - (ii) who is known or suspected to have in his possession any property of the company or is supposed to be indebted to the company; or
 - (iii) whom the Court considers capable of giving information concerning the promotion, formation, trade dealings, affairs or property of the company.

¹⁵⁴ Section 270(5) CA.

¹⁵⁵ Section 227K(2) CA.

¹⁵⁶ Section 227L(1) CA.

¹⁵⁷ Section 227L(4) CA.

¹⁵⁸ Section 285 CA. For an example, see *PricewaterhouseCoopers LLP and others v Celestial Nutrifoods Ltd (in compulsory liquidation)* [2015] 3 SLR 665

¹⁵⁹ Section 286(1) CA.

¹⁶⁰ Section 286(1) CA.

7.4.2 In a judicial management process

(a) The Court may, on the application of the judicial manager, summon to appear before it:

- (i) any officer of the company;
- (ii) any person known or suspected to have in his possession any property of the company or supposed to be indebted to the company; or
- (iii) any person whom the Court thinks capable of giving information concerning the promotion, formation, business, dealings, affairs or property of the company,

and the Court may require any such person to submit an affidavit to the Court containing an account of his dealings with the company or to produce any books, papers or other records in his possession or under his control relating to the company or any relevant matters¹⁶¹.

(b) In addition, the Court may make orders:

- (i) for the arrest of that person and for the seizure of any books, papers, records, money or goods in that person's possession;¹⁶²
- (ii) for that person to be examined on oath, either orally or by interrogatories, concerning the company or relevant matters;¹⁶³
- (iii) for that person to delivery any property of the company which is in the person's possession;¹⁶⁴ or
- (iv) for that person to pay to the judicial manager the whole or any part of the amount due if the person is indebted to the company.¹⁶⁵

QUESTION 8

8 Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation period

8.1.1 Limitation period for criminal proceedings

No limitation periods apply to actions attracting criminal liability referred to above.

8.1.2 Limitation period for civil actions

(a) The limitation period for civil actions is governed by the Limitation Act, with a general time bar of six years from the date on which the cause of action accrued.¹⁶⁶

¹⁶¹ Section 227W CA.

¹⁶² This is where the person, without reasonable excuse, fails to appear before the Court when he is summoned to do so or where there are reasonable grounds for believing that a person has absconded, or is about to abscond, with a view to avoid his appearance before the Court (s. 227W(2) CA).

¹⁶³ Section 227W(3) CA.

¹⁶⁴ This is upon the application of the judicial manager and where it appears to the Court that the person has in his possession any property of the company (s. 227W(4) CA).

¹⁶⁵ Section 227W(5) CA.

¹⁶⁶ Section 6 Limitation Act (Cap. 163) (Limitation Act).

- (b) In relation to a director's breach of fiduciary duties, the six-year time bar in S 6 of the Limitation Act generally applies.¹⁶⁷ However, if the claim is characterized as a fraud or 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, the six-year time bar is lifted.¹⁶⁸
- (c) In relation to actions based upon fraud, the period of limitation shall not begin to run until the plaintiff has discovered the fraud, or could with reasonable diligence have discovered it.¹⁶⁹

8.2 Appeals

8.2.1 Appeal process for criminal proceedings

Where criminal proceedings are commenced in the District Court or the Magistrate Court, any judgment, sentence or order pronounced can be appealed to the High Court.¹⁷⁰ In the alternative, where criminal proceedings are commenced in the High Court, any judgment, sentence or order pronounced can be appealed to the Court of Appeal.¹⁷¹

8.2.2 Appeal process for civil actions

An appeal from a decision of a District Court, Magistrates' Court or the Registrar of the High Court lies to the High Court.¹⁷² An appeal from the decision of the High Court lies to the Court of Appeal.¹⁷³

QUESTION 9

9 Foreign corporations

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

9.1 Foreign companies under insolvency process in Singapore

- (a) The ability to enforce the rights and duties of directors will usually be undertaken by a liquidator in the winding up process of the company. Consequently, the ability to bring Singapore insolvency law actions against directors of foreign companies will, first and foremost, depend on the jurisdiction of the Singapore Court to wind up the foreign company.¹⁷⁴ In this regard, for the Singapore Court to have jurisdiction to make a winding up order in respect of a foreign company, it must be shown either that the foreign company has assets in Singapore or that the foreign company has a sufficient nexus or connection with Singapore.¹⁷⁵
- (b) Note that the Singapore Court does not have jurisdiction to put a foreign company in to judicial management.

¹⁶⁷ *Dynasty Line Ltd (in liquidation) v Sukanto Sia and another and another appeal* [2014] 3 SLR 277 at [53]; See also s. 6(7) Limitation Act.

¹⁶⁸ Section 22(1)(a) Limitation Act. In *Dynasty Line Ltd (in liquidation) v Sukanto Sia and another and another appeal* [2014] 3 SLR 277, the issue before the Court was whether the claim by the liquidators of a company against its directors for breach of fiduciary duties was time-barred, and if so, whether the exceptions in s. 22 Limitation Act were applicable. The Singapore Court of Appeal held that if directors had disposed of company's assets in breach of their fiduciary duties because they failed to act honestly and in good faith in the best interests of the company, their conduct would be considered fraudulent under s. 22(1)(a) Limitation Act and the exception therein would apply.

¹⁶⁹ Section 29 Limitation Act.

¹⁷⁰ Section 377(1) Criminal Procedure Code (Cap. 68) (CPC). The appeal can be made (a) against that judgment, sentence order in respect of any error in law or in fact; or (b) in an appeal against sentence, on the ground that the sentence imposed is manifestly excessive or manifestly inadequate.

¹⁷¹ Section 377(1) CPC.

¹⁷² There is an automatic right of appeal from any judgment, order or decision of the Registrar to a Judge in chambers (Order 56, r. 1 of the Rules of Court (Cap. 322, R 5)). In relation to an appeal from the District Court and the Magistrate Court to the High Court, note that there are matters and orders which are non-appealable or can only be appealed with leave of the Court (ss. 21 and 83 Supreme Court of Judicature Act (SCJA)).

¹⁷³ In relation to an appeal from the High Court to the Court of Appeal, note that there are matters and orders which are non-appealable or can only be appealed with leave of the Court (ss. 34 and 83 SCJA).

¹⁷⁴ See also s. 350(2) CA which states that the Court and the liquidator may exercise any powers to do any act in the case of unregistered companies (i.e. any foreign company).

¹⁷⁵ *Re Projector SA* [2009] 2 SLR(R) 151 at [26]; *Re Griffin Securities Corp* [1999] 1 SLR(R) 219 at [17].

9.2 Foreign companies wound up in foreign jurisdiction

- (a) A foreign liquidator's powers and functions under Singapore law are limited to collecting and recovering the assets of the foreign company.¹⁷⁶ A foreign liquidator does not have the powers and functions of a liquidator appointed by the Singapore Court. In this regard, unless the foreign company is wound up in Singapore, the provisions outlined above generally cannot be enforced by the foreign liquidator.
- (b) It is noted, however, that the recent development in English law relating to the exercise of the Court's inherent power to assist foreign liquidators to set aside preferences and transactions defrauding creditors is of persuasive value in the Singapore Court and may be followed.¹⁷⁷

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 Indemnity and insurance

- (a) Any provision (whether in the constitution of the company or in a contract or otherwise) indemnifying a director against any liability for negligence, default, breach of duty or breach of trust is generally void.¹⁷⁸ A third party indemnity (i.e. indemnity against liability incurred by the officer to a person other than the company) is excepted insofar as the indemnity is not against any liability of the officer to pay a fine in criminal proceedings, or a penalty for non-compliance with regulatory requirements, or any liability incurred by the officer in defending criminal proceedings in which he is convicted or in defending civil proceedings brought by the company or a related company in which judgment is given against him or in connection with the application for relief of a breach from the Court.¹⁷⁹
- (b) A company is, however, not prevented from purchasing or maintaining for any officer insurance against such liability.¹⁸⁰

The information provided in this country chapter is correct as at 01/03/2017

¹⁷⁶ Sections 365 and 377(2) CA read with *Official Receiver of Hong Kong v Kao Wei Tseng and others* [1990] 1 SLR(R) 315. For example, in *Re Opti-Medix Ltd (in liquidation) and another matter* [2016] SGHC 108, the Singapore High Court recognised a foreign bankruptcy trustee appointed pursuant to bankruptcy orders granted by the Tokyo District Court. The recognised foreign bankruptcy trustee was then empowered to collect and recover the assets of the foreign company in Singapore, and entitled to stop payments and request information in respect of accounts held in the names of the foreign company.

¹⁷⁷ *Singularis Holdings Ltd v PricewaterhouseCoopers* [2014] UKPC 36.

¹⁷⁸ Section 172(1) CA.

¹⁷⁹ Section 172B(1) CA.

¹⁸⁰ Section 172A CA.

SOUTH AFRICA

Introduction

Overview of legal framework in South Africa

On 1 May 2011 the Companies Act 71 of 2008 (2008 Companies Act) was promulgated and replaced the erstwhile Companies Act 71 of 1973 (1973 Companies Act).

The provisions of Chapter 14 of the 1973 Companies Act however continues to apply to insolvent companies.¹

The Insolvency Act 24 of 1936 (Insolvency Act) applies to individuals and trusts. The provisions of the Insolvency Act are made applicable, mutatis mutandis, to the winding up of a company (Company) unable to pay its debts in respect of any matter not specifically provided for in the 1973 Companies Act.²

The Close Corporations Act 69 of 1984 (Close Corporations Act) applies to a corporate entity known as a close corporation (Close Corporation). Close Corporations were designed to allow for the creation of a simpler corporate structure that could be used for small and medium enterprises as an alternative to a private company.³ As from 1 May 2011, it was no longer possible to incorporate new Close Corporations in terms of the Close Corporations Act.⁴ Chapter 14 of the 1973 Companies Act applies to the liquidation of Close Corporations in respect of any matter not specifically dealt with in the Close Corporations Act.⁵

The 2008 Companies Act introduced the concept of business rescue into South Africa (Business Rescue).⁶ Business Rescue applies to distressed companies⁷ and allows for the rehabilitation of a financially distressed Company by providing for the restructuring of a Company to allow it to continue existing on a solvent basis or if this is not possible results in a better return for the Company's creditors.

In addition to the above mentioned legislation, the common law also applies to distressed Companies and directors, but to a limited extent.

¹ Pursuant to the transitional arrangements provided in terms of Item 9 of Schedule 5 of the 2008 Companies Act. As a result the 1973 Companies Act applies to the liquidation of insolvent companies and the 2008 Companies Act applies to the liquidation of solvent companies. In *Woodley v Guardian Assurance Co of SA Ltd* 1976 (1) SA 758 (W) it was held that "insolvent" in this context includes companies unable to pay its debts as and when they fall due (in other words commercial insolvency).

² Section 339 of the 1973 Companies Act.

³ The interest/equity in a close corporation is called a membership which is held by the members of the Close Corporation. If there is more than one member, then the membership is allocated on a percentage basis. The minimum number of members is one and the maximum is 10. Management and executive control in a Close Corporation vests in the members.

⁴ Section 13 of the Close Corporations Act.

⁵ Section 66 of the Close Corporations Act.

⁶ Chapter 6 of the 2008 Companies Act.

⁷ Financially distressed, as defined in s128(f) of the 2008 Companies Act, means, in regard to a particular Company at any particular time, where it appears to be reasonably unlikely that the Company will be able to pay all of its debts within the immediately ensuing six months or it appears to be reasonably likely that the Company will become insolvent within the immediately ensuing six months.

QUESTION 1

1. The directors and the start and duration of the “twilight “period:

(a) How are directors identified / defined?

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

1.1 Identification of directors

The definition of a director in the 2008 Companies Act⁸ is extremely wide and includes any person occupying the position of a director (by whatever name designated), such as executive and non-executive directors, alternate directors, nominee directors, *ex officio* directors, *de facto* directors and “shadow” directors.

1.1.1 *Ex officio* director

An *ex officio* director is a person who holds office as a director of a Company as a result of holding some other office, title, designation or similar status specified in a Company’s memorandum of incorporation (MOI),⁹ such as the Chief Operating Officer (COO) or Chief Financial Officer (CFO).

1.1.2 *De facto* director

(a) A *de facto* director could be a person who has been elected or appointed as a director, but in whose election or appointment some defect or irregularity exists, or a person who has not been formally appointed to the board, or who was previously appointed and has ceased to hold office, but who nevertheless takes part in the management of a Company and / or is held out as a director.¹⁰ Accordingly, senior managers of a Company may be regarded as *de facto* directors.

(b) Whether or not a person can be regarded as an *ex officio* or *de facto* director will depend on the facts and circumstances of each case.

1.1.3 Shadow director

A shadow director is a person who is not validly appointed as a director, but in accordance with whose instructions the directors are accustomed to act.¹¹ “The term shadow director usually denotes a person in accordance to whose instructions or directions the directors of a Company are accustomed to act”.¹²

1.2 Time periods

It is prudent to explain some concepts before turning to the various grounds for attack of actions during the twilight period.

1.2.1 Commencement of proceedings

(a) In South Africa, formal insolvency proceedings commence when a Company, which is unable to pay its debts is placed in liquidation (Date of Liquidation).

⁸ Section 1 of the 2008 Companies Act: “director means a member of the board of a Company... or an alternate director, and includes any person occupying the position of a director or alternate director, by whatever name designate”. Accordingly, a person who in fact been appointed or at least purportedly appointed as a director by those persons who have the power to appoint directors (*R versus Mall* 1959 (4) SA 607 (N) 624).

⁹ Section 66(7) of the 2008 Companies Act.

¹⁰ See general commentary on the definition of a “director” at p22 to 23 of Henochsberg on the Companies Act 71 of 2008 (Henochsberg 2008 Companies Act).

¹¹ p28(3) of Henochsberg 2008 Companies Act.

¹² p28(3) of Henochsberg 2008 Companies Act.

- (i) In the event that a Company is wound up by the Court (Court), then the liquidation proceedings are deemed to commence retrospectively to the date on which the application for the liquidation is issued out of the Court.¹³
 - (ii) In the event that an insolvent Company is wound up voluntarily then the liquidation proceedings commence when the special resolution of the shareholders in terms of which it is resolved to wind up a Company is registered with the Companies and Intellectual Property Commission (CIPC).¹⁴
- (b) It is convenient at this juncture to consider when Business Rescue commences:
- (i) When the board passes a resolution to commence Business Rescue Proceedings (Business Rescue Proceedings) and files the resolution with CIPC.¹⁵
 - (ii) When an affected person¹⁶ (Affected Person) applies to Court for an order to place a Company in Business Rescue.¹⁷
 - (iii) When a Court makes an order placing a Company in Business Rescue during the course of liquidation proceedings or proceedings to enforce a security interest.¹⁸

1.2.2. Categories of remedies available

- (a) There are three categories of remedies which are available to a liquidator or creditors in respect of a Company placed in liquidation:
- (i) Personal liability of directors arising from conducting the business of a Company recklessly.
 - (ii) Statutory remedies and common law remedies to impeach certain transactions entered into by a Company prior to and after the Date of Liquidation.
 - (iii) Statutory offences applicable to directors in respect of certain transgressions perpetrated prior to or after the Date of Liquidation.
 - (iv) Statutory and common law remedies arising from a breach of fiduciary duties.

1.2.3. Vulnerability periods

- (a) The vulnerability periods for South African clawbacks in respect of the above mentioned are as follows:
- (i) Reckless trading by directors (no time limit).
 - (ii) Section 26 of the Insolvency Act – dispositions made without value (time limit only applicable to onus regarding solvency at the time of the transaction).
 - (iii) Section 29 of the Insolvency Act - voidable preferences (six months before the Date of Liquidation).
 - (iv) Section 29 of the Insolvency Act – undue preference (no time limit).
 - (v) Section 31 of the Insolvency Act – collusive dealings (no time limit).
 - (vi) Section 88 of the Insolvency Act – hardening period for mortgage bonds (six months before the Date of Liquidation).

¹³ Section 348 of the 1973 Companies Act.

¹⁴ Section 352 of the 1973 Companies Act.

¹⁵ Section 132(1)(a) of the 2008 Companies Act.

¹⁶ An Affected Person refers to a creditor, shareholder, employee or a trade union representing employees of the Company (s128(a) of the 2008 Companies Act).

¹⁷ Section 132(1)(b) of the 2008 Companies Act. Although the Courts have not interpreted this section the preferred view is that the Business Rescue Proceedings only commence once the order is actually granted, otherwise this would have absurd consequences.

¹⁸ Section 132(1)(c) of the 2008 Companies Act.

- (vii) Section 34 of the Insolvency Act – failure to advertise sale of business (six months before the Date of Liquidation).
- (viii) Section 341 of the 1973 Companies Act – disposition after the Date of Liquidation.
- (xi) Actio Pauliana – a common law fraud remedy (no limit).
- (x) Fiduciary duties (no limit).

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 the director?
- (b) In relation to each act identified in 2(a) above:
 - (i) Is the director’s liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the Company’s losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or 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 Reckless trading

Reckless trading occurs when directors are carrying on the business of a Company and incurring debts when there is no reasonable prospect of the creditors receiving payment when due.¹⁹

Recklessness refers to gross negligence and not mere negligence. The Courts have interpreted gross negligence to exist in circumstances where objectively regarded, there is a strong chance, falling short of a virtual certainty, that the creditors will not be paid.²⁰

The test for recklessness is both objective and subjective. The test is objective in considering whether a reasonable businessman, in the same circumstances, would have held the view that the Company was trading recklessly. The subjective portion of the test is whether it must be postulated that the reasonable person belongs to the same group or class of directors, moving in the same sphere and having the same knowledge as the directors.²¹

In respect of the two statutory provisions (dealt with below),²² no specified period is given within which the conduct must have taken place.

¹⁹ Our Courts have been reluctant to hold directors liable for trying to turn a Company around. “In evaluating the conduct of directors, Courts should not be astute to stigmatise decisions made by businessmen as reckless simply because perceived entrepreneurial options did not in the event pan out. What is required is not the application of the exact science of hindsight, but a value judgment bearing in mind what was known, or ought reasonably to have been known, by individuals at the time the decisions were made.” (*Fourie N.O. versus Newton* 2010 JDR 1437 (SCA) 18).

²⁰ *Philotex (Pty) Limited versus Snyman* 1998(2) SA 138 (SCA) 144.

²¹ *Philotex (Pty) Limited versus Snyman* 1998(2) SA 138 (SCA) 143.

²² Section 424 of the 1973 Companies Act and s22 of the 2008 Companies Act has not replaced the common law remedy relating to reckless or fraudulent trading. The common law remedy is based on delict (equivalent of Tort in South Africa) and the creditor is therefore required to prove that the wrongful act (being the reckless trading or fraudulent trading) caused the creditor to suffer a loss or damages. (*Ex Parte Lebowa Development Corp Limited* 1989(3) SA 71 (T) 109). Because of the requirement to show causation between the wrongful act and the damages (which is not required in respect of Section 424 of the 1973 Companies Act) this remedy has been seldomly used in South Africa.

2.1.1 Section 424 of the 1973 Companies Act

- (a) A director²³ can be held personally liable for the debts of a Company for reckless trading, however this is only applicable to Companies which are insolvent and unable to pay its debts and has been placed in liquidation.
- (b) The Court can hold the director liable for all the debts of the Company and no causation is required between the reckless conduct and the loss of the creditors.
- (c) The liability that attaches to such conduct is both civil and criminal,²⁴ and will attach to all the directors who are found to have knowingly been parties to the carrying on of the business: there will be no apportionment between these directors.
- (d) A defence to proceedings under this provision is that the director was not knowingly a party to the carrying on of the business of the Company.²⁵

2.1.2 Section 22 of the 2008 Companies Act

- (a) This provision prohibits a Company from carrying on its business recklessly with, *inter alia*,²⁶ gross negligence and applies irrespective of whether the Company has been placed in liquidation.²⁷
- (b) Directors who acquiesced²⁸ to the carrying on of the business knowing that it was trading recklessly can be held liable for the losses of the Company²⁹ or a creditor.³⁰ Causation is required between the losses suffered by the creditor / Company and the reckless conduct of the directors.
- (c) Liability in terms hereof is civil³¹ and is applicable to any director³² jointly and severally.³³
- (d) A director can only be held liable if the director acquiesced in the carrying on of the business despite knowing that it was being conducted in a manner prohibited. Therefore a director can raise the defence that the director did not acquiesce in the carrying on of the business while knowing of the prohibited conduct.³⁴

2.1.3 Defences

In addition to the aforesaid defences dealt with under each statutory provision, if a director is able to demonstrate that the director did not conduct the business with gross negligence, this would constitute a defence to any such proceedings.

²³ Section 424 of the 1973 Companies Act provides that the Court can “declare that any person who was knowingly a party to the carrying on of the business” to be personally liable for the debts of the Company. Accordingly the liability is cast wider than a director. This more fully dealt with in Question 3.

²⁴ Section 424(3) of the 1973 Companies Act. Section 216(b) of the 2008 Companies Act is applicable to the penalty imposed in respect of an offence committed in terms of s424 of the 1973 Companies Act and provides that the penalty is a fine or imprisonment for a period not exceeding 12 months, or both a penalty or imprisonment.

²⁵ In *Howard versus Herrigel NO 1991 (2) SA 660 (A)* and quoted in *Henochsberg on the Companies Act*, volume 1 (Henochsberg on the 1973 Companies Act): “In this context “knowingly” means, and there must be proof “on a balance of probabilities, that the person sought to be held liable had knowledge of the facts from which the conclusion is properly to be drawn that the business of the Company was or is being carried on recklessly or with intent to defraud creditors. It would not be necessary to go further and show that the person had actual knowledge of the legal consequences”.

²⁶ Section 22 of the 2008 Companies Act also prohibits carrying on the business with intent to defraud any person or for any fraudulent purpose. This is dealt with in 2.2 below.

²⁷ With the advent of the 2008 Companies Act and the retention of Chp 14 of the 1973 Companies Act has resulted in two separate sections providing for liability for reckless trading. As set out in Question 2 there are differences between the two sections in terms of the scope of the liability. There is uncertainty amongst the legal fraternity in South Africa as to whether s424 of the 1973 Companies Act still applies due the enactment of s22 of the 2008 Companies Act. In *Alliance Mining Corporation Limited (in liquidation) versus De Kock 48387/11 GSJ* the Court held that s424 of the 1973 Companies Act will continue to apply to directors and others in circumstances where the Company is in liquidation and is unable to pay its debts. In practice lawyers will cite both Section 424 of the 1973 Companies Act and s22 of the 2008 Companies Act in the alternative when instituting legal proceedings against directors of an insolvent Company which has been placed in liquidation.

²⁸ The director must have taken part or concurred in the reckless trading of the business. Farouk Cassim *et al* “Contemporary Company Law” 2ed (2011) at p590 to 591: “It is not necessary to take positive steps in the conduct of the Company’s business- it is enough to support or concur in the Company’s business.” (Cassim’s Contemporary Company Law)

²⁹ Section 77(3)(b) of the 2008 Companies Act.

³⁰ Section 218 (2) of the 2008 Companies Act. Confirmed in *Rabinowitz versus Van Graan and Others 2013(5) SA 315 (GSJ) 320*. In fact s218(2) of the 2008 Companies Act provides that “any person who contravenes any provision of this Act is liable to any other person for any loss or damage suffered by that person.”

³¹ Criminal liability only attaches to any person who knowingly commits fraud.

³² Including alternate directors, nominee directors, *de facto* directors, prescribed officers and any person who is a member of a committee of the board, or of the audit committee.

³³ Section 77(6) of the 2008 Companies Act.

³⁴ “Knowing” or “knowingly” or “knows” as it is applied in respect of s77(3)(b) of the 2008 Companies Act is defined in s1 of the 2008 Companies Act to refer to a person: who had actual knowledge of the matter or was in a position in which the person ought reasonably to have 1) had actual knowledge or 2) investigated the matter to an extent that would have provided the person with actual knowledge or 3) taken measure which, if taken, would reasonably be expected to have provided the person with actual knowledge of the matter.

2.2 Fraudulent trading

The trading of a business with the intention to defraud *inter alia* creditors is regarded by our Courts as fraudulent trading. The essential element for fraudulent trading is the intention of the director in trading the business and the fact that a fraud has been perpetrated against *inter alia* creditors.

In respect of both statutory provisions (dealt with more fully below), the liability that attaches to the conduct is both civil and criminal.

2.2.1 Section 424 of the 1973 Companies Act

If a director is knowingly party to the business of the Company, which was being carried on with the intent to defraud creditors then that director can be held personally liable for all the debts of the Company.³⁵

The penalty for a contravention of this provision is a fine or imprisonment not exceeding 12 months or both a fine and imprisonment.³⁶

2.2.2 Section 22 of the 2008 Companies Act

The 2008 Companies Act similarly prohibits a Company from carrying on its business with the intent to defraud any person and any director who acquiesced in the carrying of the business knowing that the business was being conducted in this manner can be held liable for the losses of the Company or any third party including a creditor.³⁷

If it is demonstrated that there has been fraudulent trading in terms of the 2008 Companies Act, the 2008 Companies Act imposes a penalty of a fine or imprisonment not exceeding 10 years or to both a fine and imprisonment in respect of fraudulent trading.³⁸

2.3 Breach of fiduciary duties of directors

Although directors' fiduciary duties have been partially codified in the 2008 Companies Act,³⁹ the common law has not been excluded. In particular, there are various common law duties that have not been amended and are excluded by the 2008 Companies Act which still apply.⁴⁰

2.3.1 Common law

- (a) The common law duties of directors may be divided into fiduciary duties and the duty to act with skill, care and diligence.
- (b) Fiduciary duties:
 - (i) Duty to act in good faith and promote the best interests of the Company.⁴¹
 - (ii) Duty to avoid a conflict of interest.
 - (iii) Duty not to exceed their powers.
 - (iv) Duty not to exercise their powers for an improper or collateral purpose.
 - (v) Duty to exercise an unfettered discretion.
- (c) A director must act with the degree of skill, diligence and care of reasonable director (this is an objective test) that may be reasonably expected of a person with his knowledge and experience (this is a subjective test).

³⁵ Section 424(1) of the 1973 Companies Act.

³⁶ Section 216(b) of the 2008 Companies Act.

³⁷ Section 77(3)(b) and s218(2) of the 2008 Companies Act.

³⁸ Section 216(a) of the 2008 Companies Act.

³⁹ Section 76 of the 2008 Companies Act sets out the standard of directors' conduct.

⁴⁰ p290(4) of Henochsberg 2008 Companies Act.

⁴¹ This duty is owed to the general body of shareholders. When the Company becomes financially distressed and enters the twilight period the duty is owed to both the shareholders and the general body of creditors. The law in South Africa is not clear on the weighting which the directors should give between the creditors and the shareholders when the Company becomes financially distressed.

- (d) In terms of the common law, a Company can proceed against directors personally for acting in breach of their duties.
- (i) If a director breaches his fiduciary duty, the cause of action is neither delictual nor contractual, but a unique or sui generis one (being an action for breach of fiduciary duty / trust).⁴²
 - (ii) Liability is for damages in respect of the loss caused to the Company.
 - (iii) In respect of a director's duty to act with due skill, care and diligence, a director who breaches this duty is liable to the company in delict⁴³ for damages.⁴⁴
 - (iv) The liability is joint and several if more than one director has breached their fiduciary duties.

2.3.2 Companies Act of 2008

(a) The following fiduciary duties have been codified in the 2008 Companies Act:

- (i) A director must use the position of director, or any information obtained while acting as a director, for the benefit of the Company, and not for his own benefit or the benefit any other person, or to knowingly cause harm to the Company.⁴⁵
- (ii) A director must exercise the powers and functions of a director:
 1. in good faith and for a proper purpose;⁴⁶
 2. in the best interests of the company;⁴⁷ and
 3. with the required degree of care, skill and diligence.⁴⁸
- (iii) A director will have satisfied the obligations to act in the best interest of the company and with the required degree of care, skill and diligence if the director:⁴⁹
 1. took reasonably diligent steps to become informed about the matter;⁵⁰
 2. had no personal financial interest in the matter or disclosed the interest;⁵¹
 3. had a rational basis for believing, and indeed believing, that the decision was in the best interest of the company;⁵² and
 4. being entitled to rely on information, opinions and/or reports of employees, external advisers or committees of the board, the director reasonably believes to be reliable and competent.⁵³

(b) A director⁵⁴ may be held liable:⁵⁵

- (i) In accordance with the principles of the common law relating to breach of a fiduciary duty, for any loss, damages or costs sustained by the company as a consequence of any breach by the director of the following fiduciary duties:

⁴² p304 of Henochsberg 2008 Companies Act.

⁴³ Delict is the South African equivalent of English Tort.

⁴⁴ p298(5) of Henochsberg 2008 Companies Act.

⁴⁵ Section 76(2)(a) of the 2008 Companies Act.

⁴⁶ Section 76(3) (a) of the 2008 Companies Act.

⁴⁷ Section 76(2)(b) of the 2008 Companies Act.

⁴⁸ Section 76(2)(b) of the 2008 Companies Act.

⁴⁹ Section 76(4) of the 2008 Companies Act. This section has introduced the "business judgment rule" into South African law (p298(5) of Henochsberg 2008 Companies Act).

⁵⁰ Section 76(4)(a)(i) of the 2008 Companies Act.

⁵¹ Section 76(4)(a)(ii) of the 2008 Companies Act.

⁵² Section 76(4)(a)(iii) of the 2008 Companies Act.

⁵³ Section 76(4)(b) of the 2008 Companies Act.

⁵⁴ Section 77(1) of the 2008 Companies Act. Directors shall include prescribed officers, board committee members and audit committee members.

⁵⁵ Section 77(2)(a) of the 2008 Companies Act.

1. Duty to disclose personal financial interest.⁵⁶
 2. Duty not to use information for own advantage or to cause harm to the Company and the duty to disclose information which is material to the Company.⁵⁷
 3. Duty to act in good faith and for proper purpose.⁵⁸
 4. Duty to act in the best interest of the company.⁵⁹
- (ii) In accordance with the principles of the common law relating to delict for any loss, damages or costs sustained by the company as a consequence of any breach by the director of his:
1. duty to act with requisite care, skill and diligence;⁶⁰
 2. any provision of the 2008 Companies Act not otherwise mentioned in section 77;⁶¹ and
 3. any provision of the company's memorandum of incorporation.
- (c) Liability is joint and several with any other person who is or may be held liable for the same act.⁶²
- (d) A holder of issued securities may apply to Court for an appropriate order to rectify any harm done to the securities holder by a director to the extent that a director is or may be held liable in terms of section 77 of the 2008 Companies Act.⁶³
- (e) A director could also be held liable to any person, such as a creditor, for any loss or damage suffered by that person as a result of the director contravening any provision of the 2008 Companies Act.⁶⁴
- (f) Any person who is liable to a Company for losses or damages would also be liable jointly and severally with all other such persons:⁶⁵
- (i) to pay the costs of all parties to the Court proceedings; and
 - (ii) to restore to the Company any amount improperly paid by the Company as a result of the impugned act.

2.3.3 Criminal liability

- (a) Where a director was knowingly a party to an act or omission by a Company, calculated to defraud a creditor or employee of the Company, or a holder of the Company's securities, or with another fraudulent purpose, is guilty of an offence.⁶⁶
- (b) The penalty is a fine or imprisonment for a period not exceeding 10 years or both such fine and such imprisonment.⁶⁷
- (c) The non- disclosure of financial interests may also amount to a fraud.⁶⁸

⁵⁶ Section 75 of the 2008 Companies Act.

⁵⁷ Section 76(2) of the 2008 Companies Act.

⁵⁸ Section 76(3)(a) of the 2008 Companies Act.

⁵⁹ Section 76(3)(b) of the 2008 Companies Act.

⁶⁰ Section 76(3)(c) of the 2008 Companies Act.

⁶¹ Accordingly if a director breaches any provision of the 2008 Companies Act then that director can be held liable for any losses or damages suffered by the Company as a result of such breach.

⁶² Section 77(6) of the 2008 Companies Act.

⁶³ Section 161(1)(b) of the 2008 Companies Act.

⁶⁴ Section 218(2) of the 2008 Companies Act.

⁶⁵ Section 77(8) of the 2008 Companies Act.

⁶⁶ Section 214(1)(c) of the 2008 Companies Act.

⁶⁷ Section 216(a) of the 2008 Companies Act.

⁶⁸ In *State versus Gardener* 2011 (4) SA 79 (SCA) the requirements were stated as follows: "The authorities...support the view that an intention to cause actual or potential prejudice is a necessary element of the crime of fraud... When Company directors deliberately withhold information material to the affairs of their Company from the board of directors, there is, in the absence of an explanation for such conduct which may be reasonably true, an *a priori* case of fraudulent non-disclosure."

2.3.4 Defences

- (a) In any proceedings, other than for wilful misconduct or wilful breach of trust, the Court may relieve the director, either wholly or partially, from any liability set out in section 77 of the 2008 Companies Act, on any terms as the Court considers just if it appears to the Court that the director:⁶⁹
- (i) has acted honestly and reasonably; or
 - (ii) it would be fair to excuse the director having regard to the circumstances of the matter.
- (b) A director may also apply to Court for relief from any anticipated claim on the grounds referred to above.⁷⁰

2.4 Breach of duties when a company is in financial distress

If the board of a Company has reasonable grounds to believe that the Company is financially distressed,⁷¹ but the board has not adopted a resolution to place the Company in Business Rescue, the board must deliver a written notice to each Affected Person, setting out the criteria in the definition of “financially distressed” that are applicable to the Company and its reasons for not adopting such resolution.

The question that therefore arises is whether a failure by the board to comply with this obligation could have adverse consequences for the board, particularly where the Company is thereafter placed in liquidation and creditors suffer losses as a result of unpaid claims. The possible consequence of such breach is that the directors could be held personally liable for losses suffered by the Company⁷² and/or suffered by any third party⁷³ to the extent it is proved that such breach of the 2008 Companies Act caused the loss.

2.5 Breach of duties of directors during business rescue proceedings

Where a Company is financially distressed, and as a result Business Rescue Proceedings have commenced, section 142 of the 2008 Companies Act imposes additional responsibilities on the Company’s directors, including the following:

- (a) Each director must deliver to the Business Rescue practitioner (the Practitioner), all books and records relating to the affairs of the Company which are in such director’s possession, or must inform the Practitioner of the whereabouts, if known, of such books and records.⁷⁴
- (b) The directors must provide the Practitioner within five business days after Business Rescue Proceedings begin, with a statement of affairs of the company, containing certain prescribed particulars.⁷⁵

In the event that the directors fail to comply with these provisions then the directors could be held liable for any losses or damages suffered by the company⁷⁶ or any third party.⁷⁷ Liability is civil as the directors can be compelled to comply with these duties.⁷⁸

2.6 Disqualification of delinquent directors

A shareholder or a director of a Company may apply to Court for an order declaring a person delinquent, if the person is a director of the Company or, within the 24 months immediately preceding the application, was a director of that Company.⁷⁹

⁶⁹ Section 77(9) of the 2008 Companies Act.

⁷⁰ Section 77(10) of the 2008 Companies Act.

⁷¹ Financially distressed: is defined in s128(f) of the 2008 Companies Act to mean that “it appears to be reasonably unlikely that the Company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months; or it appears reasonably likely that the Company will become insolvent within the immediately ensuing six months”.

⁷² Section 77(2)(b)(ii) of the 2008 Companies Act.

⁷³ Section 218(2) of the 2008 Companies Act.

⁷⁴ Section 142(1) and (2) of the 2008 Companies Act.

⁷⁵ Section 142(3) of 2008 Companies Act.

⁷⁶ Section 77(2)(b) (ii) of the 2008 Companies Act.

⁷⁷ Section 218(2) of the 2008 Companies Act.

⁷⁸ Section 218 of the 2008 Companies Act.

⁷⁹ Section 162(2) of the 2008 Companies Act.

A Court must declare a person a delinquent director if such an individual, while a director:⁸⁰

- (a) grossly abused the position of director;
- (b) took personal advantage of information or an opportunity, contrary to the interests of the Company;
- (c) intentionally, or by gross negligence, inflicted harm upon the Company or a subsidiary of the Company; or
- (d) acted in a manner that amounted to gross negligence, wilful misconduct or breach of trust or as contemplated in the 2008 Companies Act.⁸¹

A person who has been declared delinquent is disqualified from being a director of a Company. A declaration of delinquency⁸² may be made subject to any conditions the Court considers appropriate and subsists for a period of seven years, or such longer period if the Court so determines.⁸³

A person declared delinquent in terms of section 162(5)(c) of the 2008 Companies Act, may apply to Court at any time more than three years after the granting of the order, to suspend such order of delinquency and substitute an order of probation, which the Court may grant if it is satisfied that the conditions attached to the original order have been complied with and where there are reasonable prospects that the delinquent director will be able to successfully serve as a director of a company in the future.⁸⁴

The Courts have seen fit to grant declarations of delinquency where a director:

- (a) has failed to hold annual meetings, prepare annual financial statements and appoint an auditor;⁸⁵
- (b) has failed to detect tax fraud;⁸⁶ and
- (c) has grossly abused the position of director for personal gain by virtue of, *inter alia*, unlawful directors' fees, taking personal advantage of information at their disposal and unauthorised loans.⁸⁷

2.7 Statutory offences in terms of the Insolvency Act and 1973 Companies Act:

Additional offences are provided for in terms of the Insolvency Act, which offences are applicable to Companies pursuant to section 425 of the 1973 Companies Act. Penalties in respect of these offences are, to the extent not provided for in terms of the Insolvency Act, to be determined in terms of the 2008 Companies Act.⁸⁸

2.7.1 Failure to make or lodge statement of affairs

- (a) When a Company intends to place itself in a creditors' voluntary liquidation the directors of the Company are required to prepare a statement of affairs, which must be presented to the meeting of shareholders.⁸⁹ The failure to lodge this statement constitutes an offence.

⁸⁰ Section 162(5)(c) of the 2008 Companies Act.

⁸¹ Section 77(3)(a), (b) and (c) of 2008 Companies Act. These subsections cover conduct, for instance where a director acts on behalf of the Company despite knowing he/she lacked authority, acquiesced in the carrying on of the Company's business in a reckless manner, with gross negligence or with intent to defraud any person.

⁸² Under s162(6)(c) of the 2008 Companies Act.

⁸³ Section 162(6)(b) of the 2008 Companies Act.

⁸⁴ Section 162(12) of the 2008 Companies Act.

⁸⁵ *Msimang N.O. and Another v Katuliiba and Others* [2013] 1 ALL SA 580 (GSJ).

⁸⁶ *Kukama v Lobelo* [2013] ZAGPJHC 137 (31 May 2013).

⁸⁷ *Grancy Property Limited and Another v Dines Chandra Manilal Gihwala and Nine Others* JDR 1292 (WCC).

⁸⁸ The reason for this is that the sections which imposed penalties in respect of any contraventions in terms of the 1973 Companies Act were repealed by the 2008 Companies Act.

⁸⁹ Section 363 of the 1973 Companies Act. The obligation rests on any person who was a director or an officer at the time of the liquidation and if the Master directs any person who was a director or officer of the Company within one year of the Date of Liquidation. An officer refers to a person who holds some office in the Company involving the exercise of a corporate function which is distinct from a function relating to the business of the Company.

- (b) The liability is criminal⁹⁰ and any person who fails to comply with any of the abovementioned sections shall be guilty of an offence.⁹¹
- (c) The penalty is a fine or imprisonment for a period not exceeding 12 months, or both a fine and imprisonment.⁹²

2.7.2 Making a false statement in a statement of affairs

If any director or officer knowingly makes a false statement in a statement of affairs that person shall be guilty of a criminal offence and shall be liable to imprisonment for a period not exceeding one year.⁹³

2.7.3 Giving false evidence under interrogation

Any person shall be guilty of a criminal offence and liable to punishment provided by the law in respect of a crime of perjury if, when that person is being interrogated under oath, that person wilfully makes a statement which he knows to be false or which he does not know or believe to be true.⁹⁴

2.7.4 Concealing or destroying books or assets

- (a) Any person who is or was a director or officer of the company shall be guilty of an offence if such person at any time before or after the liquidation of the company committed any of the following acts, unless it is proven that such person had no intention to defraud:⁹⁵
 - (i) Conceals, parts with, destroys, mutilates, falsifies or makes any false entry or erasure in any book or document relating to the affairs or business of the company or allows any other person to do so.
 - (ii) Conceals or permits the concealment of any asset.
 - (iii) Otherwise than in the ordinary course of business makes, or permits the making of a disposition of property which has been bought on credit and has not been paid for.
- (b) Liability in respect of these offences is criminal, and any person who is found guilty is liable to imprisonment for a period not exceeding three years.⁹⁶
- (c) The following provisos are applicable to the concealing or destroying books or assets:
 - (i) In respect of the offence in 2.7.4(a)(i), whenever any act referred to therein is proven to have been committed, then the director or officer shall be deemed to have committed the offence.⁹⁷
 - (ii) In respect of the offences referred to in paragraphs 2.7.4(a)(ii) and 2.7.4(a)(iii), any destruction, disposition, damage or removal of assets proven to have been committed shall, unless the contrary is proven, be deemed not have been committed in the ordinary course of business.⁹⁸
 - (iii) It appears from any book or document relating to the business, property or affairs of a Company, or if it is proven in any other manner that there ought to have been available to the liquidator at least 10 percent more assets of the Company than the assets which have been made available to the liquidator, then the directors or officers shall be deemed to have removed or disposed of the assets equal to the difference between the value of the assets

⁹⁰ Section 363(8) of the 1973 Companies Act.

⁹¹ Section 363(8) of the 1973 Companies Act.

⁹² Section 216(b) of the 2008 Companies Act which is applicable to any offence committed in terms of the 1973 Companies Act.

⁹³ Section 137(1)(d) of the Insolvency Act.

⁹⁴ Section 139(2) of the Insolvency Act.

⁹⁵ Section 132 of the Insolvency Act. It has been submitted that the requirement that the accused bears the onus to show that there was no intention to defraud is unconstitutional in that this type of reverse onus infringes the right to a fair trial in terms of the Constitution. Page 616 at paragraph 28.1 of Mars "The Law of Insolvency in South Africa" 9ed (2008) (Mars' Law of Insolvency).

⁹⁶ Section 132 of the Insolvency Act.

⁹⁷ It has been submitted that this proviso constitutes the infringement of the constitutional right to a fair trial. p617, para28.1 of Mars' Law of Insolvency.

⁹⁸ p617, para28.1 of Mars' Law of Insolvency.\

which should have been disclosed and the value actually disclosed, unless the said directors or officers, explain the deficiency and prove that the deficiency was not caused by them and that they could not have prevented it.⁹⁹

2.7.5 Concealment of liabilities or pretext to existence of assets

- (a) Any person who is or was a director or officer of the company shall be guilty of an offence if, within two years immediately prior to the Date of Liquidation, such director or officer made any statement either verbally or in writing in regard to the business, property or affairs of the Company to a creditor or to any person who became a creditor on the basis of the statement, if when the director made the statement, the director:¹⁰⁰
- (i) concealed any liability;¹⁰¹
 - (ii) mentioned, as if it were an asset, any right or property which was not an asset of the Company, or represented that the Company had more assets than it in fact had;
 - (iii) made a false statement regarding the amount, quality or value of the Company's assets; and
 - (iv) concealed any loss that the Company had sustained or gave an incorrect amount in respect thereof.
- (b) This offence attracts criminal liability, with a penalty of imprisonment not exceeding three years.¹⁰²
- (c) There are a number of defences to this offence. They are:
- (i) If an accused is able to prove that he had good reason to believe that the statement was correct and that he was not concealing or failing to disclose any relevant fact, then the section would not apply.¹⁰³
 - (ii) The fact that a statement is made as to the Company's liabilities and that the liabilities are less than they actually are does not constitute a statement that the insolvent has more assets than he in fact has.¹⁰⁴
 - (iii) If an accused is able to demonstrate that he did not make the relevant statement, this shall constitute a defence.
 - (iv) If an accused is able to demonstrate that the misrepresentation as to a liability of the Company, which is included in the statement and existed prior to the making of the statement, no longer exists as at the time of the statement, this shall constitute a defence.¹⁰⁵

2.7.6 Failure to notify change of address

A failure by a director or the secretary of a company which is being wound-up, to notify the liquidator within 14 days of any change in his residential or postal address constitutes a criminal offence,¹⁰⁶ which carries a penalty of a fine or imprisonment not exceeding 12 months or both a fine and imprisonment.¹⁰⁷

⁹⁹ p620 of Mars' Law of Insolvency.

¹⁰⁰ Section 133 of the Insolvency Act.

¹⁰¹ Refers to existing or future liability and includes a contingent liability and the failure to disclose the extent of the liability.

¹⁰² Section 133 of the Insolvency Act.

¹⁰³ This provision results in the presumption of an intention to mislead which may be unconstitutional as it results in a revers onus which infringes the right to a fair trial.

¹⁰⁴ *R v Khoja* 1940 TPD 38.

¹⁰⁵ *R v Joseph* 1933 OPD 157.

¹⁰⁶ Section 363A of the 1973 Companies Act.

¹⁰⁷ Section 216(b) of the 2008 Companies Act.

2.7.7 Failure to observe duties in relation to meeting of creditors

- (a) Every director and officer of the Company must attend the first and second meeting of creditors, including any adjournment of such meeting, unless the Master or the official presiding at the meeting has, after consulting the liquidator, excused the director or officer from the meeting.¹⁰⁸
- (b) Any director or officer who fails to attend the meeting and who has not been validly excused shall be guilty of a criminal offence,¹⁰⁹ which carries a penalty of a fine or imprisonment for a period not exceeding 12 months or both a fine and imprisonment.¹¹⁰

2.7.8 Failure to provide information at the first meeting of creditors

- (a) If no provisional liquidator has been appointed to a Company, then the Master can direct the secretary or any director or officer of the Company to attend the first meeting of creditors and to give the presiding officer the books of the company and details relating to the shareholding of the Company.¹¹¹
- (b) Should the representative of the Company fail to provide this information, the representative shall be guilty of a criminal offence, which carries a penalty of a fine not exceeding R50.00 or imprisonment for a period not exceeding three years.¹¹²

2.7.9 Disposition of property with intention to prefer

- (a) A director or officer of a company shall be guilty of an offence if the company made a disposition of any of its property prior to the liquidation of the company with the intention of preferring a creditor above another or other is an offence if at the time when the disposition was made the liabilities of the company exceeded its assets.¹¹³
- (b) This offence is dealt with more fully below, in the discussion relating to transaction during the twilight period, but if found guilty, an accused will be held criminally liable, for which the penalty is imprisonment not exceeding one year.¹¹⁴

2.7.10 Diminishing assets by gambling, betting or hazardous speculation

If a Company diminishes its assets by gambling or betting or hazardous speculation, and the Company is subsequently liquidated then the director or officer of the Company commits a criminal offence if the diminution of such assets occurs during the period of six months immediately preceding the liquidation of the company or at a time when its liabilities exceed its assets.¹¹⁵

2.7.11 Non-compliance with section 34 (1) of the Insolvency Act

- (a) If prior to the Date of Liquidation a Company fails to advertise the sale of the business of the company in terms of section 34(1) of the Insolvency Act¹¹⁶ then the directors and the officers of the Company will be guilty of a criminal offence,¹¹⁷ which carries a penalty of imprisonment for a period not exceeding two years.¹¹⁸
- (b) This conduct is dealt with more fully below in Question 4.

¹⁰⁸ Section 414(1) of the 1973 Companies Act.

¹⁰⁹ Section 414(3) of the 1973 Companies Act.

¹¹⁰ Section 216(b) of the 2008 Companies Act.

¹¹¹ Regulation 14(1) of the Winding Up Regulations to the 1973 Companies Act.

¹¹² Regulation 14(1) of the Winding Up Regulations to the 1973 Companies Act.

¹¹³ Section 135 of the Insolvency Act as read with s425 of the 1973 Companies Act.

¹¹⁴ Section 135 of the Insolvency Act as read with s425 of the 1973 Companies Act.

¹¹⁵ Section 135(1) of the Insolvency Act as read with s425 of the 1973 Companies Act.

¹¹⁶ In terms of s34(1) of the Insolvency Act if the Company is a trader then it is required to advertise the intended sale of its business, the goodwill of its business or any goods forming part of the business. Trader is defined in terms of s2 of the Insolvency Act.

¹¹⁷ Section 135(3)(b) of the Insolvency Act. This is an overlooked section in South Africa which exposes directors of a Company which sells its business but elects not to advertise the sale of the business in terms of s34 of the Insolvency Act.

¹¹⁸ Section 34 of the Insolvency Act.

2.7.12 Dealing with property with intent to defeat attachment or to prejudice creditors

If a person removes an asset belonging to a Company prior to the liquidation thereof, or conceals, disposes of, deals with or receives such asset prior to such liquidation, “with intent to defeat an attachment by virtue of a sequestration order, or with intent to prejudice the creditors” of such estate, commits a criminal offence, which carries a penalty of imprisonment for a period not exceeding three years.¹¹⁹

2.7.13 Failure to alert the Master and liquidators to possibly fraudulent proof of claim

If a director or an officer knows or suspects that someone has proved, or intends to prove, a false claim against the Company in liquidation and fails to inform the Master and the liquidator in writing of his knowledge or suspicion within seven days as from the date upon which he acquired such knowledge or such suspicion was aroused, commits an offence, which carries a penalty of imprisonment for a period not exceeding three years.¹²⁰

2.7.14 Failure to deliver property to the liquidator

(a) If a director or officer fails to deliver to the liquidator or as the liquidator may direct in writing, within 14 days as from the liquidator’s appointment, any property belonging to the company, which is in the director’s or officer’s possession or custody or under their control, is guilty of a criminal offence,¹²¹ which carries a penalty of imprisonment for a period not exceeding three years.¹²²

(b) An accused may defend such an offence by proving that he had a reasonable excuse for such failure.¹²³

2.7.15 Failure to inform the liquidator of whereabouts of property

(a) The failure by a director or officer to inform the liquidator, within 14 days as from the liquidator’s appointment, of the existence and whereabouts of certain property belonging to the Company which was not fully disclosed in the statement of affairs, is a criminal offence,¹²⁴ which carries a penalty of imprisonment for a period not exceeding three years.¹²⁵

(b) An accused may defend such an offence by proving that he had a reasonable excuse for such failure.¹²⁶

2.7.16 Failure to deliver books and documents to the liquidator

(a) If a director or officer fails to deliver to the liquidator as he may direct, within 14 days as from the liquidator’s appointment, all books and documents in his possession or custody or under the director’s or officer’s control and relating to the Company’s affairs,¹²⁷ or fails to inform the liquidator of books and records which are not in their possession or under their control,¹²⁸ is guilty of a criminal offence, which carries a penalty of imprisonment not exceeding three years.¹²⁹

(b) An accused may defend such an offence by proving that he had a reasonable excuse for such failure.¹³⁰

¹¹⁹ Section 142 of the Insolvency Act.

¹²⁰ Section 136(a) of the Insolvency Act.

¹²¹ Section 136(b)(i) of the Insolvency Act.

¹²² Section 136(b) of the Insolvency Act.

¹²³ Section 136(b) of the Insolvency Act.

¹²⁴ Section 136(b)(ii) of the Insolvency Act.

¹²⁵ Section 136(b) of the Insolvency Act.

¹²⁶ Section 136(b) of the Insolvency Act.

¹²⁷ Section 136(b)(iii) of the Insolvency Act.

¹²⁸ Section 136(b)(iv) of the Insolvency Act.

¹²⁹ Section 136 of the Insolvency Act.

¹³⁰ Section 136(b) of the Insolvency Act.

2.7.17 Failure to furnish information concerning property

- (a) A director or officer who fails to furnish to the liquidator, at any time after the Date of Liquidation, and on the liquidator's request, "complete and truthful information regarding any property which was at any time in his possession or custody or under his control, or regarding the time when or the manner or circumstances in which he disposed of such property or ceased to be in possession, custody or control thereof" commits a criminal offence,¹³¹ which carries a penalty of imprisonment for a period not exceeding three years.¹³²
- (b) An accused may defend such an offence by proving that he had a reasonable excuse for such failure.¹³³

2.7.18 Procuring agreement to frustrate investigation

It is an offence to grant, promise or offer, during the winding up of a Company, any consideration to induce another to refrain from investigating any matter relating to such company or from disclosing information in regard thereto.¹³⁴ Any person found guilty of this offence shall be criminally liable, which carries a penalty of imprisonment for a period not exceeding one year.¹³⁵

2.7.19 Failure to give information at a meeting of creditors

- (a) If at a meeting of creditors, a director or officer is required by the liquidator or the presiding officer or any creditor "to account for or to disclose what has become of any property which was in his possession so recently that in the ordinary course he ought to be able to account therefore", and he fails to do so, he commits a criminal offence,¹³⁶ which carries a penalty of imprisonment for a period not exceeding six months.¹³⁷

2.7.20 Failure to appear, and refusal to testify, in legal proceedings by or against the company

- (a) A director or an officer who is subpoenaed to give evidence in proceedings instituted by or against the Company, commits an offence if the director or officer "conceals himself or quits the Republic of South Africa (the Republic) or without reasonable excuse fails to attend" such proceedings or "refuses to answer any question which may lawfully be put to him".¹³⁸
- (b) The liability for this offence is criminal and carries a penalty of a fine not exceeding R500 or to imprisonment without the option of a fine not exceeding six months.¹³⁹

2.7.21 Withholding information concerning, and failing to deliver, property of company

- (a) A person who has "in his possession or custody or under his control" any property of a Company in liquidation, and who knows of the liquidation thereof and that the property belongs to it, must inform the liquidator as soon as possible of the existence and whereabouts of such and must deliver it to, or place at the disposal of, liquidator.¹⁴⁰
- (b) A person who fails to comply with this obligation shall be guilty of a criminal offence, which carries a penalty of a fine not exceeding R1000 or imprisonment without the option of a fine for a period not exceeding one year.¹⁴¹

¹³¹ Section 136(c) of the Insolvency Act.

¹³² Section 136 of the Insolvency Act.

¹³³ Section 136(b) of the Insolvency Act.

¹³⁴ Section 137(b) of the Insolvency Act.

¹³⁵ Section 137 of the Insolvency Act.

¹³⁶ Section 138(c) of the Insolvency Act.

¹³⁷ Section 138 of the Insolvency Act.

¹³⁸ Section 140 of the Insolvency Act.

¹³⁹ Section 140 of the Insolvency Act.

¹⁴⁰ Section 142(2) of the Insolvency Act.

¹⁴¹ Section 142(2) of the Insolvency Act.

2.7.22 Obstructing the liquidator

A person who obstructs or hinders a liquidator or his representative in the performance of his functions as such commits a criminal offence,¹⁴² which carries a penalty of a fine not exceeding R500 or imprisonment without the option of a fine for a period not exceeding six months.¹⁴³

2.8 Statutory offences in terms of the 2008 Companies Act

2.8.1 Providing false or misleading information

Where a person, with a fraudulent purpose, knowingly provides false or misleading information in any circumstances in which the 2008 Companies Act requires a person to provide information or give notice to another person,¹⁴⁴ the person will be held both criminally¹⁴⁵ and civilly¹⁴⁶ liable, which liability attracts a penalty of a fine or imprisonment for a period not exceeding 10 years or both such fine and such imprisonment.¹⁴⁷

2.8.2 Falsification of accounting records

A person is guilty of an offence if the person “is a party to the falsification of any accounting records of the Company, irrespective of the intention of such person”,¹⁴⁸ The person will be held both criminally and civilly liable,¹⁴⁹ which liability attracts a penalty of a fine or imprisonment for a period not exceeding 10 years, or both a fine and such imprisonment.¹⁵⁰

2.9 Statutory offences in terms of the Close Corporations Act¹⁵¹

2.9.1 Repayment of amounts received by a member

(a) In the winding up of a Close Corporation, which is unable to pay its debts, a member shall be required to repay any amount received by him only by reason of his membership unless he can prove the following:¹⁵²

- (i) After the payment was made the value of assets of the Close Corporation exceeded its liabilities.
- (ii) Such payment was made while the Close Corporation was able to pay its debts in the ordinary course of business.
- (iii) Such payment did not render the Close Corporation unable to pay its debts as and when they became due.

2.9.2 Payment not *bona fide* or unreasonable

If, in respect of the winding-up of a Close Corporation, any direct or indirect payment of a salary or remuneration made to by the Close Corporation within two years of its winding up to a member in his capacity as an officer or employee of the Close Corporation, and such payment was in the opinion of the Master not reasonable or bona fide, then the Master shall direct that such payment, or part thereof, be repaid by the member to the Close Corporation.¹⁵³

2.9.3 Reckless and fraudulent trading

Section 64 of the Close Corporations Act is an identical provision to section 424 of the 1973 Companies Act, and is likewise applicable to Close Corporation.

¹⁴² Section 145 of the Insolvency Act.

¹⁴³ Section 145 of the Insolvency Act.

¹⁴⁴ Section 214(1)(b) of the 2008 Companies Act.

¹⁴⁵ Section 214(1)(b) of the 2008 Companies Act.

¹⁴⁶ In terms of s218(2) of the 2008 Companies Act. This section allows the Company, a creditor or a shareholder to sue for any civil loss caused by the contravention of a provision of the 2008 Companies Act.

¹⁴⁷ Section 216(b) of the 2008 Companies Act.

¹⁴⁸ Section 214(1)(a) of the 2008 Companies Act.

¹⁴⁹ Section 218(2) of the 2008 Companies Act.

¹⁵⁰ Section 216(a) of the 2008 Companies Act.

¹⁵¹ As mentioned in Question 4 the provisions of Chp 14 of the 1973 Companies Act applies to Close Corporations which have been wound up on an insolvent basis. This part will deal with provisions in the Close Corporations Act which are not dealt with in the 1973 Companies Act.

¹⁵² Section 70 of the Close Corporations Act.

¹⁵³ Section 71 of the Close Corporations Act.

QUESTION 3

3. Other persons involved with the Company's affairs who may be liable in relation to their actions during the twilight period
- (a) In addition to those persons referred to in 2 above, can others be held liable in respect of the Company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in 2 above?
- (c) Can those other persons be made personally liable for all or part of the Company's losses or for all or part of the deficit to creditors?

3.1 Introduction

In addition to directors, a number of other persons are also vulnerable to personal liability during the twilight period. In this regard it is important to distinguish these persons from the wider group of directors dealt with under Question 1, which included *ex officio* directors, alternate directors and *de facto* directors. This part will instead deal with officers, prescribed officers, shadow directors, members of committees of the board, senior management, employees of the Company and third parties transacting with the Company.

3.2 Prescribed officers, audit committees, board committees and shadow directors

3.2.1 Prescribed officers

- (a) A prescribed officer¹⁵⁴ is a person who:
- (i) exercises general executive control over and management of the whole, or a significant portion, of the business and activities of the Company; or
- (ii) participates to a material degree in the exercise of the general executive control referred to in paragraph 3.2.1(a)(i).¹⁵⁵

3.2.2 Audit committee

At each general meeting a public company, state owned company and any Company that is required by its MOI to form an audit committee must elect an audit committee comprising at least three members.¹⁵⁶

3.2.3 General committees

The board of a Company may appoint any number of committees¹⁵⁷ and may appoint any person to the committee who is not a director of the Company.¹⁵⁸

3.2.4 Shadow directors

- (a) In South Africa there are differing views regarding the classification of "shadow directors" and the Courts have not resolved this issue. In this regard –
- (i) One view is that shadow directors do not fall within the definition of a director in terms of the 2008 Companies Act. In accordance with this view, a shadow director may be regarded as a prescribed officer depending on the influence the particular shadow director has on the Company.¹⁵⁹

¹⁵⁴ Defined in s1 of the 2008 Companies Act. Dealt with further under Question 3.

¹⁵⁵ Regulation 38 of the Regulations to the 2008 Companies Act. "This limits the participation to that of a direct nature and where the participation is equivalent to that of a director in terms of authority and control." (quoted at p28(2) of Henochsberg 2008 Companies Act).

¹⁵⁶ Section 94 of the 2008 Companies Act. Each member of an audit committee must be a director.

¹⁵⁷ Section 72 of the 2008 Companies Act. The power to appoint committees is subject to the provisions of the MOI.

¹⁵⁸ Section 72(2)(a) of the 2008 Companies Act. This section provides further that a non-director appointed to the committee is subject to the provisions of the 2008 Companies Act and such a person is not allowed to vote on any matter decided by the committee.

¹⁵⁹ p28(3) of Henochsberg 2008 Companies Act.

- (ii) The other view is that shadow directors do fall within the definition of director in terms of the 2008 Companies Act.¹⁶⁰

3.2.5 Duties and liabilities of these representatives

- (a) A prescribed officer, any members of an audit committee or general committee are given the same duties and have the same liabilities as a director in terms of the 2008 Companies Act.¹⁶¹
- (b) A “shadow director” may be given the same duties and have the same liabilities as a director in terms of the 2008 Companies Act, however this will depend on whether or not the particular person is regarded as a prescribed officer or director. In the event that the person is not regarded as a prescribed officer or director, then their liabilities and duties will be determined in accordance with the common law. The most likely source of liability would be found in the law of agency.¹⁶²

3.3 Employees and managers

Senior employees and managers¹⁶³ who are not directors may also have fiduciary duties to the Company depending on the nature of the position occupied by such person.¹⁶⁴

The fiduciary relationship requires the person that owes the duty, to act in good faith and in the interests of the Company to whom the duty is owed. A number of duties are applicable “and they are aimed at ensuring that a fiduciary does not abuse the fiduciary relationship of trust and confidence”.¹⁶⁵

The liability of employees arising from a breach of a fiduciary duty would be for any losses or damages suffered by the Company.

3.4 Persons who are knowingly a party to the business of the company

In terms of section 424 of the 1973 Companies Act any person who is knowingly a party to the carrying of the business in a reckless or fraudulent manner may be held liable in terms of this section.¹⁶⁶

Any such person can be held liable for all the debts of the Company.

3.5 Persons transacting with the company

This refers to transactions entered into between the Company and third parties that could be impeached. This is dealt with in Question 4.

¹⁶⁰ p410 Cassim’s Contemporary Company Law. In such an event the “shadow director” will have the same liabilities as a director and may be held liable for any loss suffered by the Company or any creditor as a result of breaching any such duty including being a party to any reckless trading.

¹⁶¹ Section 75, 76 and 77 of the 2008 Companies Act specifically include a prescribed officer in the definition of a director for purposes of these sections. It follows that the duties and liabilities set out under Question 2 in so far as they relate to any duty or liability which arises in terms of the 2008 Companies Act will apply to this group. Therefore these group of persons could be held liable for any loss suffered by any person arising from a breach of s75 to 77 of the 2008 Companies Act. This could include being liable for the losses suffered by any creditor resulting from a breach of any of these sections including any reckless conduct.

¹⁶² P28(3) of Henochsberg 2008 Companies Act. In terms of the laws of agency the “shadow director” will have certain fiduciary duties to the Company. In such event the “shadow director” will be liable to the Company for any losses suffered by the Company as a result of a breach of fiduciary duty owed by such person to the Company.

¹⁶³ In *Phillips versus Fieldstone Africa (Pty) Limited and Another* 2004 SA (3) 465 (SCA), the SCA held that fiduciary duties could be applicable to an employee of a Company. The SCA held that it is the nature of the relationship not the category of the position of the person which was relevant to determining whether a fiduciary duty existed.

¹⁶⁴ p298(4) of Henochsberg 2008 Companies Act.

¹⁶⁵ p513 of Cassim’s Contemporary Company Law.

¹⁶⁶ See discussion in para 2.1.5(d).

3.6 Offences

Certain offences apply to officers¹⁶⁷ of the Company in terms of the 1973 Companies Act.¹⁶⁸

Certain offences apply to any person.¹⁶⁹

QUESTION 4

4. Transactions During the twilight period

- (a) On what basis may transactions with the Company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?

4.1 Introduction¹⁷⁰

There are various types of transactions, which may take place during the twilight period, which stand to be set aside, pursuant to proceedings¹⁷¹ by the liquidator¹⁷² of a Company.¹⁷³

4.2 Dispositions made without value¹⁷⁴

Companies are entitled to dispose of their assets or funds with or without receiving adequate compensation. However, if after the disposition has been made, the liabilities of the Company exceed its assets and the Company is subsequently placed in liquidation, that disposition may be impeached by a liquidator if no value was received by the Company for the disposition.

4.2.1 Requirements for setting aside dispositions made without value

- (a) The Court may make an order restoring the status quo¹⁷⁵ by way of relief under this provision if the following conditions are satisfied:
- (i) a disposition was made by the Company, and
 - (ii) no value was received by the Company for the disposition, and
 - (iii) if the disposition was made:
 - More than two years before the Date of Liquidation, the liquidator will be required to prove that immediately after the disposition by the Company, the liabilities of the Company exceeded its assets.
 - Within a period of two years before the Date of Liquidation no such proof of the liabilities exceeding the assets is required on the part of the liquidator.

¹⁶⁷ See discussion in para 2.7.1.

¹⁶⁸ These include *inter alia* making a false statement (see para 2.7.2); concealing or destroying books or records (see para 2.7.4); concealment of liabilities (see para 2.7.5); failure to observe duties in relation to meeting of creditors (see para 2.7.7); failure to provide information at first meeting of creditors (see para 2.7.7); disposition of property with intention to prefer (see paragraph 2.7.09); diminishing assets by gambling (see para 2.7.10); non-compliance with obligation to advertise sale of business (see para 2.7.11); failure to alert the Master and liquidator to fraudulent claim (see para 2.7.13); failure to deliver property to the liquidator (see para 2.7.14); failure to inform the liquidator of the whereabouts of property (see para 2.7.15); failure to deliver books and records to the liquidator (see para 2.7.16); failure to furnish information concerning property (see para 2.7.17); failure to give information at a meeting of creditors (see para 2.7.19); and failure to appear and testify (see para 2.7.20).

¹⁶⁹ These include *inter alia* giving false evidence under interrogation (see para 3); dealing with property with the intent to defeat attachment or to prejudice creditors (see para 2.7.12); withholding information concerning, and failing to deliver, property of company (see para 2.7.21); obstructing the liquidator (see para 2.7.22); providing false or misleading information (see para 2.8.1); and falsification of accounting records (see para 2.8.2).

¹⁷⁰ Impeachable transactions are dealt with in terms of the Insolvency Act and the common law.

¹⁷¹ The Insolvency Act does not dictate whether proceedings should be brought by way of action or application proceedings, save to state that the ordinary legal principles are applicable thereto.

¹⁷² There are exceptions to this, however these are dealt with more fully later herein.

¹⁷³ Refers to a Company which has been placed in liquidation and is unable to pay its debts. The impeachable provisions of the Insolvency Act would be applicable to such a Company in terms of s339 of the 1973 Companies Act. See Introduction, para 3 in this regard.

¹⁷⁴ Section 26 of the Insolvency Act.

¹⁷⁵ The powers of the Court in respect of the setting aside of impeachable dispositions is dealt with more fully later herein.

- (vi) The rationale for the distinction drawn in 4.2.1(a)(iii) as to the time period within which the disposition is made is the result of a presumption that within the period of two years before the Date of Liquidation, after each disposition the liabilities of the Company would have exceeded its assets,¹⁷⁶ whereas for the period more than two years preceding liquidation, the liquidator is required to prove this.¹⁷⁷ Notwithstanding the presumption that is created, this may be utilised as a defence by the recipient of the disposition.¹⁷⁸

4.2.2 What is a disposition?

- (a) The Insolvency Act provides that a disposition is “any transfer or abandonment of rights to property [including] a sale, lease, mortgage, pledge, delivery, payment, release, compromise, donation or any contract, buy [excluding] a disposition in compliance with an order of Court”.¹⁷⁹
- (b) A Company must have parted with property that belongs to the Company, whether or not the property is corporeal or incorporeal.¹⁸⁰ The possible list of dispositions is therefore not exhaustive.¹⁸¹

4.2.3 What is no value?

- (a) No technical meaning has attached to the word “value”. However the Courts have found that the ordinary meaning of the word must be used.¹⁸² Consideration must be given to any kind of consideration given and not merely money with reference to all the circumstances of the transaction.¹⁸³
- (b) There is however a distinction between “no value” and “inadequate value”. Nominal value (which is manifestly inadequate) will always be regarded as no value. Inadequate value on the other hand is where the value is not proper or fair, but some value was given.¹⁸⁴ If inadequate value is given, the liquidators may not utilise this action, and are to rely on another action.
- (c) A disposition may be for value even in circumstances where the recipient is not the party who gives the value to the Company. Simply put, dispositions shall not be with no value in circumstances where the recipient does not give any consideration, but someone else gives the value to the Company.¹⁸⁵

4.2.4 Liabilities exceed assets

- (a) This is an objective test¹⁸⁶ that must be satisfied on a balance of probabilities.¹⁸⁷
- (b) In order to determine whether the liabilities of the Company exceeded the assets, values need to be attributed to the assets and the liabilities as at the date of each disposition.¹⁸⁸
- (c) Value is attributed by fixing probable market values to each of the assets. The liabilities are determined by considering the debts of the Company as at the date of the disposition. Reliance may be placed on the Company’s books and records, to the extent that they provide *prima facie* evidence of the assets and the liabilities.¹⁸⁹

¹⁷⁶ In this regard a reverse onus is placed on the recipient of the dispositions and is dealt with more fully below.

¹⁷⁷ *Venter and Others NNO v Barrit* 2008 (4) SA 639 (C).

¹⁷⁸ This defence is dealt with more fully below.

¹⁷⁹ Section 2 of the Insolvency Act.

¹⁸⁰ *Grobler v De Beer’s Trust* 1915 AD 265, *Ensor NO v Nedbank Ltd* 1978 (3) SA 110 (D) 113E.

¹⁸¹ Dispositions may include *inter alia* the abandonment of rights in another’s movable property; the transfer of immovable property and the abandonment of one’s rights in movable property (where the movable property has knowingly acceded to another’s immovable property). Even if a disposition is made in terms of a transaction which may be illegal, this will not bar a liquidator from pursuing the recovery of such property (*Estate Jager v Whittaker and Another* 1944 AD 246 at 250).

¹⁸² *Estate Wege v Straus* 1932 AD 76 at 82; *Estate Jager v Whittaker and Another* 1944 AD 246 at 250.

¹⁸³ *Langeberg Kooperasie Bpk v Inverdoorn Farming and Trading Company Ltd* 1965 (2) SA 587 (AD) 604.

¹⁸⁴ *Terblanche NO v Baxtrans CC and Another* 1998 (3) SA 912 (C).

¹⁸⁵ *Hurley NO v Muller and Co* 1924 NLR 121.

¹⁸⁶ *Venter v Volkskas Ltd* 1973 (3) SA 175 (T) 179A.

¹⁸⁷ *Nicholls and Whitelaw NO v Akoo* 1948 (4) SA 197 (N) at 203.

¹⁸⁸ *Venter v Volkskas Ltd* 1973 (3) SA 175 (T) 179.

¹⁸⁹ *Lipschitzand Another NNO v Landmark Consolidated (Pty) Ltd* 1979 (2) SA 482 (W) 494.

- (d) If the disposition was made outside of the two year period, the onus in respect of this element rests with the liquidator of the Company. However, if the disposition is made within two years of liquidation, a presumption exists that the liabilities did exceed assets within two years of liquidation.¹⁹⁰

4.2.5 Defences

- (a) As noted above, for dispositions that are made within a period of two years of the liquidation of the Company, the liquidator is not required to prove that the liabilities of the Company exceeded its assets. A recipient may be able to raise this as a defence on the basis that the assets of the Company actually exceeded its liabilities immediately after the disposition was made.¹⁹¹
- (b) In addition to the aforesaid defence, any recipient of such a disposition shall not be required to return the property subject to the disposition, if the recipient acted in good faith in transacting with the Company.¹⁹²

4.3 Dispositions made with the effect of preferring one creditor over another¹⁹³

Dispositions made by a Company, within six months of the Date of Liquidation, which have the effect of preferring one creditor of the Company over another, may be set aside by way of proceedings issued by the liquidator of the Company. These types of dispositions are referred to as a “voidable preference”.

4.3.1 Requirements for setting aside voidable preferences

- (a) The Court may make an order restoring the status quo by way of relief under this provision if the following conditions are satisfied:
- (i) A disposition has been made by the Company within six months of the Date of Liquidation (dealt with more fully above);
 - (ii) The disposition had the effect of preferring one creditor over another; and
 - (iii) Immediately after the disposition by the Company, the Company’s liabilities exceeded its assets (dealt with more fully above).

4.3.2 Effect of preferring one creditor over another

- (a) The test to determine whether the disposition had the effect of preferring one creditor over other creditors is an objective one.¹⁹⁴
- (b) Although generally such a preference would be exhibited when a creditor is paid in whole or part of its claims whilst the other creditors receive no payment or proportionately less, it is also possible for a creditor to be preferred over others where the Company disposes of property to a third party in such a way that the proprietary benefit of the disposal would accrue to the preferred creditor to the disadvantage of the remaining creditors.¹⁹⁵
- (c) The purpose of the law is to prevent a Company in liquidation, who cannot perform its obligations to all creditors, from preferring any one of its creditors to the prejudice of the others.¹⁹⁶

4.3.3 Defences

- (a) A recipient of a disposition sought to be attached in terms of this basis may rely on one of the following defences:

¹⁹⁰ *Estate Hunt v De Villiers* 1940 CPD 79 at 119.

¹⁹¹ *Keevy NO and Others (Joint Liquidators of Central Lake Trading 256 (Pty) Ltd) v Born Free Investments 364 (Pty) Ltd; Keevy NO and Others (Joint Liquidators of Summer Season Trading 49 (Pty) Ltd) v Born Free Investments 364 (Pty) Ltd* [2011] JOL 26752 (GNP).

¹⁹² The recipient will not be required to return the property unless the liquidator indemnities him for the parting of the property.

¹⁹³ Section 29 of the Insolvency Act.

¹⁹⁴ *Simon NO and Others v Coetzee* [2007] 2 all SA 110 (T) para 20.

¹⁹⁵ *Standard Finance Corporation of South Africa Ltd (in liquidation) v Greenstein* 1964 (3) SA 573 (AD) 577

¹⁹⁶ *Grobler v Grobler’s Trustees* 1908 TS 423.

- (i) The disposition was made in the ordinary course of business.
- (ii) The disposition was not intended to prefer one creditor over another.
- (iii) The recipient was acting in good faith in receiving the disposition.

4.4 Dispositions made with the intention of preferring one creditor over another¹⁹⁷

Unlike voidable preferences, dispositions made with the intention of preferring one creditor over another do not have any limit on the period in which the disposition was made, as long as a liquidator is able to demonstrate that an intention to prefer the recipient creditor existed as at the time of the disposition.

This is an onerous disposition to prove, as a liquidator is required to demonstrate that the Company intended to prefer the recipient creditor over others, which intention is determined by a subjective test.

Notwithstanding the onerous burden, if a liquidator is able to prove the intention to prefer, no defences are available to the recipient.

4.4.1 Requirements for setting aside dispositions of undue preference

- (a) The Court may make an order restoring the status quo by way of relief under this provision if the following conditions are satisfied:
 - (i) a disposition has been made (dealt with more fully above);
 - (ii) the Company's liabilities exceeded its assets as at the time of the disposition (dealt with more fully above); and
 - (iii) this disposition was made with the intention to prefer the recipient creditor.

4.4.2 Intention to prefer one creditor over another

- (a) As intention is a subjective test¹⁹⁸ regard needs to be given to the intentions of the Company as at the date of the disposition.
- (b) The Supreme Court of Appeal of South Africa (SCA)¹⁹⁹ has expressed the factors and circumstances which must be taken into account when determining whether the Company had the intention to prefer one creditor over another, notably:
 - (i) the dominant, operative or effectual intention in substance and in truth of the Company;
 - (ii) whether the Company actually considered making the disposition and if no application is found, the Courts have held that no intention can be present;
 - (iii) the fact that there is no evidence to the contrary does not give rise to the inference that there was intention to prefer; and
 - (iv) had the Company known that that the liquidation was substantially inevitable and still selected to make payment to certain creditors and not others, a natural inference can be drawn that the conduct of the Company was not fair, from which it may be inferred that there was an intention to prefer.
- (c) Essentially what is required from this type of action is an evaluation of the state of the controlling minds of the Company as at the date of the disposition.

¹⁹⁷ Section 30 of the Insolvency Act.

¹⁹⁸ *Van der Walt NO and Another v Le Roux NO* [2004] 4 All SA 476 (O) 485.

¹⁹⁹ The SCA is the highest court in South Africa in respect of non-constitutional disputes. *Cooper and Another NNO v Merchant Trade Finance Limited* 2000 (3) SA 1009 (SCA) and *Gore NO and Others v Shell South Africa (Pty) Ltd* [2003] 4 All SA 370 (C).

4.5 Collusive dealings²⁰⁰

If a disposition is made by a Company prior to the Date of Liquidation, which disposition either had the effect of prejudicing the Company's creditors or had the effect of preferring one creditor over another, a liquidator may apply to Court for such a disposition to be set aside if the disposition was effected in collusion with another.

This action is distinguishable from the other statutory proceedings as these dispositions are impeachable and are voidable at the instance of the liquidators and shall only become invalid from the date they are set aside by the Court. The remaining proceedings, should they be set aside, are void ab initio.

4.5.1 Requirements for setting aside collusive dealings:

- (a) The Court may make an order restoring the status quo by way of relief under this provision if the following conditions are satisfied:
 - (i) A disposition has been made (dealt with more fully above);
 - (ii) The disposition had the effect of prejudicing the creditors of the Company or had the effect of preferring one creditor over another (dealt with more fully above);
 - (iii) The Company and the contracting party knew that the Company's liabilities exceeded its assets;
 - (iv) The disposition was made with the intention to defraud the creditors of the Company.

4.5.2 Intention

- (a) Although this action requires intention on both the Company and the contracting parties,²⁰¹ the Courts have held that the fact that the contracting parties knew, as at the time of the disposition, that the disposition would have the effect of prejudicing the creditors or would have the effect of preferring one creditor over another, is *prima facie* evidence of the requisite fraudulent intention.
- (b) It is furthermore imperative that the fraud be proven by the liquidators: however, the onus is one of a balance of probabilities.²⁰²

4.5.3 *Actio Pauliana*

- (a) In addition to the statutory provisions applicable to collusive dealings, the common law facilities the prosecution of collusive dealings in terms of the *actio Pauliana*. A party²⁰³ may seek an order from Court setting aside a disposition by a Company of its property pursuant to a fraudulent agreement with one of its other creditors, which disposition has the effect of diminishing the Company's property.²⁰⁴
- (b) The intention to commit fraud exists where the Company disposing of the property has the intention to defraud its other creditors.²⁰⁵
- (c) The key differences between the *actio Pauliana* and the statutory provision for collusive dealings are the following:
 - (i) The *actio Pauliana* is founded in common law and not in terms of the Insolvency Act.
 - (ii) The *actio Pauliana* is available to creditors and a liquidator, as opposed to the statutory proceedings, which are only available to a liquidator. Although the *actio Pauliana* is available to a liquidator, generally a liquidator will pursue collusive dealings by utilising the statutory proceedings.

²⁰⁰ Section 31 of the Insolvency Act.

²⁰¹ Which test is a subjective one (*Van der Walt NO and Another v Le Roux NO* [2004] 4 All SA 476 (O) 485).

²⁰² *Bagus v Estate Moosa* 1941 AD 62 at 71.

²⁰³ Either a liquidator or creditor. This is unlike the statutory proceedings in terms of s31 of the Insolvency Act which requires a liquidator to prosecute the proceedings.

²⁰⁴ *Fenhalls v Ebrahim and Others* 1956 (4) SA 723 (D) 727.

²⁰⁵ *Trustees Estate Chin v National Bank of South Africa Ltd* 1915 AD 353 at 363.

- (iii) The *actio Pauliana* is available to creditors before the liquidation of the Company, which right shall ensue following the liquidation of the Company.²⁰⁶ This is unlike the statutory provisions, which only become available to the liquidator following the Date of Liquidation.

4.6 Voidable sale of business²⁰⁷

Section 34 of the Insolvency Act provides the process to be adopted by traders should they intend to dispose of their business or a portion thereof, to protect the transaction.²⁰⁸

If section 34 of the Insolvency Act is not complied with by traders, whereafter the trader is placed in liquidation, a sale of business or portion thereof will be declared void, should the transfer have taken place within six months of the Date of Liquidation.

This provision has been included in the legislation in order to protect innocent third parties from acquiring the business of a Company that is later placed in liquidation and the transaction having to be unwound.²⁰⁹

In order for a Company to be subjected to this provision, the Company must be regarded as a trader, being “[any entity which] carries on any trade...or undertaking in which property is sold”.²¹⁰

Like the *actio Pauliana*, proceedings for the setting aside of the transfer of business may be brought by creditors and a liquidator. If a transfer fails to comply with the aforesaid requirements, the transfer shall be void to the extent of the claim of the creditor who instituted the proceedings.²¹¹

4.7 Disposition of property after the “date of liquidation”²¹²

Although these dispositions are made following the Date of Liquidation, and not within the twilight period, such transactions and dispositions are important to this discussion.

Any disposition of property by the Company, subject to the Company being unable to pay its debts²¹³ following the Date of Liquidation is void, unless a Court otherwise orders.²¹⁴

The rationale behind this provision in the 1973 Companies Act is to ensure that the property of the Company can be properly utilised by a liquidator to distribute to the creditors and is not improperly dissipated following the Date of Liquidation.

In proceedings to Court in terms of this provision, although the Court has a discretion to determine the fairness of the setting aside of such dispositions as void, there are limited circumstances and instances where the Court will validate the disposition. Circumstances in which the Court may refuse to set aside the disposition (thereby validating the disposition) is where the disposition in effect amounted to a bona fide transaction by the Company and the recipient pursuant to the Company carrying on business in the ordinary course.²¹⁵

In dispositions of this nature, the Court will also consider the knowledge of the recipient of the disposition. Should the recipient have been aware that there was pending proceedings for the liquidation of the Company, this will be a factor, but not decisive.²¹⁶

²⁰⁶ *Fenhalls v Ebrahim and Others* 1956 (4) SA 723 (D) 727.

²⁰⁷ Section 34 of the Insolvency Act.

²⁰⁸ The process provides for the publication of the sale of a business to the general public and the requirements of same.

²⁰⁹ *Harrismith Board of Executors v Odendaal* 1923 AD 530 at 538.

²¹⁰ Section 2 of the Insolvency Act.

²¹¹ *Welrmans Custom office furniture (Pty) Ltd (in liquidation) v Whistlers* CC 1999 (3) SA 1116 (SCA) 1121.

²¹² Section 341(2) of the 1973 Companies Act.

²¹³ *International Shipping Co (Pty) Ltd v Affinity (Pty) Ltd and Another* 1983 (1) SA 79 (C) 85.

²¹⁴ *International Shipping Co (Pty) Ltd v Affinity (Pty) Ltd and Another* 1983 (1) SA 79 (C) 85.

²¹⁵ *Gainsford NO and Others v Tanzer Transport (Pty) Ltd and Others* [2014] 3 All SA 21(SCA) para 28.

²¹⁶ *Hirrigel NO v Bon Roads Cosntruction Co (Pty) Ltd and Another* 1980 (4) SA 669 (SWA) 680.

QUESTION 5

5. By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 1973 Companies Act

In respect of any action brought in terms of section 424 of the 1973 Companies Act, the actions may be brought by the following persons:²¹⁷

- (a) A liquidator of the Company;
- (b) The Master;
- (c) Any creditor; and
- (d) Any shareholder.

5.2 2008 Companies Act

In respect of any action arising from a contravention of any provision of the 2008 Companies Act the actions may be brought by the following persons:

- (a) The Company;²¹⁸ and
- (b) Any person, including a creditor or shareholder, who has suffered a loss as a result of such contravention;²¹⁹

The following persons are granted a derivative action by the 2008 Companies Act to commence or continue legal proceedings against any person in the name of and on behalf of the Company:²²⁰

- (a) Shareholder;
- (b) A director or prescribed officer of the Company or a related Company; and
- (c) A registered trade union representing the employees of the Company or another representative of the employees of the Company.

5.3 Impeachable dispositions

In respect of impeachable dispositions in terms of the Insolvency Act, a liquidator may bring the proceedings against the third party recipient.²²¹

However, should a liquidator fail to take such proceedings, creditors may take such proceedings, in the name of a liquidator and upon the creditors' indemnification of a liquidator against all costs thereof.²²² Strictly speaking, all these proceedings, even at the instance of creditors, are on behalf of a liquidator.

Notwithstanding this, and although the proceedings are in the name of the liquidator, the creditor at whose instance the proceedings are brought is entitled to the proceeds recovered in terms of the proceedings, up until that creditor has been paid in full, whereafter the remaining creditors may benefit.²²³

²¹⁷ Section 424(1) of the 1973 Companies Act.

²¹⁸ Section 77 of the 2008 Companies Act. In the event that the Company is in liquidation then the Company will be represented by the liquidator.

²¹⁹ Section 218(2) of the 2008 Companies Act.

²²⁰ Section 165 of the 2008 Companies Act. This section has abolished any common law rights which such persons have to bring legal proceedings on behalf of the Company. The section provides that the person is required to serve a demand on the Company with the leave of the Court in terms of which the Company is required to commence or continue with legal proceedings to protect the legal interest of the Company. The board (if it has not applied to Court to set aside the demand) is required to investigate the request and to appoint an independent and impartial person to investigate the request and to report to the board. If the board does not comply with the provisions of this section or decides not to comply with the demand after following the process required by this section then the person making the demand can apply to Court to continue or bring the proceedings in the name and on behalf of the Company.

²²¹ Section 32 of the Insolvency Act.

²²² Section 32 of the Insolvency Act.

²²³ Section 104(3) of the Insolvency Act; *Chait v Short NO and Others* 1940 CPD 606.

5.4 Common law

In respect of any action under the common law then the Company may bring the action.

5.4.1 *Actio Pauliana*

- (a) In respect of the *actio Pauliana*, a liquidator is authorised to bring such proceedings however, it is uncommon for liquidators to bring such proceedings as they have recourse to the statutory remedies and in most cases will pursue collusive dealings in that manner.
- (b) In addition thereto, a creditor of the Company may bring an *actio Pauliana* in the creditor's own name and at his own risk.²²⁴ The creditor is required to join the liquidators as defendants to the proceedings, however is under no obligation to indemnify the liquidators.²²⁵

QUESTION 6

6. In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

6.1 Reckless trading

6.1.1 Section 424 of the 1973 Companies Act

In respect of any action instituted in terms of this provision, the Court can declare that the defendants²²⁶ to the action be held liable for all the debts of the Company.²²⁷

6.1.2 Section 22 of the 2008 Companies Act

- (a) The Company can hold the director²²⁸ liable for any loss, damages or costs sustained by the Company as a direct or indirect consequence of the director acquiescing in the conduct prohibited by section 22 of the 2008 Companies Act.²²⁹
- (b) Any person, including a creditor, can hold the director liable for any losses or damages suffered by that person as a result of the director contravening this section.²³⁰
- (c) The authorised persons²³¹ can apply to Court to have the directors, who have been found to have traded the business recklessly, declared delinquent.²³²

6.2 Breach of fiduciary duties by a director²³³

6.2.1 Statutory remedies

- (a) In accordance with the principles of the common law relating to a breach of a fiduciary duty,²³⁴ a director may be held liable for any loss or damages suffered by the Company as a consequence of any breach by the director of various provisions of the 2008 Companies Act, which liability is dealt with in terms of section 77(2) of the 2008 Companies Act, including the following breaches:

²²⁴ Notwithstanding the fact that the creditor brings the proceedings in its own name, should the creditor be successful in these proceedings, the proceeds must be delivered to the liquidators for distribution and administration by the liquidators in terms of the Insolvency Act.

²²⁵ The indemnification of liquidators will be dealt with more fully below as contemplated in s32(1) of the Insolvency Act.

²²⁶ The "defendants" will be any person alleged to have been knowingly a party to the reckless or fraudulent trading.

²²⁷ Section 424(1) of the 1973 Companies Act.

²²⁸ See Question 1 for the definition of director.

²²⁹ Section 77(3)(b) of the 2008 Companies Act.

²³⁰ Section 218(2) of the 2008 Companies Act. See footnote 30 supra.

²³¹ Set out in s162(2) of the 2008 Companies Act and includes the Company, shareholder, director or prescribed officer, employee or registered trade union.

²³² Section 162(2) of the 2008 Companies Act.

²³³ See Question 1 for a definition of a director in terms of the 2008 Companies Act.

²³⁴ Emphasis added.

- (i) Breach of the disclosure of financial interest.²³⁵
 - (ii) Breach of the use of the position of a director to gain an advantage.²³⁶
 - (iii) Breach of the duty to act in good faith and for proper cause.²³⁷
 - (iv) Breach of the duty to act in the best interests of the Company.²³⁸
- (b) In accordance with the principles of the common law relating to delict,²³⁹ a director may be held liable for any loss, damages or costs sustained by the Company as a consequence of the breach by the director of various provisions of the 2008 Companies Act, which liability is dealt with in terms of section 77(2) of the 2008 Companies Act, including the following breaches:
- (i) Breach of the duty to act with the required diligence and skill.²⁴⁰
 - (ii) Any provision of the 2008 Companies Act not specifically mentioned.
- (c) A director of a Company can be held liable for any loss, damage or costs suffered by a Company as a direct or indirect consequence of the director having been a party to an act or omission by the Company despite knowing that the act or omission was calculated to defraud a creditor, employee or shareholder of the Company.²⁴¹

6.2.2 Common law remedies

- (a) The liability for a breach of a fiduciary duty at common law is not delictual but is *sui generis*.²⁴²
- (b) The remedy is for any damages suffered by the Company as a result of the breach.
- (c) The Company can also seek an interdict the conduct that constitutes a breach of the fiduciary duty.²⁴³

6.3 Impeachable dispositions (contemplated in section 32 of the Insolvency Act)

The relief that is sought by a liquidator in respect of impeachable disposition proceedings is the setting aside of the dispositions and the recovery of compensation or a penalty in respect of the disposition.²⁴⁴ Therefore, the Court, if satisfied that the requirements of the various dispositions have been met, shall set aside the disposition as void *ab initio*.²⁴⁵

The Court is thereafter bound to declare that a liquidator is entitled to recover the property subject to the disposition, alternatively, in the event that the property is no longer capable of being returned, the value of the property as at the date of the disposition or on the date on which the disposition is set aside (whichever is higher).²⁴⁶

6.4 *Actio Pauliana*

The *actio Pauliana* facilitates the setting aside of disposition and the recovery of compensation or a penalty in respect of the disposition.²⁴⁷ To the extent that a creditor or liquidator is unable to recover the property from the Company that made the disposition, a creditor or liquidator may pursue the recipient of the disposition.²⁴⁸

²³⁵ Section 75 of the 2008 Companies Act.

²³⁶ Section 76(2) of the 2008 Companies Act.

²³⁷ Section 76(3)(a) of the 2008 Companies Act.

²³⁸ Section 76(3)(b) of the 2008 Companies Act.

²³⁹ Emphasis added.

²⁴⁰ Section 76(3)(c) of the 2008 Companies Act.

²⁴¹ Section 77(3)(c) of the 2008 Companies Act.

²⁴² p304 of Henochsberg 2008 Companies Act. This would apply to any person who has a fiduciary duty to the Company.

²⁴³ p304 of Henochsberg 2008 Companies Act.

²⁴⁴ *Ultrapolymers (Pty) Ltd v Maredi NO and Others* 16 March 2012 (GSJ) 6171/2012.

²⁴⁵ Collusive dealings on the other hand shall not be set aside as *void ab initio*, but shall be regarded as void as at the date on which the court sets such disposition aside.

²⁴⁶ *Ultrapolymers (Pty) Ltd v Maredi NO and Others* 16 March 2012 (GSJ) 6171/2012.

²⁴⁷ Mathilde Sumampoun *et al* "Law and Reality: Essays on National and International Procedural Law (1992) at p90 (Sumampoun's Law and Reality).

²⁴⁸ p90 Sumampoun's Law and Reality.

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other directors and other persons identified in Question 3 above obliged to co-operate within the insolvency office holder's investigation into the Company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Introduction

During Business Rescue Proceedings, there is a general obligation on each director of the Company²⁴⁹ to attend to the requests of the Practitioner at all times and to provide the Practitioner with any information about the Company's affairs as may be reasonably required.

In respect of a Company that has been wound up and is unable to pay its debts, the directors cease to be directors functionally, officially and nominally²⁵⁰ and their powers and duties also terminate.²⁵¹ However they are still required to perform certain tasks in respect of the liquidation.

7.2 Business rescue proceedings

As soon as practicable after business rescue proceedings begin, each director of a Company must deliver to the Practitioner all books and records that relate to the affairs of the Company and are in the director's possession.²⁵²

Any director of a Company who knows where other books and records relating to the Company are being kept, must inform the Practitioner as to the whereabouts of those books and records.²⁵³

Within five business days after business rescue proceedings begin, or such longer period as the Practitioner allows, the directors of a Company must provide the Practitioner with a statement of affairs containing, at a minimum, particulars of the following:²⁵⁴

- (a) Any material transactions involving the Company or the assets of the Company, and occurring within 12 months immediately before the business rescue proceedings began.²⁵⁵
- (b) Any Court, arbitration or administrative proceedings, including pending enforcement proceedings, involving the Company.²⁵⁶
- (c) The assets and liabilities of the Company, and its income and disbursements within the immediately preceding 12 months.²⁵⁷
- (d) The number of employees, and any collective agreements or other agreements relating to the rights of employees.²⁵⁸
- (e) Any debtors and their obligations to the Company.²⁵⁹
- (f) Any creditors and their rights or claims against the Company.²⁶⁰

²⁴⁹ Section 137(3) of the 2008 Companies Act.

²⁵⁰ p14-197 to p14-198 to Commentary on the 1973 Companies Act, Blackman, Volume 3 (**Blackman**).

²⁵¹ Page 14-198 to Blackman.

²⁵² Section 142(1) of the 2008 Companies Act.

²⁵³ Section 142(2) of the 2008 Companies Act.

²⁵⁴ Section 142(3) of the 2008 Companies Act.

²⁵⁵ Section 142(3)(a) of the 2008 Companies Act.

²⁵⁶ Section 142(3)(b) of the 2008 Companies Act.

²⁵⁷ Section 142(3)(c) of the 2008 Companies Act.

²⁵⁸ Section 142(3)(d) of the 2008 Companies Act.

²⁵⁹ Section 142(3)(e) of the 2008 Companies Act.

²⁶⁰ Section 142(3)(f) of the 2008 Companies Act.

No person is entitled, as against the Practitioner, to retain possession of any books or records of the Company, or to claim or enforce a lien over any such books or records, unless such books or records are in the lawful possession of such person and he or she has made copies available to the Practitioner or had afforded the Practitioner a reasonable opportunity to inspect the books or records concerned.²⁶¹

7.3 Winding up proceedings

7.3.1 Directors have an obligation to submit a statement of affairs²⁶²

- (a) Where a Company intends to pass a resolution (by its members) for a creditors' winding up, the directors are required to place before the meeting a statement of affairs of the Company in the form prescribed by the 1973 Companies Act.
- (b) Where an order is made for the winding up of the Company by the Court then the directors (appointed as at the Date of Liquidation) and if required by the Master, all persons who were directors at any time within one year of the Date of Liquidation, are required to submit a statement of affairs to the Master.²⁶³

7.3.2 Duty to attend meetings of creditors and interrogation of directors

- (a) In any winding up of the Company which is unable to pay its debts every director and officer shall be required to attend the first and second meeting of creditors.²⁶⁴
- (b) The Master or any officer presiding at a meeting of creditors may subpoena any person who in the opinion of the Master or such other officer may be able to give material information concerning the Company or its affairs, to appear at such meeting for the purpose of being interrogated.²⁶⁵
- (c) The Master or the presiding officer at any meeting of creditors of a Company which is being wound up and is unable to pay its debts, may call on any director of the Company to be interrogated under oath by the Master, the liquidator or any creditor who proved a claim against the Company in respect of any matter which pertains to the affairs of the Company.²⁶⁶
- (d) In the event that:
 - (i) A director fails to attend a meeting of creditors or fails to remain in attendance at the meeting then the presiding officer may issue a warrant of arrest for the director to be brought before the presiding officer.²⁶⁷
 - (ii) Unless the director is able to satisfy the presiding officer that he had a reasonable excuse for failing to attend the presiding officer can commit the director to prison and to produce him at the time and place determined by the presiding officer.²⁶⁸
 - (iii) In the event that the director fails to produce any book or document which he was summoned to produce at the meeting or fails to answer a question lawfully put to him then the presiding officer may commit him to prison where he can be detained until he undertakes to do what is required of him.²⁶⁹
 - (iv) Only a presiding officer who is a magistrate may commit a person to prison in terms of the above provisions.

²⁶¹ Section 42(4) of the 2008 Companies Act.

²⁶² Section 363(1) of the 1973 Companies Act.

²⁶³ Section 363(2) of the 1973 Companies Act. The Master is required to transmit a copy of the statement of affairs to the Master.

²⁶⁴ Section 414(1) of the 1973 Companies Act.

²⁶⁵ Section 414 of the 1973 Companies Act.

²⁶⁶ Section 415 of the 1973 Companies Act.

²⁶⁷ Section 66 of the Insolvency Act as read with s416 of the 1973 Companies Act.

²⁶⁸ Section 67 of the Insolvency Act as read with s416 of the 1973 Companies Act.

²⁶⁹ Section 68 of the Insolvency Act as read with s416 of the 1973 Companies Act.

7.3.3 Interrogation of directors at a section 417 and section 418 of the 1973 Companies Act enquiry.

- (a) In any winding up of a Company²⁷⁰ unable to pay its debts, the Master or the Court may summon any director or officer of the Company to appear before it to be examined by the Master or the Court to give evidence which is relevant to the trade, affairs and dealings of the Company.²⁷¹
- (b) The Master or the Court may refer the enquiry to a commissioner appointed by the Master or the Court for this purpose.²⁷² This is known locally as a “section 418 enquiry”.

The section 418 enquiry is usually convened at the request of the liquidator or a creditor.

The liquidator, a creditor or a shareholder shall be entitled to be represented at the enquiry and shall be entitled to interrogate the witnesses summoned to the enquiry.²⁷³

7.4 Defence against self - incrimination

A director who has been summoned to an interrogation in terms of the 1973 Companies Act is not entitled to refuse to answer a question on the ground that the answer will incriminate the director, provided that the presiding officer at the enquiry shall only be obliged to compel the director to answer after the presiding officer has consulted with the Director for Public Prosecutions.²⁷⁴

Any incriminating evidence or answer or information which is procured directly at an enquiry into the affairs of the Company is not admissible as evidence in any criminal proceedings against the person concerned except in respect of a charge of perjury or failing to answer a question lawfully.²⁷⁵

QUESTION 8

8. Appeals and limitation periods

- (a) What limitation period, if any, applies to the actions referred to above?**
- (b) What rights of appeal are available from the decisions of the lower courts?**

8.1 Prescription

In South Africa there is a three-year period in which to institute proceedings in terms of the Prescription Act 68 of 1969 (Prescription Act).²⁷⁶ The expression prescription means the process whereby a legal claim or right is extinguished if enforcement proceedings by way of summons are not commenced within the applicable prescriptive period.

If the three-year period lapses without summons being issued to enforce the debt, then the debt prescribes and ceases to exist.

In terms section 12(1) and (3) of the Prescription Act, prescription shall commence to run as soon as the debt is due and a debt shall not be deemed to be due until creditor has knowledge of the identity of the debtor and of the facts from which the debt arises, provided that a creditor shall be deemed to have knowledge if he could have acquired it by exercising reasonable care.²⁷⁷

²⁷⁰ This refers to a winding up by the Court. *Phillips versus The Master* 2000 (2) SA 841 (N).

²⁷¹ Section 417 (1) of the 1973 Companies Act.

²⁷² Section 418(1) of the 1973 Companies Act.

²⁷³ Section 418(2) of the 1973 Companies Act.

²⁷⁴ Section 415(3) and 417(2)(b) of the 1973 Companies Act.

²⁷⁵ Section 415(5) and 417(2)(c) of the 1973 Companies Act.

²⁷⁶ Section 3 of the Prescription Act.

²⁷⁷ Section 12(1) and (3) of the Prescription Act.

In a situation where a Company is in liquidation and there is a fraudulent transaction that needs to be set aside, the liquidators will only be bound to institute proceedings on their knowledge of that, which is imputed to them on their appointment.

In *Duet and Magnum Financial Services CC (in liquidation) v Koster*²⁷⁸ the Court held that proceedings to be instituted by liquidators are subject to the Prescription Act, however that the prescriptive period shall begin to run no later than the date on which the liquidator was appointed, subject to the liquidator having the requisite locus standi to institute the proceedings.²⁷⁹

Therefore, until such a time as a liquidator has been appointed, and the liquidator has the requisite locus standi to issue summons, prescription shall not run against the Company.²⁸⁰ For this reason, until such time as a liquidator has had an opportunity to have creditors authorise the liquidator, or the liquidator has had an opportunity to formally apply to Court or the Master for an order extending its powers.²⁸¹

Any proceedings to recover any loss, damages or costs in terms of section 77 of the 2008 Companies Act may not be proceeded with after a period of three years have lapsed after the act or omission which gave rise to the liability in terms of this section.²⁸²

8.2 Leave to appeal

In terms of section 16(1) of the Superior Court Act²⁸³ (Supreme Court Act), an appeal may be pursued should leave be granted to do so either:

- to a full bench of the Court a quo (in the event that the Court a quo only had one judge presiding over the matter) or to the SCA; or
- if the Court a quo sat as a full bench, to the SCA.

Section 17(1) of the Supreme Court Act, provides that leave to appeal may only be given where the presiding judge or judges in the Court a quo are of the opinion that –

- (a) the appeal would have a reasonable prospect of success; or
- (b) there is some other compelling reason why the appeal should be heard, including conflicting judgments on the matter under consideration.

Leave to appeal is sought from the judge/s over which the first hearing was heard. If leave to appeal is denied by the presiding judge, one can apply to the full bench of the Court a quo which consists of 3 or more judges, who will hear the application for leave to appeal. If this application is still unsuccessful, an application can be made to the SCA, which is the supreme Court in South Africa for all commercial transactions. The SCA has the sole discretion to decide if the matter should be heard on appeal in the Court quo or in the SCA.²⁸⁴

Notwithstanding the fact that the SCA is the highest Court for commercial transactions, the Constitutional Court (which has previously been solely for constitutional issues) has now been authorised to decide any other matter, if leave to appeal is granted by the Court on the grounds that the matter raises an arguable point of law of general public importance which ought to be considered by that Court.²⁸⁵

²⁷⁸ *Duet and Magnum Financial Services CC (in liquidation) v Koster* 2010 (4) SA 4 991.

²⁷⁹ *Duet and Magnum Financial Services CC (in liquidation) v Koster* 2010 (4) SA 4 991 para 27.

²⁸⁰ *Imperial Bank Limited v Henderick Jacobus Rust Barnard N. O & Four Others* 2013 (ZASCA) 42.

²⁸¹ Section 386(5) of the 1973 Companies Act authorises applications to Court or the Master for an order extending a liquidator's powers in order to institute legal proceedings, failing which a liquidator shall require creditors to authorise the liquidator to institute proceedings following a second meeting of creditors.

²⁸² Accordingly the provisions of the Prescription Act will not apply to any causes of action which arise in terms of this section. For example the provision in the Prescription Act that prescription will not begin to run until the creditor has knowledge of the debtor and the facts will not apply to actions commenced in terms s77. p303 of Henochsberg 2008 Companies Act.

²⁸³ The Supreme Court Act 10 of 2013.

²⁸⁴ Rule 19(c) of the Uniform Rules of Court.

²⁸⁵ Section 167(3)(b)(ii) of the Constitution of the Republic of South Africa, 1996.

QUESTION 9

9. Foreign corporations

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

9.1 Winding-up of external companies

Foreign companies and corporations are defined in S 1(1) of the 1973 Companies Act as ‘external companies’ and include all companies or associations incorporated outside the Republic, which entities have lodged their respective founding documents with the relevant authorities and have established a place of business in the Republic (which may include the acquisition of immovable property).²⁸⁶ Section 23 of the 2008 Companies Act however provides further requirements for the incorporation of external companies.²⁸⁷

Section 337 of the 1973 Companies Act, which is still applicable to the compulsory winding-up of companies by application of item 9, schedule 5 of the 2008 Companies Act, provides that the term ‘Company’, for the purposes of the winding-up provisions of the 1973 Companies Act, shall be applicable to external companies.

Therefore, the process and procedure in respect of the compulsory winding-up of Companies in terms of the 1973 Companies Act is applicable to external Companies. The provisions aforesaid are irrespective of whether an external Company is already subject to winding-up proceedings in their respective country of incorporation.²⁸⁸ Therefore, there may be a concurrent and simultaneous liquidation of an external company despite the fact that the Company is being wound-up in its Company of incorporation.

Notwithstanding this, should an external Company wish to be voluntarily wound-up, this process is not to take place in the Republic.²⁸⁹ Although the statutory provisions do not provide guidance in this regard, the commentary is such that the external Companies should only be voluntarily wound-up in their own jurisdiction and country of incorporation.

9.2 Recognition of a foreign liquidator

In the event that an external company is wound-up in their country of incorporation, the liquidator appointed there shall require recognition to deal with the assets, property or business incorporated in the Republic.

9.2.1 Movable property

- (a) In South Africa law, a foreign liquidator is automatically vested with the Company’s movable property in whatever jurisdiction they may be situated.
- (b) This is only, if at the date of the liquidation, the Company was registered in the area of the jurisdiction of the Court that granted the order.
- (c) Notwithstanding the fact that a foreign liquidator is automatically vested with the movable property, the foreign liquidator shall require recognition from the Court to be authorised to deal with the property.

9.2.2 Immovable property

In order for a foreign liquidator to deal with a Company’s immovable property registered in the Republic, recognition from the Court of the authority of the liquidator is required.

²⁸⁶ Section 1 of the 1973 Companies Act.

²⁸⁷ Section 23 of the 2008 Companies Act.

²⁸⁸ *Ward & Another v Smit & Others, In re: Guree v Zambia Airways Corporation Ltd* [1998] 2 All SA 479 (A).

²⁸⁹ p28(3) of Henochsberg 2008 Companies Act.

9.2.3 Recognition

- (a) The Court has discretion whether to recognise a foreign liquidator for the purposes of dealing with the property of the Company. This discretion is subject to the Court being satisfied that the recognition of a foreign liquidator will provide the local creditors in the Republic sufficient protection.
- (b) The recognition of foreign liquidators will also provide the foreign liquidator with the necessary authority to *inter alia* convene enquiries into the affairs of the Company.
- (c) The Court may, in such recognition applications, order that any local assets or the process of the sale thereof may only be removed to the foreign jurisdiction or utilised by the foreign liquidator once the administration costs and Court costs, as well as all the local creditors' claims have been satisfied.

QUESTION 10

10. Insurance

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

10.1 Indemnity

Directors²⁹⁰ may enjoy the benefit of an indemnity from the Company and / or directors liability insurance, provided that such cover must fall within the parameters permissible in terms of South African law.²⁹¹

A director may not contract out of his common law or statutory duties.²⁹²

A Company may indemnify a director in respect of any liability arising, other than in respect of the following:²⁹³

- (a) Any liability arising in terms of S 77(3)(a),²⁹⁴ 77(3)(b),²⁹⁵ and 77(3)(c)²⁹⁶ of the 2008 Companies Act;
- (b) any liability arising from wilful misconduct or wilful breach of trust on the part of the director;²⁹⁷
- (c) any fine contemplated in S 78(3) of the 2008 Companies Act.
- (d) S 78 of the 2008 Companies Act does not seem to prevent a director from being indemnified by someone other than the Company.²⁹⁸

²⁹⁰ See discussion of directors in Question 1.1.

²⁹¹ Section 78 of the 2008 Companies Act.

²⁹² In terms of s78(2) of the 2008 Companies Act a provision of any agreement, the Memorandum of Incorporation, the rules or resolution of a Company, whether express or implied, is void to the extent that it directly or indirectly purports to (1) relieve a director of a duty contemplated in s75 or s76 of the 2008 Companies Act; (2) relieve a director of any liability contemplated in s77 of the 2008 Companies Act; or (3) negate, limit or restrict the legal consequences arising from any act or omission that constitutes willful conduct. This is mitigated by the Company being allowed in, certain circumstances, to indemnify the director or purchase indemnity insurance for the director.

²⁹³ Section 78(5) and s78(6) of the 2008 Companies Act. Section 78(5) provides that unless the MOI provides otherwise a Company may indemnify a director against any liability other than as contemplated in s78(6) of the 2008 Companies Act.

²⁹⁴ Knowingly acting without authority on behalf of a Company.

²⁹⁵ Acquiescing in the fraudulent or reckless conduct of the company contrary to s22 of the 2008 Companies Act.

²⁹⁶ Knowingly being a party to conduct calculated to defraud a creditor, employee or shareholder of the Company or for another fraudulent purpose.

²⁹⁷ Section 78(6)(a)(ii) of the 2008 Companies Act.

²⁹⁸ p575 Cassim's Contemporary Company Law.

Except if an MOI provides otherwise, a Company may advance expenses to a director to defend litigation in any proceedings arising out of the director's service to the Company,²⁹⁹ and in addition may directly or indirectly indemnify a director against such expenses if the proceedings:

- (a) have subsequently been abandoned or exculpated; or
- (b) have arisen in respect of a liability in respect of which the Company is entitled to indemnify the director.³⁰⁰

Except to the extent that the MOI of a Company provides otherwise, a Company may purchase insurance to protect a director against any liability or expenses for which the Company is permitted to indemnify a director. A Company is therefore allowed to take out directors' and officers' insurance against most contingencies (including negligence) at its own cost, even if the director receives the proceeds of the policy.³⁰¹

The information provided in this country chapter is correct as at 31/03/2017

²⁹⁹ Section 78(4)(a) of the 2008 Companies Act.

³⁰⁰ Section 78(4)(b) of the 2008 Companies Act.

³⁰¹ Section 78(7) of the 2008 Companies Act. *It is important to note that a Company cannot take out insurance indemnifies a director against reckless trading prohibited by the 2008 Companies Act. This would not apply to reckless trading in terms of s424 of the 1973 Companies Act. See para 10.1.3.*

SPAIN

OVERVIEW

The Spanish Insolvency Act (the Insolvency Act) came into force on 1 September 2004 and applies to any insolvency proceedings initiated in Spain after that date. The Insolvency Act replaces the previously archaic and fragmented regulation¹ with a single consolidated insolvency law. Insolvency proceedings pending at the time the Insolvency Act became effective are still administered in accordance with the old insolvency legislation, subject to certain modifications. The Insolvency Act:

- (a) establishes a single insolvency procedure (*concurso*) pursuant to which a company may be declared insolvent if it cannot meet its payment obligations;
- (b) abolishes the retroactive bankruptcy rule, pursuant to which the Court would establish a date prior to the declaration of insolvency on which the company effectively became insolvent. Under the old legislation, all acts and transactions completed in the period between the date of effective insolvency and the date of the declaration were void, even if entered into at arm's length and for good commercial reasons or otherwise. Under the Insolvency Act, any transaction entered into during the two years prior to the declaration of insolvency that negatively affects the company's estate may be rescinded (see 1.1 and 4.1 below for more detail);
- (c) provides for a single insolvency practitioner (the IP) instead of the various categories of receivership under the old insolvency legislation;
- (d) creates special commercial Courts (*Juzgados de lo Mercantil*; the Commercial Courts) for dealing with insolvency and other commercial issues; and
- (e) includes the rules on cross-border insolvency proceedings introduced by Regulation 1346/2000 of the Council of the European Union, dated 29 May 2000 (the EU Regulation).

Procedural issues not governed by the Insolvency Act are subject to the provisions of the Civil Procedure Act (*Ley de Enjuiciamiento Civil*) of 7 January 2000 (CPA). The CPA aims to speed up proceedings, make them less complex and more flexible, and to facilitate communication between the parties, and between the parties and the Court. In particular, the CPA is designed to simplify the appeal procedure and enforcement requirements.

On 31 March 2009, the Insolvency Act was subject to reform under Royal Decree-Law 3/2009, of 27 March. The main changes were:

- (a) the protection from the Rescission Regime (see 1.2 below) of restructuring agreements entered into by the insolvent company prior to the filing for insolvency provided certain requirements are met; and
- (b) the ability for an insolvent company to initiate a negotiation period in order to obtain agreement to an Advanced Settlement Proposal prior to an actual filing for insolvency and thereby delay the insolvency filing. (Refer to the Appendix for further information about the Spanish single insolvency procedure and, in particular, the Settlement phase and the procedure for obtaining approval of Settlements.)

The reform also includes the clarification of certain issues that were debated amongst scholars and the reform of articles of the Insolvency Act regarding notification of the events of the Insolvency.

In January 2012, the Insolvency Act was subject to further reform under Law 38/2011 of 10 October. The main amendments to the Insolvency Act were:

- (a) To provide alternatives to filing for insolvency.

¹ The old Spanish general insolvency regime was set out mainly in:

- (a) the Spanish Commercial Code of 1885 (*Código de Comercio*) and by its predecessor which dates all the way back to 1829; and
- (b) the Suspension of Payments Act of 1922 (*Ley de Suspensión de Pagos*). There were also certain special insolvency rules applicable to, amongst others, insurance companies, credit entities and public work concessionaries. Finally, the Civil Procedure Act of 1881 (*Ley de Enjuiciamiento Civil*) governed procedural issues.

- (b) Enhanced protection of refinancing agreements.
- (c) Favourable treatment of new monies obtained by means of a refinancing agreement or during the insolvency proceeding.
- (d) A single IP instead of various IPs, and more detail on the IP's functions and profile. Possible appointment of incorporated entities to act as IP.
- (e) Amendments to the abbreviated proceeding in order to make it more flexible.

In September 2013, the Insolvency Act was subject to further reform under Law 14/2013 on support for entrepreneurs and their “internationalization”, a term used by the Spanish legislation to refer to the endeavours of entrepreneurs to start exporting their assets and services. Law 14/2013 introduced a new character in the insolvency scenario, the insolvency mediator (*mediador concursal*) who, among other duties, is in charge of promoting out-of-Court payment agreements entered into between the insolvent company and its creditors.

On 5 September 2014, the Insolvency Act was subject to reform under Royal Decree-Law 11/2014. The main changes were:

- (a) On ranking of claims, it was provided that the special preference shall be limited to the value of the respective security that is recorded on the list of creditors.
- (b) Amendments to the concept of persons specially related to the insolvent company.
- (c) Amendments in the content of the composition proposal.

On 1 October 2014, the Insolvency Act was subject to reform under Law 17/2014, of 30 September. Law 17/2014 developed the ability for an insolvent company to initiate a negotiation period in order to reach refinancing agreements or to obtain an Advanced Settlement Proposal prior to an actual filing for insolvency (Article 5 *bis* of the Insolvency Act).

The main amendment was that, within a maximum of three months as from the submission of the communication, no judicial or extrajudicial foreclosures may be performed on assets or rights that are necessary to continue the professional or commercial activity of the insolvent company.

In the event that the insolvent company neither reaches a refinancing agreement nor obtains an Advance Settlement Proposal within the above-mentioned term of three months, it must apply for the initiation of the insolvency proceedings.

On 26 May 2015, the Insolvency Act was subject to reform under Law 9/2015, of 25 May. Interesting amendments to the Insolvency Act were:

- (a) Amendment to Article 5 *bis* of the Insolvency Act, aiming to clarify certain practical issues related to the negotiation period (for example, in case of controversy on the qualification of assets “that may be necessary to continue the professional or commercial activity of the insolvent company”, the Judge in charge of the communication will decide on such qualification).
- (b) New rules regarding the enhanced cram-down effects of the homologation of refinancing agreements.

In the light of the frequency of such legislative amendments, readers are encouraged to establish the current state of the insolvency legislation before acting on any information in this section.

QUESTION 1

1. The directors and the start and duration of the relevant period

(a) How are directors identified / defined?

(b) 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 Identification and definition of directors

A director is the person in charge of the management of the company, the one who participates in its day-to-day decision making process or carries out the necessary duties to comply with the company's commercial purpose. Directors can be natural or corporate persons.

As per their identification, we need to distinguish between legal directors and *de facto* or shadow directors.

Legal directors are those who have been formally appointed as directors of the company by the shareholders and appear as such in the Commercial Registry. Identifying shadow directors (those who have not been formally appointed as directors but have acted *de facto* as if they were the true directors of the company) requires further efforts.

As a matter of fact, only a judicial decision may declare that a person is deemed to be or have been a shadow director once it has been proven that the latter has acted as director of the company in spite of not having been formally appointed by the shareholders and of not having being inscribed as such in the Commercial Registry.

1.2 Rescission regime under the Insolvency Act

One of the fundamental differences between the Insolvency Act and the old insolvency legislation is the abolition of the retroactive bankruptcy rule and its substitution with a system based not on the concept of breach of law, but economic harm (the Rescission Regime).

The retroactive bankruptcy rule provided that, if supporting evidence was submitted to the Court, it could establish a date (prior to the filing for insolvency) on which the company effectively became insolvent (that is, when it ceased generally paying debts). All transactions completed during that period, even if at arm's length and for good commercial reason or otherwise, were null and void (as opposed to voidable).

The Rescission Regime is radically different. It represents a more pragmatic approach based on the concept of detriment. Transactions that are detrimental for the company's estate may be rescinded, whether or not there has been intention to defraud, if completed within the two years immediately preceding the date of the declaration of insolvency provided they were not performed in the context of a "restructuring agreement" (as set out in the Royal Decree-Law 3/2009 – see further 4.1.2 below).

1.3 Rescission claim under the Civil Code

In addition to the Rescission Regime, any unsatisfied creditor may claim rescission of certain contractual or commercial operations on the basis of a fraud on creditors (*accion rescisoria por fraude de acreedores*). Insolvency proceedings under the Insolvency Act need not necessarily have been commenced; the claim must be made within four years of the date of the relevant contractual or commercial operation.

The IP is also entitled to bring an action in relation to transactions performed by the debtor prior to the two-year "twilight" period referred to above.

An amendment introduced by Law 9/2015 states that the exercise of rescission claims shall not prevent other actions to contest acts by the insolvent company that are appropriate according to Law (for example, requesting the annulment of the operation due to fraud).

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 the director?

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

(i) Is the director’s liability considered to be civil, criminal or both?

(ii) Can a director be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?

(iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement or responsibility?

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

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

There are no special provisions giving rise to liability of company directors during the “twilight” period. Rather, any director may be held liable if any action carried out during the “twilight” period would give rise to liability according to corporate, insolvency and criminal law as stated below. There is therefore no difference between the liability regime during and outside the “twilight” period.

2.1 Liability under corporate law

2.1.1 Actions giving rise to directors’ liability

Under Spanish company law, directors of both SA companies and SL companies may be held jointly and severally liable to the company, its shareholders and creditors for any act or omission which is:

(a) contrary to the provisions of Spanish law;

(b) contrary to the company’s by-laws; or

(c) carried out in breach of directors’ duties to the company.

Directors’ liability is established in Article 236 of the Spanish Companies Act (*Ley de Sociedades de Capital*), (LSC).

2.1.2 Liability of *de facto* directors

Corporate directors’ duties and liabilities apply to *de facto* directors (those who are not formally appointed as directors but have acted *de facto* as if they were directors of a company).

2.1.3 Corporate duties of company directors

The principal general duty imposed on directors of Spanish limited liability companies is to act at all times in good faith, with the diligence of an “*organised businessman and a loyal representative*” (*ordenado empresario y representante leal*). This general duty applies to directors of both SA companies and SL companies (Articles 225 and 226 LSC).

This broad rule allows each director’s behaviour to be assessed on a case-by-case basis. Spanish Courts judge directors’ diligence by demanding a high standard of behaviour.

The specific duties for directors included in the Spanish Companies Act are as follows: -

(a) Duty of loyalty

Under the LSC, the former duty of fidelity has been merged with the duty of loyalty. The duty of loyalty was introduced by Law 26/2003 aimed at avoiding conflicts of interest between directors and the company and also at impeding directors from carrying out unauthorised competing activities.

The duty of loyalty requires that:

- (i) directors must not use the company’s name nor their position as director to carry out transactions on their own account or through persons connected with them;
- (ii) a director must not, for his own benefit or for that of a connected person, invest in or carry out any transaction relating to the property of the company which he became aware of by virtue of his position as director and which was offered to the company or in which the company had an interest unless the company has, independently of any influence by the director, decided not to make the investment or enter into the transaction;
- (iii) directors must inform the board of directors of any direct or indirect conflict of interest which they may have with the company. In the event of conflict, the director shall cease his involvement in the transaction causing the conflict. Information on conflicts of interest between the company and its directors should be included in the annual report on corporate governance; and
- (iv) directors must notify the company of any shares that they hold in a company that has the same, analogous or complementary corporate objects (*objeto social*) as the company in which they are a director, and must also notify the company of any position held, or duties carried out, by him in that company.

(b) Duty of confidentiality

Even after their appointment has ceased, directors must not disclose confidential information. Information, figures, reports and records that they are aware of as a result of their position may not be disclosed to third parties or otherwise divulged if this could be detrimental to the company’s interests. When the director is a legal entity, the duty of confidentiality rests with its representatives. The duty described shall not apply to cases in which, pursuant to the legislation, such information may be conveyed to third parties or if it is required by or must be sent to the respective legal supervisory authorities.

2.1.4 Available courses of action

The Spanish Companies Act provides for the following actions for breach of directors’ duties:

(a) Corporate action (*acción social*)

This action is aimed at protecting and recovering a company’s assets damaged by the directors’ actions. Only the insolvency administrator has legal standing to file a corporate action against the directors once the insolvency proceeding has been initiated.

(b) Individual action (*acción individual*)

This action is aimed at protecting and recovering the personal assets of the claimant to the extent that it has suffered personal damages as a consequence of any directors' action or omission giving rise to liability. Only shareholders personally affected by directors' actions or omissions and creditors have legal standing to file an individual action against corporate directors.

There is a four-year limitation period for both corporate and individual actions. Previously, this limitation period was supposed to start running as from the removal or dismissal of the responsible director(s). However, the LSC was subject to reform under Act 31/2014, and currently the limitation period runs from the day on which these actions could have first been exercised. Due to this recent reform, Spanish case law has not developed the exact interpretation of this new legal framework. Nevertheless, it should be understood that the statute of limitations would only begin to run when the claimant has sufficient knowledge of all the relevant facts of the case and is therefore able to calculate damages he may have suffered as a consequence of the directors' conduct.

2.1.5 Type of liability and limitation

The liability of the directors is joint and several. Directors are not protected from liability, even if the relevant action or decision of the board or individual director was adopted, authorised or ratified by a general shareholders' meeting of the company. Likewise, directors' legal liability cannot be modified contractually, unless a more strict liability is agreed and, therefore, any corporate document or corporate arrangement aimed at limiting directors' liability is invalid.

However, a director will not be liable for the acts of other directors where the relevant director can demonstrate that:

- (a) he was unaware of the act, decision or omission of the other director(s) for a reason other than his absence from a board meeting; or
- (b) he was aware of the relevant act, decision or omission, but took all reasonable measures to prevent it from taking place, or (at least) expressly opposed the relevant board resolution.

Therefore, the general defences available to directors are:

- (a) the director's behaviour was not negligent; he did not breach any law, regulation, the by-laws or his duties as a director of the company; and
- (b) the director did not take part in the damaging event and was either: (i) not aware of the existence of the damaging event; or (ii) took the necessary steps to avoid such a damaging event.

2.1.6 Special (direct and objective) liability in cases of capital impairment

In cases of capital impairment (including when the company breaches certain "subscribed capital to net equity ratios",² which are not then re-established within a certain period), directors may be held jointly and severally liable for all company's debts incurred from the date the directors were aware or should have been aware of the capital impairment (Article 367 of LSC).

This liability is direct and objective in the sense that no damages have to be proven. In comparison, the corporate action and the individual action mentioned above require the claimant to prove actual damages.

In particular, they will be held liable:

- (a) if they fail to call a general shareholders' meeting to pass a resolution to wind up the company within two months from the date they were aware or should have been aware of the capital impairment; or

² The subscribed capital to net equity ratio will be 2:1.

- (b) if they fail to file for a judicial winding up or, if applicable, for a declaration of the company's insolvency: (i) within two months of the general shareholders' meeting if the shareholders voted against declaring the winding-up or the insolvency, as the case may be; or (ii) within two months of the proposed date for the general shareholders' meeting, if it was not held.

The Spanish Courts have established that complying with the requirement in former Article 367 LSC to convene a meeting to wind-up the company does not relieve the directors of potential liabilities under the Insolvency Act if the company was insolvent at the time of the winding-up. (Appeal Court Decision –*Audiencia Provincial* – of Valencia of 10 March 2008).

2.2 Liability under the Insolvency Act

The Commercial Court may declare directors and others liable as set out below during the liability phase (or “qualification” phase) of the proceedings. The liability phase starts either: (i) upon the approval of a settlement agreement with creditors which proposes a reduction in excess of one-third of debts or a delay of payments in excess of three years, (ii) when the liquidation phase is commenced (including where the liquidation is triggered by the breach of a Settlement which had been previously approved). For further information on the liability and other phases in the insolvency proceedings process, refer to the Appendix to this chapter.

2.2.1 Liability under Article 172 of the Insolvency Act

The Commercial Court may declare liable the company's directors and liquidators (whether formally appointed or in the shadows) provided they occupied that position at any time during the last two years prior to the declaration of insolvency when:

- (i) the liability section of the insolvency has been opened; and
- (ii) the insolvency has been categorised as “guilty”.

An insolvency is deemed “guilty” when, in the creation and worsening of the state of insolvency, there has been either *dolus* or gross negligence by the company, its legal representatives, directors or liquidators. In particular, an insolvency would be classified as guilty if:

- (a) the company has failed substantially in its obligation to maintain proper accounts, or has committed an irregularity which impedes the adequate comprehension of the underlying economic or financial situation of the debtor;
- (b) the company has filed false or misleading documents in support of the application for the declaration of insolvency or during the course of insolvency proceedings;³
- (c) the liquidation phase is opened following a breach of the settlement agreement by the company;
- (d) the company has concealed its assets to the detriment of its creditors or has carried out any act that delays, obstructs or impairs the effectiveness of a seizure (*embargo*) or of an enforcement proceeding initiated or likely to be initiated;
- (e) during the two years prior to the declaration of insolvency, assets or rights of the company were fraudulently misappropriated; or
- (f) before the declaration of insolvency, the company took legal action intended to present a misleading picture of its financial situation.

The existence of *dolus* or gross negligence is presumed (absent proof to the contrary) if the company or its legal representatives, directors or liquidators:

³ The Spanish Courts have established that the misleading or false document or fact must be relevant to the comprehension of the situation of the company. (Sentence of the Commercial Court of Asturias of 29 October 2007.)

- (a) have failed in their duty to apply for the insolvency. A company must apply for insolvency within two months of the date on which it knew, or should have known, that it had become insolvent. Alternatively, within this two-month period, the company has the option of notifying the Court that it has initiated negotiations for a refinancing agreement or for obtaining the necessary support to an Advanced Settlement Proposal. In this case, the company will be given three months to close the refinancing agreement or to obtain the support for the Settlement Proposal. Otherwise, once the three-month period has expired, the company will have one additional month to file for insolvency;⁴
- (b) have failed in their duty to co-operate with the Commercial Court and the IPs, have failed to provide the Court with the necessary or relevant information in the general interests of the insolvency proceedings or have failed to attend the creditors' general meeting either in person or by proxy; or
- (c) have failed to produce annual accounts, have failed duly to submit them for auditing or, once approved, have failed to file them with the Commercial Registry (*Registro Mercantil*) in any of the three financial years leading up to the declaration of insolvency.

The judicial decision declaring the insolvency as “guilty” would order:

- (a) the disqualification of those persons affected by the ruling from managing third party assets or representing or managing any person/company for a period of between two and fifteen years, depending on the seriousness of both the infractions and the injury.

Upon the request of the insolvency administrator, the Court may authorise the disqualified director to continue managing the company to facilitate the settlement agreement with creditors;

- (b) the removal of the rights of any person affected by the qualification (including any person found to have contributed towards the insolvency) as creditors of the company;
- (c) that any rights or assets of such persons, that may have been unduly obtained from the assets of the company or received from the estate, be returned; and
- (d) that any loss or damage caused be indemnified.

2.2.2. Patrimonial liability under Article 172 bis.1 of the Insolvency Act

Provided the liability section is opened as a result of the winding-up of the insolvent company, directors and liquidators (whether formally appointed or in the shadows) and general managers may be held liable for any deficit in the amount available to pay to creditors (that is, all or part of the debts that remain unpaid after the liquidation of the assets of the company) to the extent that their conduct, which has caused the guilty qualification, has caused or has aggravated the insolvency of the debtor. Once the insolvency has been declared, the Commercial Court may order the seizure of rights or assets of the directors if, from the information available at the insolvency proceedings, it appears that: (i) the insolvency may be qualified as “guilty”; and (ii) the estate of the company is insufficient to meet all of the debts.

2.2.3 Interaction between liability under corporate law and under insolvency law

The general view is that directors may be declared liable under both Spanish company law and the Insolvency Act in one set of insolvency proceedings. The aim under Spanish company law is to indemnify against loss caused by the directors to the company or third parties, whereas liability under the Insolvency Act could extend both to damages caused to the company and to debts (deficit) which the liquidation of the company cannot cover.

Whilst there is no legal basis for saying that the liability under the Insolvency Act should prevail over the directors' liability under the Spanish company law, it is generally understood that the Insolvency liability rules prevail. This is because, under the Insolvency Act, directors are liable to all creditors whereas under Spanish company law, directors are liable only to creditors whose claims have been affected by the loss suffered by the company or to creditors who have directly suffered by the company or to creditors who have directly suffered loss themselves.

⁴ As established by the Royal Decree-Law 3/2009.

While the insolvency is running, creditors will be prevented from bringing any claims against directors based on breach of obligations relating to the winding up of the company. This limitation does not extend to claims against directors based on damages derived from individual wrongdoings. The general opinion is that the approval of a settlement agreement does not affect the liability of the directors. Therefore, creditors will be entitled to claim for any loss caused by the directors, even if a settlement is approved and regardless of how creditors voted. However, creditors can only claim for loss to the extent they are not compensated by the settlement agreement.

2.3 Liability under criminal law

2.3.1 Corporate liability

Since the amendment to the Spanish criminal code under Act 5/2010 entered into force on 24 December 2010, not only individuals but also companies can be held criminally liable for certain offences – which include insolvency offences. In other words, the amendment negated the Latin principle “*societas delinquere non potest*” (i.e. companies cannot commit crimes).

The system of corporate criminal liability provided for by the Reform is based on Article 31 *bis* of the Spanish Criminal Code. This Article establishes that a company can be held liable for certain criminal offences committed (on its behalf and for its benefit) by (i) persons holding powers to represent the company, or by its *de facto* or *de jure* directors, and (ii) by persons subject to the control of managers and directors, if the crime ensues from a violation of their supervisory and control obligations.

The criminal liability of a company may arise even if no liability has been established on the part of a director or legal representative. This is to say that the company is not precluded from being held liable if a specific individual responsible for the criminal offence has not been identified or has escaped justice.

Fines are established as the ordinary consequence of any criminal behaviour committed by companies. However, usually for cases of significance, the Courts may impose punishments such as winding-up, suspension of trading, prohibition from engaging in activities related to the unlawful act, the closing of offices or establishments, confiscation, prevention from obtaining public subsidies, public incentives tax or social security benefits.

Likewise, the Organic Law 5/2010 recognises the possibility that the penalty of winding-up may be extended to a company that, despite not having carried out the offence, continued the economic activity of the wound-up company and maintained its identity of clients, employees and suppliers.

The last amendment to the Spanish Criminal Code under Act 1/2015 has added to the wording of Article 31 *bis* the possibility of avoiding criminal liability for companies if the company has implemented a criminal corporate compliance programme that allows the company to control the actions of its employees.

Article 31 *bis* now also includes a description of the minimum requirements of a corporate criminal compliance programme, which include:

- (i) to identify the activities in which the offences to be prevented may be committed;
- (ii) to establish protocols or procedures specifying the process for the definition of the will of the legal entity, the adoption of decisions and the execution thereof with regard to the former;
- (iii) to have in place appropriate financial resource management models to prevent the commission of the offences;
- (iv) to impose the obligation to report potential risks and breaches to the body responsible for oversight of the functioning of compliance with the prevention model;
- (v) to establish a disciplinary system which appropriately penalises a breach of the measures established by the model; and

(vi) to perform periodic verification of the programme and the potential modification thereof should any significant violations of the provisions arise, or where so required in the event of changes in the organisation, the supervisory structure or the activity undertaken.

2.3.2 Director's liability

Besides the criminal liability of corporations, the Spanish Criminal Code provides for individuals who carry out a criminal act (be it by action or omission) in the name and on behalf of a legal entity (i.e. directors or legal representatives of a company or any other individual with managerial duties) to be criminally liable where the felony / misdemeanour has been committed (and the conditions of the felony satisfied) in the name of the legal entity in whose name or on behalf of whom he so acts (even if that individual does not himself fulfil the conditions or qualities required by the relevant felony / misdemeanour). However, not all directors or representatives in office when the offence is committed will be criminally liable. Knowledge and intent (or gross negligence for certain crimes) are essential. Likewise, omissions may give rise to criminal liability when the director breaches his duty of care *vis-à-vis* the company's so that the wrongful result materialises as if he had actively caused it.

The voluntary or compulsory removal of a director does not exempt him from criminal liability arising as a result of past conduct. New directors of a company that has committed criminal offences in the past (through previous directors, legal representatives or managers) are not liable for past criminal offences, though newly appointed directors helping former directors to conceal their crime from the authorities or to enjoy the proceeds their crime may commit several different offences (covering up, money laundering, etc.).

2.3.3 Insolvency and corporate offences under the Spanish Criminal Code

2.3.3.1 Crimes committable by both natural and legal persons (insolvency offences)

- Concealment of assets ("*alzamiento de bienes*"): This offence arises when any person, to the detriment of creditors, conceals or disposes of assets or enters into any obligation that delays, obstructs or impairs the effectiveness of a seizure ("*embargo*") or the commencement of any actual or foreseeable executive ("*procedimiento ejecutivo o de apremio*"), judicial, extra-judicial or administrative proceedings. The offence also arises where any person disposes of assets, enters into obligations that decrease his or her estate or conceals such estate with the aim of avoiding payment of civil liability derived from the offence in the framework of an actual or foreseeable executive proceedings ("*procedimiento ejecutivo o de apremio*").
- Filing an incomplete or fake list of goods in the framework of executive proceedings: This offence arises when somebody files an incomplete or fake list of goods in the framework of judicial or administrative executive proceedings with the aim of delaying, obstructing or impairing the payment to the creditor.
- Using deposited assets seized by a public authority without authorization: This offence arises when somebody uses without authorization one or several assets that were seized by a public authority, and assets remain in the possession of the debtor.
- Punishable insolvency: This offence arises when somebody is in a situation of actual or foreseeable insolvency or causes such an insolvency situation, and develops some of the following conducts:
 - (i) concealment, damage or destruction of the goods or assets included or potentially included in the insolvency state at the time the insolvency proceedings started;
 - (ii) performance of acts of disposition by delivery or transfer of money or other assets or by assuming debts which have no proportion with the assets of the debtor or his income, and with no economic or business justification;
 - (iii) performance of sales or services below production or acquisition costs and with no economic justification;
 - (iv) simulation of third party credits or recognition of fictitious credits;

- (v) involvement in speculative businesses if there is no economic justification and if it is contrary to the required due diligence when conducting economic issues, taking into account the circumstances of the case and the economic activity performed;
- (vi) infringement of the legal accounting duties, if, for example, assets are double-counted or other accounting irregularities are detected;
- (vii) destruction or alteration of the accounting books if these actions obstruct or impede an understanding of its asset or financial situation;
- (viii) concealment, alteration or destruction of the documentation that the company is legally obliged to preserve during a certain period of time, if these actions take place before the aforementioned period elapses and by this way it is difficult or impossible to evaluate the real economic situation of the debtor;
- (ix) preparation of the financial statements or the accounting books contravening the accounting legislation and: a) the evaluation of the real economic situation of the debtor is complicated or impeded; or b) if the preparation duties of the balance sheet or the inventory in due time are infringed;
- (x) development of any other action or omission implying a serious infringement of the required financial due diligence when managing economic issues and causing:
 - (a) a decrease of the debtor assets; or
 - (b) a concealment the real economic situation of the debtor or of its business activities.

This offence can only be prosecuted if the debtor does not comply with its legal duties or if the insolvency proceedings have started. In addition, the aforementioned offences can be prosecuted before the conclusion of the insolvency proceedings and irrespective of its continuation. Criminal jurisdiction will not be affected by any decision taken in the insolvency proceedings.

- Favouring creditors: The offence arises -
 - (a) when a debtor is in a situation of actual or foreseeable insolvency and unlawfully disposes of assets or assumes further obligations with a view to favouring one or more creditors to pay them undue credits or to provide them undue guarantees, if the operation does not have economic or business justification; or
 - (b) where an insolvent company or person, which (or in respect of which someone) has successfully applied for insolvency, unlawfully disposes of assets or assumes further obligations with a view to favouring one or more creditors (whether preferred or otherwise) to the detriment of other creditors, if such action was taken without the authorisation of the Court or the insolvency administrators.
- Inaccuracy of accounting documents: This offence arises if any person files documents in the insolvency proceedings which knowingly provide inaccurate data on the company's financial situation with the aim of improperly obtaining a declaration of insolvency.

2.3.3.2 *Crimes committable only by natural persons (corporate offences)*

- Forging corporate documents: Any director (whether formally appointed or *de facto*) who forges the company's annual accounts or other corporate documents evidencing the legal or financial status of the company in a manner that is capable of causing economic loss to any person.
- Abusive resolutions: Any person who, by exercising his or her majority on the board or in general shareholders' meetings, passes a resolution with the intention of making a profit (either for himself or herself or for third parties), to the detriment of the other shareholders and which does not otherwise benefit the company.

- Harmful resolutions: Any person who harms the company or any of its shareholders by imposing a resolution that has been adopted by fraudulent means (e.g. not giving voting rights to shareholders entitled to vote, etc.) and makes a profit out of such act (either for himself or herself or for third parties).
- Violation of shareholders' rights: Any director (whether formally appointed or *de facto*) who prevents shareholders from exercising their rights as shareholders (eg. right to information, right to take part in the running of the company, etc.).
- Breach of obligation to cooperate with any relevant authority: Any director (whether formally appointed or *de facto*) of a company which is supervised by a regulatory authority, who impedes the supervision by the authority, or fails to provide relevant documentation.
- Illegal disposition or illegal contracting: Anybody with powers to administer the assets of another person (natural or legal) according to the faculties given by the Law, the authorities or by agreement, exceeds them causing a damage to the assets.

2.3.4 Penalties attached to the above criminal offences

2.3.4.1 For natural persons

- Concealment of assets: imprisonment for one to four years and a daily pecuniary fine for a period of 12 to 24 months; however, if the debts evaded were public (i.e., if the creditor was a Public Administration or entity, such as the Treasury), imprisonment will be up to six years. Imprisonment will range from two and a half to four years (six in the case of public debts) and a daily fine for a period from 18 to 24 months if one or several of the following aggravating circumstances were met: the amount of assets concealed exceeds EUR 50,000 or it affects a large number of individuals; or when the concealment is perpetrated abusing the personal relations that exist between the victim and the offender, or then the latter takes advantage of the latter's corporate or professional credibility.
- Filing an incomplete or fake list of goods in the framework of executive proceedings: imprisonment for between three months and one year or a daily fine for a period of six to 18 months.
- Using deposited assets seized by a public authority without authorization: imprisonment for between three and six months or a daily fine for a period of six to 24 months.
- Punishable insolvency: imprisonment for between one to four years and a daily fine for a period of eight to 24 months. Imprisonment will range for two to six years and a fine based on a period of eight to 24 months if some of the following aggravating circumstances were met: (i) if a real or potential financial damage is caused to a large number of people or they are caused serious economic damage; (ii) if creditors are caused economic damage in excess of EUR 600,000; or (iii) if at least the half of the credits in insolvency proceedings belong to the national, regional or local Tax Authorities or to the Social Security.
- Favouring creditors: (a) imprisonment for six months to three years or a daily fine for a period of eight to 24 months. (b) imprisonment for one to four years and a daily fine for a period of 12 to 24 months.
- Inaccuracy of accounting documents: imprisonment for one to two years and a daily fine for a period of six to 12 months.
- Forging corporate documents: imprisonment for one to three years and a daily fine for a period of six to 12 months. If economic loss is caused, penalties will include imprisonment for two to three years and a daily fine for a period of 18 to 24 months.
- Abusive resolutions: imprisonment for between six months and three years or a fine of up to three times the profit obtained.
- Harmful resolutions: imprisonment for between six months and three years or a fine of up to three times the profit obtained.

- Violation of shareholders' rights: a daily fine for a period of six to 12 months.
- Breach of obligation to co-operate with any relevant authority: imprisonment for between six months and three years or a daily fine for a period of 12 to 24 months.
- Illegal disposal or illegal contracting: imprisonment for between six months to three years. Imprisonment will range from one to six years and a fine for a period of six to 12 months if one or several of the following aggravating circumstances were met:
 - (i) if it affects assets of prime necessity, dwellings or other assets of recognised social utility;
 - (ii) if the offence is perpetrated by forging the signature of another, or by stealing, concealing or fully or partially destroying any process, file, archive or public or official document of any kind;
 - (iii) if it affects assets forming artistic, heritage, cultural or scientific property;
 - (iv) if it is especially serious, in view of the magnitude of the damage and the financial situation in which it leaves the victim or his family;
 - (v) if the amount at stake exceeds EUR 50,000 or it affects a large number of individuals;
 - (vi) if the offence is perpetrated abusing the personal relations that exist between the victim and the offender, or then the latter takes advantage of the latter's corporate or professional credibility;
 - (vii) if procedural fraud is committed. This is incurred by those who manipulate the evidence on which they intend to found base allegations or use any other similar procedural fraud in judicial proceedings of any kind, causing the Judge or Court of Law to mistakenly be led to hand down a resolution that damages the financial interests of the other party or a third party;
 - (viii) if the offender has been sentenced previously at least for three times in connection with some of the aforementioned circumstances.

Imprisonment will range from four to eight years and a daily fine for a period of 12 to 24 months will be imposed if circumstances (iv), (v), (vi) or (vii) concur with (i), or if the amount at stake exceeds EUR 250,000.

When imposing a penalty, the general rule is that the Court must have regard to the degree of participation by the individual in the criminal offence (that is, whether they were the perpetrator, an accomplice or were otherwise profiting from the crime). Consequently, the extent of the specific involvement of a director would be relevant to the sanction imposed.

2.3.4.2 *For legal persons*

- A daily fine for two to five years, if the offence committed by a natural person is punishable by imprisonment exceeding a period of five years.
- A daily fine for one to three years, if the offence committed by a natural person is punishable by imprisonment exceeding a period of two years.
- A daily fine for six months to two years, in the rest of the cases.
- If the judge deems it suitable, in accordance with the general aggravating circumstances set out in the Criminal Code and to the established extent, several penalties may be imposed on companies that are found criminally accountable.
- Dissolution of the legal person. The dissolution shall cause definitive loss of its legal personality, as well as of its capacity to act in any way in legal transactions, or to carry out any kind of activity, even if lawful.

- Suspension of its activities for a term that may not exceed five years.
- Closure of its premises and establishments for a term that may not exceed five years.
- Prohibition from carrying out the activities through which it has committed, favoured or concealed the felony. Such prohibition may be temporary or definitive. If temporary, the term may not exceed 15 years.
- Barring from obtaining public subsidies and aid, from entering into contracts with the public sector and enjoying tax or Social Security benefits and incentives, for a term that may not exceed 15 years.
- Judicial intervention to safeguard the rights of the workers or creditors for a period deemed necessary, which may not exceed five years. The intervention may affect the whole of the organisation or may be limited to some of its premises, sections or business units. The Judge or Court of Law shall determine exactly, (in the sentence, or subsequently by ruling) the content of the intervention and shall determine who shall take charge of the intervention and how often monitoring reports must be submitted to the judicial body. The intervention may be amended or suspended at any time, following a report by the IP and the Public Prosecutor. The IP shall be entitled to access all the installations and premises of the company or legal person and to receive as much information as he may deem necessary to exercise his duties. The implementing regulations shall determine the aspects related to the exercise of the duties of the IP, as well as his remuneration or necessary qualifications. Temporary closure of premises or establishments, suspension of corporate activities and judicial intervention may also be agreed by the Investigating Judge as a precautionary measure during the investigation of the case.

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the "twilight" period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the "twilight" period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

There are no special provisions giving rise to liability of other persons involved in the company's affairs during the "twilight" period. Rather, any other person may be held liable if any action carried out during the "twilight" period would give rise to liability as discussed in Sections 2.1, 2.2 and 2.3 above. There is therefore no difference between the liability regime during and outside the "twilight" period for other persons not involved in the company's affairs.

3.1 Managers' liability

Managers are not personally liable to third parties for acts and obligations undertaken on behalf of the company (even when they exceed the scope of their powers), provided they act within the scope of the company's activities. Accordingly, managers can be held personally liable to third parties for any acts and obligations falling outside the company's corporate objects / main activity. In any event, the company itself, its partners or shareholders and creditors may claim damages from a manager that acts negligently or in breach of his duties to the company.

As a general principle, managers are also subject to the general duty to act at all times in good faith and honestly. The duties of a general manager (director general) (that is, a non-executive director who is effectively in charge of running the company) and all other managers of Spanish companies are customarily set out in their employment agreements, with specific guidelines being given by the company's management body and by market/sector general practice.

According to Article 1903 of the Spanish Civil Code (*Código Civil*), the owners, directors or managers of a company (*dueños o directores de un establecimiento o empresa*) may be liable to third parties for activities carried out by the company's employees (vicarious liability). However, the owner, director or manager may, in turn, bring a claim against the relevant employee(s) to recover any loss and / or expenses incurred as a result of the imposition of vicarious liability.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Rescission regime

4.1.1 Transactions that prejudice the estate of the company, whether or not there was an intention to defraud⁵, are rescindable if completed within the two years immediately preceding the date of the declaration of insolvency. The Rescission Regime includes the following general rules:

- (a) generally speaking, gratuitous transactions (that is, transactions for no consideration or no material consideration) are presumed to be prejudicial (*iuris et de iure* presumption);
- (b) the same irrebuttable presumption of prejudice applies to debts maturing after the insolvency is declared but which are discharged prior to then, except if such debts enjoyed an in rem guarantee in which case the presumption would be rebuttable.
- (c) a rebuttable (*iuris tantum*) presumption of prejudice is established in respect of:
 - (i) transactions for consideration entered into with persons or entities connected with the company; and
 - (ii) security created in respect of pre-existing obligations or new obligations assumed in substitution for pre-existing obligations;
- (d) evidence of prejudice must be adduced in respect of other transactions; and
- (e) transactions within the ordinary course of business of the company and completed on the company's normal terms and conditions are not rescindable. Equally, payments effected through clearing and settlement systems for securities and derivative instruments are not rescindable.

⁵ According to the ruling of the Commercial Court of Madrid no. 1 of 21 May 2007, the fact that both companies knew, at the time of signing the rescinded transaction, that the company was in an insolvency situation can be sufficient evidence of bad faith in the negotiation of the transaction, therefore giving rise only to a subordinated claim in the event of rescission.

4.1.2 The Royal Decree-law 3/2009 has established that ‘restructuring’ agreements may not be rescinded⁶ provided they are part of a viability plan which warrants the continuation of the company in the short to medium term and which provides for either a substantial increase in the disposable credit / loans available to the company or which modifies the payment obligations of the company (or other similar modification) and provided they meet the following requirements:

- (a) the restructuring agreement is signed by creditors that amount to, at least, three-fifths (60 per cent.) of the total insolvency claims including secured claims at the time of the restructuring;
- (b) the restructuring agreement has been analysed by an independent expert appointed by the Commercial Registry; and
- (c) the restructuring agreement is documented in a Spanish notarial deed.

Law 9/2015 also introduced a judicial endorsement regime which is available to agreements that meet the above mentioned requirements and, in addition, have the support of 51 per cent of the debt held by financial creditors (Additional Provision Four of the Insolvency Act). By obtaining the endorsement the parties of the refinancing agreement will ensure that the agreement is not challenged in case the debtor ends up in insolvency. In addition, if the agreement has the degree of creditors’ support provided in the Insolvency Act, its effects might be imposed on dissenting financial creditors.

4.1.3 Each party to a rescinded transaction must return the asset received by it to the other party. For the purpose of this rule:

- (a) if the asset to be returned is cash, this will give rise to a claim against the company which will qualify as a claim against the Estate (see below) except where the rescinded transaction was entered into in bad faith, in which case it will rank as a subordinated claim (a specific category of insolvency claims, as defined below).

The Insolvency Act establishes a fundamental distinction between two basic types of debts of the company. Claims are deemed either to be liabilities of the estate of the company (a claim against the Estate) or (for the vast majority) remain liabilities of the company (Insolvency claims).

Claims against the Estate either originate during the insolvency proceedings (that is, following the declaration of insolvency) or relate specifically to the insolvency proceedings and must be expressed as such by statute. Claims against the estate are payable on their respective maturity date (except salary claims in respect of the last 30 days of work which, up to a maximum of two times the statutory minimum wage, are payable immediately) provided that the available assets of the company are sufficient to cover all these claims. Otherwise the Insolvency Act establishes the order in which the claims against the Estate are to be paid. In any case, the claims against the Estate are always paid in preference to all insolvency claims (other than secured claims to the extent they are covered by the secured asset).

Insolvency claims are any other claims not qualifying as claims against the estate;

- (b) if an asset to be returned has been disposed of, the party obliged to deliver it shall, provided the asset was disposed of in good faith, satisfy its obligation by paying the value of the asset (as at the date of disposal plus interest accruing since then). Failing this, the party obliged to return the asset shall be liable for all loss (direct, consequential or otherwise) caused to the value of the estate of the company as a result of the rescinded transaction.

4.2 Rescission claim under the Civil Code

According to the Spanish Civil Code (*Código Civil*), any unsatisfied creditor may claim rescission of certain contractual or commercial operations on the basis of a fraud on creditors (*actio pauliana* or *acción rescisoria por fraude de acreedores*) and this remedy does not necessarily require the existence of insolvency proceedings under the Insolvency Act.

⁶ One of the issues which had created uncertainty previously was the potential to rescind refinancing or restructuring agreements entered into during the two-year period under the Rescission Regime (ie during the two-year period prior to filing for insolvency).

4.3 Defences

The rescission regime is based on the concept of detriment.

The Insolvency Act provides for an irrebuttable presumption of detriment in the following cases: -

- (a) Gratuitous transactions. To avoid this presumption, the counterparty should ensure that the company obtains some benefit from the transaction; and
- (b) Payment obligations maturing after the date that insolvency is declared but which are discharged prior to that date, except if such debts enjoyed an *in rem* guarantee in which case the presumption would be rebuttable. To avoid this presumption, the counterparty should include termination rights based on pre-insolvency situations. For example, in the context of a financing agreement, lenders could impose further and more sophisticated financial ratios which would be triggered before the borrower became insolvent.

The Insolvency Act provides for a rebuttable presumption of detriment in respect of:

- (a) transactions entered into with persons or entities related to the company. In order to avoid this presumption, the counterparty should ensure that it is not a related entity for the purposes of the Insolvency Act, namely:
 - (i) a shareholder holding at least ten per cent. of the share capital of the company (or five per cent. in the case of a listed company) and a shareholder with unlimited liability in respect of the company's debts;
 - (ii) a director (whether in law or in fact), liquidator or attorney of the company and / or any person who was a director, liquidator or attorney of the company in the two years prior to the declaration of insolvency;
 - (iii) a company that forms part of the company's group and/or a shareholder of such a company; and
 - (iv) a rebuttable presumption of related entity is established in respect of any assignee of a financing agreement granted in favour of any of the above persons / entities, if the assignment took place in the two years prior to the declaration of insolvency;
- (b) security granted in respect of pre-existing obligations or in respect of new obligations assumed in substitution for pre-existing obligations⁷. In the context of a debt restructuring, this presumption may mean lenders are required to ensure sufficient funds are available to the company so that it remains solvent for two years following completion of the restructuring.

Otherwise (and with the exception of transactions that are not rescindable at all), proof of detriment is needed to rescind any other type of transaction. Consequently, it is a defence to show that no detriment has been caused.

Finally, specific actions (*acciones de reintegración*) that are aimed at rescinding transactions negatively affecting the company's estate cannot be brought by Insolvency Practitioners to set aside a transaction that is subject to the law of another state unless the transaction could be set aside not only under Spanish law, but also under the law of the other state.

4.4 Incurring further credit during the twilight period

When a company is in financial distress, no additional funding will normally be available unless it can ensure the future solvency of the company. This is because, pursuant to the Rescission Regime, transactions completed within the two years immediately preceding the date of the declaration of insolvency may be rescinded, whether or not there was fraudulent intent.

⁷ Save for security granted in the context of a restructuring agreement discussed in 4.1.2 above.

Formally-appointed directors may be held liable for any act or omission in breach of their duties to the company. De facto directors may be held liable for any act (but not omission) in breach of the duties that the directors duly appointed have to the company. All directors should ensure that any further credit incurred is, directly or indirectly, for the corporate benefit of the company and should be sufficiently comfortable that the transaction will not immediately cause the company to become insolvent (for example, because the company is incapable of timely compliance with its payment obligations).

In line with the above, it should be noted that:

- (a) directors and others may be held liable if the Commercial Court considers that in the creation or worsening of the state of insolvency, there was either wilful misconduct or gross negligence by the company or its legal representatives, directors or liquidators (whether in law or in fact); and
- (b) directors (formally appointed or shadow directors) may be held criminally liable if the insolvency of the company was caused or aggravated with *dolus* by the company or by the directors.

Finally, directors and others may be held liable if they do not provide the lender with accurate and true information about the financial situation of the company. In this regard it should be noted that:

- (a) the Insolvency Act provides an irrebuttable presumption of wilful misconduct or gross negligence if, before the declaration of insolvency, the company took legal action in order to mislead persons as to its financial situation; and
- (b) the Spanish Criminal Code also makes it a criminal liability for any director (formally appointed or de facto) to forge the company's annual accounts or any other corporate document showing the legal or financial status of the company in a way that is capable of producing economic loss to any person.

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

Under Spanish law, a distinction is made between a personal guarantee (payment undertakings) and an *in rem* guarantee (that is, security over assets).

4.4.1.1 *Personal guarantees*

In an insolvency, the position of the guaranteed creditor will vary depending on whether or not the granting of the guarantee is or is not rescinded by the Commercial Court pursuant to the Rescission Regime (as set out in 4.1 above):

- (a) Where a guarantee has been granted within the two years prior to the declaration of insolvency and negatively affects the guarantor's estate, the guarantee may be rescinded by the Commercial Court. There is an irrebuttable presumption of damage in cases of disposals for no consideration; an upstream guarantee may be included in this category. If the Commercial Court declares the transaction rescinded, the transaction will be reversed. It is important to highlight, however, that any loss suffered by the beneficiary of the guarantee as a result of the reversal will be paid upon the reversal of the transaction as it will qualify as a claim against the Estate (as opposed to an Insolvency claim), except where the Commercial Court declares the beneficiary acted in bad faith, in which case the claim of that beneficiary will be subordinated to the claims of other creditors.

Also, it must be noted that where the granting of new securities or guarantees forms part of a restructuring agreement with the requisites established in 4.1 such guarantees or securities will not be rescindable.

- (b) Where the guarantee has not been granted within the two-year period or is not considered to be detrimental for the guarantor's estate, the guaranteed creditor shall be considered to be an ordinary creditor (that is, Insolvency claims). In this case, the effect that insolvency proceedings may have on guaranteed creditors varies depending on the manner in which the insolvency proceedings are brought to an end. If there is:
- (i) a settlement agreement, guarantee claims will be subject to the settlement agreement; or
 - (ii) a liquidation, guarantee claims will be subject to the general rules on the ranking of creditors.

Upon the declaration of insolvency, a creditor cannot initiate judicial or non-judicial enforcement procedures and outstanding enforcement proceedings shall be suspended.

4.4.1.2 Security

The effect that insolvency proceedings may have on secured creditors (provided that the security is not rescinded under the Rescission Regime) varies depending on how the insolvency proceedings are brought to an end.

- (a) Where the proceedings end with a settlement agreement, the general rule is that secured creditors are unaffected by the approval of the creditors agreement (as stated in article 124.3 of the Insolvency Act), unless a percentage of the creditors of their same class of (a) generally privileged creditors or of (b) preferential creditors (with an in rem guarantee over certain assets of the debtor) vote in favour of the creditors agreement.⁸
- (b) Where the proceedings end with liquidation, secured creditors must be paid out of the proceeds of sale from assets subject to their security (usually by means of public auction). If secured creditors are not paid in full from the secured assets, the unsecured portion of their claim will be considered an insolvency claim and subject to the usual rules on priority and ranking of creditors. However, please note that:
 - (i) the Insolvency Practitioners may choose to pay secured amounts outstanding out of assets other than the secured assets. Any non-matured secured claims are payable as a claim against the Estate ranking ahead of insolvency claims; and

⁸ As stated in articles 124 and articles 134.2 of the Spanish Insolvency Act (current drafting introduced by Act 9/2015 of 25 May):

Article 124 – Required majorities for acceptance of proposed compositions

1. In order for the meeting to accept a proposal of composition, the following majorities shall be required:

- a) Fifty per cent of the ordinary liabilities, when the proposal of composition contains write-downs that are equal to or less than half the amount of the credits; whether of principal, interest or any other sum owed, with a term not exceeding five years; or, in the case of creditors other than the public or labour ones, the conversion of debt into participation loans during that same term.

Notwithstanding the terms set forth in the preceding Paragraph, when the proposal consists of full payment of the ordinary credits within a term not exceeding three years, or of immediate payment of mature ordinary credits with a write-down lower than twenty per cent, it shall be sufficient for a vote in favour to be issued by a portion of the liabilities higher than that voting against. To these ends, in cases of an early proposal and of written procedure, where appropriate, the creditors shall state their vote against under the same requisites as foreseen for adherence under Article 103 and the terms, as appropriate, of Articles 108 and 115 bis.

- b) If a vote in favour has been issued by 65 per cent of the ordinary liabilities, when a moratorium for a term of more than five years, but under no case exceeding ten years, is involved; or write-offs exceeding half the amount of the claim and, in the case of creditors other than the public or labour ones, in the case of conversion of debt to participation loans for the same term, and the other measures foreseen in Article 100.

2. For the purposes of calculation of the majorities foreseen in the preceding Section, preferential creditors who vote in favour of the proposal shall be deemed to be included in the ordinary liabilities of the insolvency proceeding.

3. Approval of the composition shall involve extension of its effects to the ordinary and subordinated creditors who have not voted in favour, without prejudice to the terms set forth in Article 134. If the requisite majorities are not reached, it shall be deemed that the composition submitted to the vote is rejected.

Article 134 – Subjective limits [of the creditors composition agreement]

1. The content of the composition shall bind the debtor and ordinary and subordinated creditors, with regard to claims that are prior to the insolvency proceedings being declared open, although that may not have been recognised for any reason whatsoever.

Subordinated creditors shall be affected by the same write-downs of debts and moratorium of payment periods established in the composition for the ordinary ones, but the moratorium of payment terms shall be calculated as of the complete fulfilment of the composition with regard to the latter. This is notwithstanding their entitlement to accept, as foreseen in Article 102, alternative proposals for conversion of their claims into shares, stakes or business quotas, or participation loans.

2. Preferential creditors shall only be bound by the content of the composition if they have voted in favour of the proposal or if their signing or adhesion thereto has been calculated as a favourable vote. Moreover, they may commit themselves to the composition already accepted by the creditors or approved by the Court, by adhesion provided in the due manner prior to the judicial declaration of its fulfilment, in which case they shall be affected by the composition.

3. Without prejudice to the terms set forth in the preceding Paragraph, preferential creditors shall also be bound to the composition when the following creditor majorities of the same class concur, as defined in Article 94.2:

- a) Of 60 per cent, in the case of the measures established in Article 124.1.a);
- b) Of 75 per cent, in the case of the measures established in Article 124.1.b).

In the case of creditors with a special preference, calculation of the majorities shall be performed in proportion to the accepting collateral compared with the total value of the collateral established within each class.

In the case of creditors with a general preference, the calculation shall be made using accepting liabilities out of the total liabilities benefited by a general preference within each class.

- (ii) the Court may authorise the sale of a secured asset with the security attached, the transferee assuming (as assignee) liability for the secured obligation (so that the payment obligation of the purchaser is not limited to the value of the secured asset).

Upon the declaration of insolvency, creditors cannot generally initiate judicial or non-judicial enforcement procedures, and outstanding enforcement proceedings are stayed.

In relation to security over an asset that is necessary for the performance of the company's business, the judicial declaration of insolvency:

- (a) prevents the enforcement of the security until the earlier of either: (i) the approval of a settlement agreement which does not affect the right to enforce the relevant security; or (ii) the expiration of one year from the declaration of insolvency (if liquidation has not been initiated) (the suspension period); and
- (b) suspends any on-going enforcement proceedings for the duration of the suspension period unless there is an express declaration by the Commercial Court stating that the asset concerned is not necessary for the continuation of the business of the company.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Actions under corporate law

- (a) Corporate action (*acción social*)

Only the insolvency administrator is entitled to file a corporate action against directors once the insolvency proceeding has been initiated.

- (b) Individual action (*acción individual*)

- (c) Only shareholders personally affected by directors' actions or omissions and creditors have legal standing to file an individual action against corporate directors.

5.2 Actions under the Spanish Criminal Code

According to Spanish statutory provisions, the public prosecutor does not have a monopoly on prosecution. The right to prosecute is also attributed to the victim.

The investigating judge always has the final say as to whether to open criminal proceedings to investigate an offence. In every case where the facts constitute a crime and there is a probable cause that an offence has been committed, the criminal procedure has to be opened in order to carry out a thorough investigation. The *notitia criminis* reaches the investigating judge through several channels:

- (a) Through the report (*denuncia*) of a citizen before the police, the public prosecutor or the criminal Courts of the facts that, *prima facie*, there appears to be an offence. As a general rule, the person reporting can be any individual who has witnessed the facts or has known them in another way. However, the corporate offences referred to above may only be prosecuted when reported by the person offended or his legal representative. When the former is a minor, an incapacitated or a handicapped person, it may also be reported by the Public Prosecutor. Nevertheless, this report shall not be necessary when commission of the offence affects general interests or multiple persons.

- (b) Through a formal complaint / accusatory pleadings (*querella*) before the criminal Courts. With it, the party who files the complaint not only gives the judge information about some facts that have the appearance of a crime but also expresses his will to constitute himself as an accusing party in the process.
- (c) Through the judge's direct knowledge of the offence.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

6.1 Civil infringements

Any individual who considers that he has suffered damage as a consequence of the directors' behaviour can file a civil claim in the Spanish civil Courts.

The Insolvency Act provides a specific remedy to obtain an order condemning the directors and others, which is dealt by the judge in charge of the insolvency during the liability phase of the proceedings. This remedy within the Insolvency Act will only be available if the liability section is opened.

6.2 Criminal offences

The filing of criminal offences may take place by either:

- (a) filing a criminal denounce (*denuncia*) before the police, the public prosecutor or the criminal Courts which thereby gives notice that a criminal offence may have been committed but does not actually invoke the exercise of any remedy in Court.
- (b) filing a criminal complaint (*querella*) before the criminal Courts which notifies the Court of the potential criminal offence and effectively exercises such criminal remedy.

QUESTION 7

7. Duty to co-operate

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

(b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable in relation to any such obligations?

7.1 General obligation to co-operate under the Insolvency Act

The Insolvency Act imposes the following obligations on an insolvent person / company: -

- (a) a general obligation to appear before the judge and the IP whenever requested and to co-operate and provide information where necessary or convenient in the interests of the insolvency proceedings; and
- (b) a specific obligation to provide the IPs with all documentation relating to the financial aspects of its business.

All the directors, liquidators and attorneys of the insolvent company (and any former directors, liquidators and attorneys of the company in the two years immediately preceding the declaration of insolvency) are required to comply with this obligation.

Although in the context of the general obligation to co-operate, the Insolvency Act does not impose any specific co-operation provisions, it does state expressly that co-operation and the provision of information may be requested wherever necessary or convenient in the interests of the insolvency proceedings. This is a question of fact, dealt with on a case-by-case basis.

A breach of the obligation to co-operate and/or provide information gives rise automatically to a rebuttable presumption of guilty insolvency which may result in disciplinary or economic sanctions for the persons affected by the Court decision that qualifies the insolvency as “guilty”.

Any director of a company (whether formally appointed or *de facto*) who is subject to the supervision of a regulatory authority may commit a criminal offence if he impedes the supervision of the regulatory authority or neglects to provide any document.

7.2 Obligation to co-operate under the Spanish Constitution

The Spanish Constitution imposes an obligation to co-operate and provides that, during the course of trials and the execution of judgments, it is compulsory to assist judges and the Courts alike.

7.3 Human rights

The Spanish Constitution provides that the principles relating to fundamental rights and liberties recognised by the Spanish Constitution shall be interpreted in accordance with the Universal Declaration of Human Rights and international treaties and agreements ratified by Spain. Once a treaty is officially published in Spain, it forms part of the Spanish legal framework and its provisions may only be repealed, amended or suspended pursuant to the provisions of the treaty or the general rules of international law.

On 16 September 1979 Spain ratified and became a party to the European Convention for the Protection of Human Rights and Fundamental Freedoms of 4 November 1950. Therefore, this Convention forms part of the Spanish legal framework and the principles relating to fundamental rights and liberties recognised by the Spanish Constitution are to be interpreted in accordance with this convention.

Moreover, provisions of the Spanish Constitution governing fundamental rights significantly reinforce the provisions of the Universal Declaration of Human Rights and the European Convention for the Protection of Human Rights and Fundamental Freedoms of 4 November 1950. The following fundamental rights protected by the Spanish Constitution may be relevant in the context of insolvency proceedings:

(a) Safeguarding and inviolability of domicile

No entry or search may be performed without consent except with a Court order or where a flagrant criminal offence is taking place.

(b) Safeguarding and inviolability of the secrecy of communications

The secrecy of communications is guaranteed, in particular all postal, telegraphic and telephonic communications. No infringement of secrecy may take place without a Court order.

(c) Freedom to set the state of residence and to relocate within the boundaries of the national territory and to enter and leave the national territory.

The Insolvency Act was enacted together with the Organic Law 8/2003, of 9 July⁹ (the Organic Insolvency Act) and provides the rules governing the impact of insolvency proceedings on fundamental rights. In light of the Organic Insolvency Act, the Commercial Court may make an order:

⁹ Organic laws (Leyes Organicas) are, amongst others, those relating to the development of fundamental rights and public liberties. The passing or amendment of organic laws requires an absolute majority of the members of the Spanish Parliament in a final vote on the bill as a whole.

- (a) to enter and search the domicile of the company;
- (b) to monitor the communications of the company (that is, tapping communications), although the secrecy of the communications that do not relate to the insolvency proceedings must be preserved; and
- (c) to require the company to stay in its place of residence, thereby restricting its freedom of movement.

These orders may be made in respect of the directors, liquidators and attorneys of the company and / or former directors, liquidators and attorneys who acted during the two years immediately preceding the declaration of insolvency.

In criminal proceedings, a number of fundamental rights are provided for by the Spanish Constitution. In particular, every person has the right:

- (a) to a fair trial which shall be safeguarded by judges and Courts;
- (b) to be tried by the judges and Courts determined by the law;
- (c) to a trial without undue delay and with full procedural guarantees;
- (d) to the defence and assistance of a lawyer;
- (e) to be informed of the charges;
- (f) to use all evidence pertinent to the defence;
- (g) not to make self-incriminating statements; and
- (h) to the presumption of innocence.

QUESTION 8

8. Appeals and limitation periods

- (a) What limitation period, if any, applies to actions referred to above?
- (b) What rights of appeal are available from the decision of the lower Courts.

8.1 Limitation periods

8.1.1 Actions under corporate law

For both the corporate action (*accion social*) and the individual action (*accion individual*), there is a four-year limitation period to be counted from the day on which these actions could have first been exercised.

8.1.2 Actions under the Insolvency Act

These are dealt with by the Commercial Court in charge of the insolvency itself during the qualification phase of the proceedings.

8.2 Appeals

Judgments rendered by Spanish First Instance Courts can always be challenged before the relevant Provincial Court by filing an appeal.

Judgments rendered by the Spanish Provincial Courts can be appealed (*recurso de casacion*) before the Spanish Supreme Court if certain requirements are met such as the amount of the claim is over 600,000 euros and the appeal has a “*cassational*” interest (*interes casacional*).

QUESTION 9

9. Foreign corporations

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

9.1 Spanish Companies Law

LSC governs companies incorporated as SA companies or SL companies in Spain. Therefore, foreign companies are not subject to the provisions of the Spanish Companies law.

9.2 The Insolvency Act

Under the Insolvency Act, two types of insolvency proceedings may be opened in Spain: main proceedings of universal scope (the main insolvency proceedings) and secondary proceedings of territorial scope (the secondary insolvency proceedings).

9.2.1 Main insolvency proceedings

Main insolvency proceedings may be opened in Spain if the company’s centre of main interest is located in Spain. “Centre of main interest” (COMI) is defined as the place where the company conducts the administration of its interests on a regular basis, as ascertainable by third parties. A company’s COMI is presumed to be the place of its registered office.

Despite the definition, it is not always clear what factors determine a company’s COMI for the purposes of the Insolvency Act. The Insolvency Act does not include a list of points to be considered by the Courts.

The European Court of Justice’s (ECJ) decision in Eurofood contains some guidance as to how a company’s COMI is to be assessed. The ECJ held that the location of a company’s registered office is key to determining its COMI. The presumption that the company’s COMI is the location of its registered office can only be rebutted if factors which are both objective and ascertainable by third parties enable it to be established that an actual situation exists which is different from the conclusion to which the registered office presumption would lead. Where a company carries on its business in the territory of the Member State where its registered office is situated, the mere fact that its economic choices are or can be controlled by a parent company in another Member State is not enough to rebut the registered office presumption. However, notwithstanding the Eurofood decision, ECJ guidance is still needed on what “interests” encompasses and which “interests” have greatest weight when seeking to rebut the registered office presumption.

To discourage companies from forum shopping, the Insolvency Act states that a change in the registered office of the company carried out within the six months prior to the request of the insolvency will be disregarded for the purpose of the COMI presumption.

Main insolvency proceedings will encompass all of the company’s assets and will affect all creditors, wherever located, except where secondary insolvency proceedings are opened, in which case the assets in that jurisdiction will be administered in those proceedings.

When main insolvency proceedings are opened in Spain, the Court involved will be the Commercial Court located where the company’s COMI is, and Spanish law shall govern (subject to some exceptions) all aspects of the proceedings. The exceptions to the application of Spanish law include:

- (a) rights *in rem* (mortgages, pledges) of creditors and third parties in respect of assets and rights of the company located within the territory of another state;

- (b) retention of title rights in respect of assets sold to the company and located within the territory of another state;
- (c) rights of the company in real estate assets, ships and aircraft subject to registration in a public register under the authority of another state, as well as the validity of acts of disposal for consideration of these assets;
- (d) rights under contracts in respect of real estate assets located in another state;
- (e) rights under employment contracts governed by the law of another state;
- (f) rights over securities represented by book-entries registered in another state;
- (g) rights and obligations of the parties to a payment or settlement system or to a financial market regulated by the law of another state;
- (h) declarative judicial proceedings (*juicios declarativos*) pending in another state and concerning an asset or a right of which the company has been divested;
- (i) set-off rights where the set-off is governed (and permitted) by the non-Spanish law applicable to the company's credit counterclaim¹⁰; and
- (j) rights to set-aside transactions. Specific actions (*acciones de reintegración*)¹¹ that are aimed at rescinding transactions negatively affecting the company's assets cannot be brought by IPs of Spanish insolvency proceedings to set aside a transaction that is subject to the law of another State unless the transaction could be set aside not only under Spanish law but also under the law of the other State.

9.2.2 Secondary insolvency proceedings

To the extent that a company's COMI is not located in Spain, secondary insolvency proceedings may be opened if the company has an establishment in Spain. "Establishment" is defined as any place of operation where the company carries out a non-interim activity with human means and goods.

Secondary insolvency proceedings are governed by the same rules as main insolvency proceedings; however, they apply solely to the assets of the company located in Spain. Accordingly, any restriction on creditors' rights deriving from a settlement agreement approved within the Spanish proceedings, such as a stay in payment or discharge of debt, may not apply to those of the company's assets not covered by the Spanish insolvency proceedings, except with the consent of all creditors interested.

If main insolvency proceedings are opened, rules on the co-ordination of proceedings will be applicable. Where the request to open secondary insolvency proceedings is made after the recognition of main insolvency proceedings, there will be no need to re-examine the question of solvency. The competent Commercial Court will be that of the location of the establishment.

The EU Regulation establishes common rules for cross-border insolvencies throughout the European Union and is directly applicable in all European member states (with the exception of Denmark). Accordingly, the Insolvency Act will be directly applicable except in cases that fall outside the scope of the EU Regulation (that is, where the company is one of the corporate entities excluded from its application¹² or has its COMI outside the territory of the European Union).

¹⁰ Under Spanish law, once the insolvency has been declared, no set-off is allowed between the credits and debts of the company; however any right of set-off that has been perfected prior to the declaration of the situation of insolvency will be enforceable.

¹¹ According to the Rescission Regime, any transaction negatively affecting the company's assets carried out within the two years prior to the declaration of insolvency may be rescinded, whether or not any fraudulent preference can be established.

¹² Insurance undertakings, credit institutions, collective investment undertakings and investment undertakings holding funds or securities for third parties are specifically excluded from the scope of the EU Regulation.

The aim of the Insolvency Act is to impose a framework for the efficient administration of cross-border insolvencies. In order for the framework to be successful and to reduce the scope for conflict between the parties involved so as to maximise the return for creditors, there needs to be co-operation between the relevant Courts and co-ordination of the proceedings. The Insolvency Act attempts to address these issues in various ways. For example, it sets out a regime, based on principles of mutual recognition and cooperation, for: (i) the recognition and enforcement of foreign insolvency proceedings carried on outside the territory of the European Union; and (ii) the co-ordination of parallel insolvency proceedings. In addition, it states that the authority of the Commercial Courts is restricted, in international scope, to the issues that are closely related to those proceedings.

Whether the Insolvency Act, together with the EU Regulation, will create a streamlined insolvency regime applicable to cross-border insolvency proceedings remains to be seen. Principally, it will depend on the way the Commercial Courts interpret and apply its provisions.

9.3 Spanish Criminal Code

As a general rule, only criminal offences carried out in the Spanish territory are subject to the provisions of the Spanish Criminal Code.

QUESTION 10

10. Insurance

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

The strict legal regime on directors' liabilities introduced by Spanish company law caused a significant concern among directors of Spanish limited liability companies. As a consequence, a significant number of Spanish companies entered into directors' and managers' liability insurance policies.

In theory, directors and managers can protect themselves by including an indemnity clause in their contract of service (directors) or contract of employment (managers). Nonetheless, this protection is invariably backed up by an insurance contract entered into by the company. Premiums payable under the insurance policies are paid by the companies.

Most of the largest Spanish companies (especially listed companies) have directors' and managers' liability insurance policies. The larger the company, the more likely that it will offer insurance cover. Insurance policies tend to include standard provisions and are not usually subject to negotiation between the directors or the managers and the insurance company.

A standard directors' and managers' liability insurance policy would generally have the following features:

- (a) Parties: all senior executives and members of the board.
- (b) Coverage: any act carried out by the directors / managers producing economic loss to either the company, its shareholders or creditors and not expressly excluded in the policy, specifically:
 - (i) directors' civil liability;
 - (ii) defence and Court expenses; and
 - (iii) deposits / bonds required by the Courts.

- (c) Exclusions: these policies often exclude:
 - (i) acts of bad faith or wilful misconduct;
 - (ii) losses suffered by individuals or assets;
 - (iii) administrative fines;
 - (iv) actions taken by the majority shareholders; and
 - (v) liabilities based on facts or infringements actually known by the directors / managers.
- (d) Duration: an agreed contractual term. The insured director / manager will, therefore, be insured against any risk covered that is claimed within the contractual term.

APPENDIX: SUMMARY OF THE INSOLVENCY PROCEEDINGS

1. The insolvency declaration

1.1 Requirement to obtain the insolvency declaration

Under the Insolvency Act a debtor is considered legally insolvent when it cannot comply regularly with its due obligations. However, questions arise as to the legal meaning of:

(a) “inability to comply”

Under Spanish law, economic insolvency is not the same as legal insolvency; not every cessation of payments will be a symptom of insolvency. A debtor is not incapable of paying when it can organise payment (that is through the funding of the parent company, etc.). The mere cessation of, or delay in, payments does not provide grounds to initiate insolvency proceedings;

(b) “regularly”

Regularity is not defined. It is undoubtedly broader than a breach of a single obligation. Regular implies a general and repeated cessation of payments; and

(c) “due”

Under Spanish law, obligations are due when fulfilment can be claimed in Court.

1.2 Voluntary and involuntary insolvency

There are two types of insolvency depending on who applies. Insolvency may be applied for by the debtor (Voluntary Insolvency) or by its creditors (Involuntary Insolvency):

(a) Voluntary insolvency

The debtor is entitled to initiate Voluntary Insolvency proceedings in the event of imminent, and not actual, insolvency.

(b) Involuntary insolvency

In order to file for Involuntary Insolvency, a creditor must provide evidence of:

(i) actual, and not potential or imminent, insolvency;

(ii) the concurrence of, at least, one of the following:

(a) general cessation of payments by the debtor;

(b) the assets of the debtor having been generally seized or that there are insufficient free assets to be seized;

(c) a concealment of assets or an accelerated or defeated liquidation of assets; or

(d) a general breach during the three months preceding the filing of the insolvency application of either tax obligations, Social Security contributions and salaries, compensation or other amounts due to employees, provided, however, that the debt upon which the petition is founded must not have been acquired by the creditor, after becoming due and payable, during the six-months period prior to the filing for insolvency.

1.3 Application period

The debtor is obliged to apply for insolvency within two months following the date on which it knows, or should have known, that it became insolvent. It is presumed that the debtor was aware of its insolvency if any of the circumstances that justify the filing for Involuntary Insolvency apply.

There is now also the option for the insolvent debtor to notify the Court that it is entering into negotiations in order to obtain support to an Advanced (anticipated) Settlement Proposal (refer to paragraph 1.4 below) within the two- month period for filing for insolvency. In this event, the Court will grant the insolvent debtor an additional three-month period to obtain sufficient support, following which the debtor company will have a month to file for insolvency. The initiation of this negotiation period prevents creditors of the insolvent debtor from filing for Involuntary Insolvency during the three-month period granted to seek support for a Settlement Proposal.

2. Insolvency proceedings

2.1 Background

The Insolvency Act unifies and simplifies the insolvency procedures by establishing a unique procedure divided into the following phases:

- (a) the filing of the insolvency application (the Application);
- (b) the common phase (the Common Phase);
- (c) the settlement and/or liquidation phase; and
- (d) the qualification of the insolvency (liability section of the proceedings).

2.2 The Application

- (a) The Application for insolvency must be in writing and must state whether the insolvency is actual or imminent and attach a number of documents including, among others:
 - (i) a report containing the financial and legal history of the debtor and the causes of the current financial situation; and
 - (ii) the books of accounts.
- (b) The Application is filed;
 - (i) with the Commercial Court in the place where the debtor has its centre of main interests, presumed to be the city where the company has its registered address; or
 - (ii) in the event that insolvency affects a number of companies forming part of the same group, the application is filed with the Commercial Court in the location where the parent company has its registered address.
- (c) In the event of Involuntary Insolvency, the debtor may agree or oppose the Application. If the Debtor opposes the application, it is obliged to deposit in Court the amount of the outstanding debts which gave ground to the filing.
- (d) If the application is accepted, the Commercial Court will make an insolvency order which, among other matters, will decide:
 - (i) the effect of the insolvency declaration on the powers to manage the business and/or dispose of its assets;
 - (ii) the interim measures necessary to secure the integrity of the debtor's estate;
 - (iii) the identity and powers of the Insolvency Administration (the IA).
 - (A) Under the Insolvency Act, the IA will generally be composed of one Insolvency Practitioner (the IP) who might be:
 - a lawyer with, at least, five years' effective experience;
 - a chartered accountant with, at least, five years' effective experience; and

- a receivership company which employs this sort of professionals.

In complex proceedings, a creditor with an important ordinary or preferential claim (but not a secured claim) might be appointed to act as a second IP.

(B) The appointment of IPs for certain types of debtors is subject to special rules. Where the debtor is:

- a listed company, the chartered accountant will be replaced by a representative of the Spanish Securities Market Commission;
- a credit institution, the chartered accountant will be replaced by a representative of the Spanish Guarantee of Deposits Fund; and
- an insurance company, the chartered accountant will be replaced by a representative of the Spanish Insurance Compensation Consortium.

2.3 Common phase

Once the Court has declared the debtor insolvent, the Common Phase of the procedure commences. The Common Phase comprises:

- (a) the preparation of a report by the IP (the Report of the IA) containing, at least:
 - (i) an analysis of the contents of the debtor's report;
 - (ii) the status of the debtor's accounts;
 - (iii) a summary of the decisions taken and acts performed by the IA;
 - (iv) the following documents:
 - (A) a list of the debtor's assets and rights;
 - (B) a list of the debtor's creditors; and
 - (C) an evaluation of the settlement proposals (if any) that have been submitted; and
 - (v) an analysis of the situation of the debtor's estate;
- (b) the publication of the Report of the IA; and
- (c) the granting of a certain time period so that the list of assets or the list of the creditors can be challenged:
 - (i) within the ten days following receipt of the Report of the IA;
 - (ii) with the aim of:
 - (A) including / excluding any right or asset;
 - (B) increasing / decreasing the value of any asset or right; and
 - (C) including / excluding any claim or changing the classification of the claim; and
 - (iii) by commencing a side proceeding known as an insolvency incident (an Insolvency Incident). An Insolvency Incident is a summary proceeding, the object of which is to discuss particular claims before the Commercial Court. The Insolvency Incident comprises the following phases:
 - (A) the filing of a claim, subject to the same requirements as any other claim;
 - (B) the filing of a writ of defence within the ten days following notice of the decision admitting the claim;

(C) the eventual trial, during which the parties place all evidence that they deem appropriate and pertinent before the Commercial Court; and

(D) the handing down of a judgment which, generally, cannot be appealed.

2.4 Settlement phase

2.4.1 General considerations

One of the objects of the insolvency proceedings is to bring about the possibility of a settlement (the Settlement) either in terms of a reduction in the amount of the company's debts and / or the delay in the payment of the debts. The Settlement phase only takes place if:

- (i) the debtor has not requested liquidation; or
- (ii) if a proposal for a Settlement has not been approved during the Common Phase.

2.4.2 Content of the Settlement

The Settlement is limited in its scope, given that it:

- (i) may include a reduction (quita) in the amount of the debts and/or the delay (espera) in the payment of the amounts due, which particular terms and conditions will depend on the degree of creditors' support obtained by the Settlement;
- (ii) may propose different alternatives for different creditors or debts, including the conversion of debts into equity;
- (iii) may propose the sale of assets or rights devoted to the business activities or of certain business units to specific individuals; and
- (iv) must include a payment plan or feasibility plan, the latter only where fulfilment of the Settlement is subject to the income obtained from the continuation of the business.

However, the Settlement cannot consist of:

- (v) the assignment to creditors of assets or rights that may be necessary to continue the professional or commercial activity of the insolvent company and which fair value is higher than the corresponding creditor's claim (if so, the assignee-creditor should include the difference in the aggregate);
- (vi) the liquidation of the entire estate of the debtor; or
- (vii) the modification of the ranking of claims.

2.4.3 Consequences of the Settlement

The approval of any Settlement:

- (i) is fully effective from the date on which the Settlement is approved by the Commercial Court;
- (ii) triggers the cessation of the consequences of the insolvency, which are substituted by the specific measures approved by the Commercial Court;
- (iii) generally terminates the appointment of the IP, unless and to the extent otherwise provided for in the Settlement; and
- (iv) the Settlement,
 - (A) binds the debtor and the common ordinary and subordinated creditors;
 - (B) does not bind secured creditors unless they voted in favour of the Settlement or otherwise ratified, or adhered to, the Settlement; and

(C) does not affect or impair rights of creditors who voted against the Settlement in respect of third parties jointly liable with, or guarantors of, the debtor.

2.4.4 Settlement proceedings

Settlement proposals can be filed with the Commercial Court:

- (i) any time after the final date for creditors to give notice of their claims and the end of the Common phase; or
- (ii) between the opening of the Settlement Phase (which takes place after the approval by the Court of the definitive list of creditors and inventory included in the Report of the IA) and 40 days prior to the date appointed for the creditors' meeting. The IA is obliged to prepare a report on the various Settlement proposal(s) filed.

Once filed, the proposals are analysed at a creditors' general meeting. Only one Settlement proposal can be approved by a majority consisting of:

- (iii) votes of creditors holding at least half of the ordinary claims, when the proposal contains a reduction that is equal to or less than half the amount of the credits, with a term not exceeding five years. However, if the Settlement proposes that full payment of the debts is to be completed within three years or, alternatively, that immediate payment of due ordinary debts, which are to be reduced by no more than 20 per cent., a simple majority of ordinary debts will be sufficient to approve the Settlement; and
- (iv) votes of creditors holding at least 65 per cent of the ordinary claims, when the proposal contains a delay for a term of more than five years (up to a maximum of 10 years) or a reduction higher than half the amount of the credits.

Pursuant to the new Law 9/2015, the purposes of calculation of the majorities above mentioned, preferential claims of creditors who vote in favour of the proposal shall be considered as ordinary claims, also in respect of the fraction of the secured creditors' claim that does not exceed the value of the respective security, since the fraction that exceeds the value of the security is considered in any case as an ordinary claim by the Insolvency Act.

Notwithstanding approval, the debtor, its shareholders or even the creditors are entitled to challenge the Settlement by initiating an Insolvency Incident, at which the Commercial Court will definitively approve or reject the Settlement.

It is important to note that,

- (vii) once the Settlement has been complied with by the debtor, the debtor is entitled to request the Commercial Court to issue a judicial declaration of compliance with the Settlement; and
- (viii) conversely, any creditor may request the Commercial Court to declare that the debtor has breached the Settlement. If the request is successful, the Commercial Court will order the rescission (that is termination) of the Settlement and the insolvency proceedings will be reopened to liquidate the company.

2.4.5 Advanced Settlement proposal

In addition, the debtor is entitled to file advanced / anticipated Settlement proposals (each, an Advanced Settlement Proposal) along with the filing of the voluntary insolvency petition and at any time until the expiry of the period in which creditors can give notice of their claims. An Advanced Settlement Proposal can only be filed if the debtor has not:

- (i) been found guilty by definitive ruling of an economic crime; and
- (ii) breached its obligation to deposit its annual accounts during the last three financial years.

Advanced Settlement Proposals are also subject to the Report of the IA, and can be approved any time before the end of the period for challenging the list of assets. If approved, the Commercial Court will not need to initiate the Settlement phase.

An Advanced Settlement Proposal needs only the support of creditors holding ten per cent. of the claims in order to be admitted, provided it is filed at the same time as the filing for insolvency. Otherwise the support required for the admission is 20 per cent.

2.5 Liquidation phase

Liquidation only takes place:

- (a) at the debtor's request, in the context of a Voluntary Insolvency, if:
 - (i) the debtor applies for liquidation as part of its Application; and
 - (ii) no Settlement proposals have been approved;
- (b) when the debtor becomes aware that it is unable to comply with the terms of an approved Settlement; or
- (c) if the Commercial Court decides, based on:
 - (i) failure to file a Settlement proposal or failure to admit any of those filed;
 - (ii) rejection by the Commercial Court of any Settlement proposal accepted at a creditors' general meeting;
 - (iii) the Settlement being void; or
 - (iv) a breach of the Settlement.

Liquidation triggers the suspension of the debtor's powers to manage the business and / or to dispose of its assets, as well as the winding up of the debtor and the maturity of any debt.

Moreover, liquidation provides for the possibility of establishing a liquidation plan subject to the Commercial Court authorisation.

2.6 Liability phase or “qualification” phase of the insolvency proceeding

Insolvency is subject to qualification, either (i) upon approval of a Settlement which foresees a reduction in excess of one third of the amount of the debts or a delay of payments in excess of three years or (ii) when the debtor enters into liquidation (including where the liquidation is triggered by the breach of a Settlement which had been previously approved).

Insolvency can be qualified as either fortuitous or guilty.

- (a) An insolvency is considered guilty where the debtor:
 - (i) has breached its accounting obligations;
 - (ii) has filed false or untrue documents with the Application;
 - (iii) has breached the Settlement; or
 - (iv) has concealed assets.
- (b) The qualification of insolvency as guilty may disqualify the individuals who managed the debtor from administering assets for a 15-year period and declare them personally liable for all or part of the debts.

The information provided in this country chapter is correct as at 01/01/2017

THE NETHERLANDS

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 General remarks on insolvency proceedings in the Netherlands

Netherlands law is familiar with two types of collective insolvency proceedings: suspension of payments (*surséance van betaling*) and bankruptcy (*faillissement*). These proceedings are predominantly governed by the Dutch Civil Code (DCC), the Dutch Bankruptcy Act (DBA) and – in case of insolvency with European cross-border aspects – the EU Council Regulation 1346/2000 on Insolvency Proceedings.

Suspension of payments seeks to provide a company with an opportunity to reorganise its business and thereby prevent liquidation. Only the company itself may apply for suspension of payments, but there is no legal obligation to do so. A company may request suspension of payments in case it foresees it will no longer be able to satisfy its due and payable debts. As long as the request is properly submitted to the court having jurisdiction, a provisional suspension of payments is immediately granted. When granting provisional suspension of payments, the court will appoint one or more administrators (*bewindvoerders*) and a supervisory judge (*rechter-commissaris*). During suspension of payments unsecured creditors may no longer take recourse against the debtor's assets. The debtor may still pay its creditors but only if payment is made to all creditors in proportion to their respective claims.¹ Directors are still authorized to represent the company during suspension of payments; they do, however, require the co-operation of the administrator.²

The purpose of bankruptcy is to liquidate the insolvent company, although a going-concern sale of assets out of bankruptcy is common. Bankruptcy may be filed for by a company itself, by one or more creditors (including the tax authorities) or by the Dutch Public Prosecution.³ The court will declare a company's bankruptcy if the relevant facts and circumstances indicate the company is in the state of having ceased to pay its outstanding debts. Case law has specified "ceasing to pay one's debts" to mean that at least one of the outstanding obligations is due and payable and a total of two or more creditors exist. Furthermore, the use of the word "state" assumes an ongoing period of having ceased to pay, although the Dutch Supreme Court (*Hoge Raad*) has acknowledged that, strictly speaking, the DBA does not require such period. Upon declaration of bankruptcy, the court will appoint one or more trustees (*curatoren*) and a supervisory judge (*rechter-commissaris*).⁴ Other than in the case of suspension of payments, a company's directors lose their authority to dispose of the company's assets as at midnight at the onset of the day on which the bankruptcy is declared.⁵

A company in financial distress is not legally obliged to apply for suspension of payments or bankruptcy. However, its directors do run the risk of incurring personal liability if they allow an insolvent company to remain in business under circumstances that compel otherwise.

¹ Article 233 DBA.
² Article 228 DBA.
³ Article 1 DBA.
⁴ Article 14 DBA.
⁵ Article 23 DBA.

1.2 Directors and the twilight period

The DCC does not provide for a definition of “director” as such. It merely states that the board of directors is responsible for the management of the company.⁶ It follows that – in terms of the DCC – directors are formally identified as (legal) persons forming (part of) the company body that is responsible for the statutory management task. Formal members of the board of directors are appointed through a statutory procedure with the possibility of additional or differing requirements following from, for example, the articles of association or shareholders agreements.

So it is decisive whether a person or entity is formally appointed to take part in the body entrusted with the company’s management.⁷ Consequently, it – strictly speaking – does not matter whether or not a director is referred to as such in the articles of association or whether he has been registered with the trade register as required by the Dutch Commercial Registers Decree. However, the identification of directors for liability purposes goes beyond the notion of formal directors as will be discussed in more detail hereafter.

Dutch company law is unfamiliar with a general concept of a period prior to insolvency proceedings during which the acts of a company may be questioned or undone. Statute grants the trustee, the company’s creditors and the tax authorities specific means to hold the directors of a company liable for losses caused by mismanagement, as well as remedies to undo prejudicial transactions concluded during the period prior to the adjudication of bankruptcy. In this respect, two temporal distinctions deserve highlighting. First of all, the period of three years prior to the adjudication of bankruptcy is important for liability purposes. In case of mismanagement that is deemed to constitute a significant cause of the bankruptcy as provided in articles 2:138/248 DCC, the trustee will only be able to bring a claim if such performance has occurred within a three-year period prior to the bankruptcy.⁸ Secondly, transactions are most vulnerable to being successfully challenged by a trustee if concluded within a one-year period preceding the bankruptcy. In that particular case, the DBA provides for a statutory evidentiary presumption assuming the (board of) director(s) to have been aware of such transactions being prejudicial to the joint creditors’ interest.⁹

⁶ For example, Article 2:44, 129, 239 and 291 DCC.

⁷ See H. de Groot, *Bestuurdersaansprakelijkheid*, Deventer: Kluwer 2011, p. 18.

⁸ Article 2:138/248(6) DCC.

⁹ Article 43(1) DBA.

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 acts may otherwise have adverse consequences for the director?
- (b) In relation to each act identified in (a) above:
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or 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 remarks

Directors are responsible for the management of the company. The management task may be described as all acts serving the objects clause contained in the company's articles of association. This includes the day-to-day management, but also the efficient representation and control of the company in transactional matters with third parties. The position of director inherently entails taking risks, which under specific circumstances may lead to losses for which directors can be held liable *pro se*. Most acts potentially giving rise to directors' liability under Dutch law can be sanctioned by more than one statute, each with different remedies and legal consequences. The classification of these acts is largely dependent on the specific circumstances of the case, which renders it difficult to arrange them into groups.

A director may be personally liable to the company itself (internal liability; paragraph 2.2) and / or to a third party (external liability). The latter includes liability to the bankruptcy estate (paragraph 2.3), as well as liability for a wrongful act or tort (paragraph 2.4). Directors may further be held liable by the tax authorities for leaving tax debts unpaid under specific circumstances (paragraph 2.5). Finally, the risk of criminal directors' liability under Dutch law will be looked into (paragraph 2.6).

In the Netherlands, enterprises are generally in one of two different legal forms, known as the public limited company (*naamloze vennootschap* or *N.V.*) and the private limited company (*besloten vennootschap* or *B.V.*). Both types of companies have capital divided into shares. However, with the simplification and flexibilization of private company law as from 1 October 2012, capital requirements for the private limited company were reduced from €18,000.00 to €0,01, whereas public limited companies statutorily require a minimum share capital of €45,000. A second significant difference between the two legal forms is the former obligation and – with the simplification and flexibilization of private company law – current option of private limited companies to restrict the transferability of its shares in the articles of association.

In terms of governance of both types of companies, Dutch law takes a two-tier board structure consisting of a board of directors and a supervisory board as a starting point. Companies qualifying as "small", however, are allowed to adopt a corporate structure comprising only of a board of directors. Larger companies are obligated to adopt the two-tier system if they (i) have at least one hundred employees, (ii) are required by statute to instate a works council and (iii) have an issued share capital of at least €16,000,000.¹⁰ As from 1 January 2013 (and while upholding the two-tier board structure as a starting point), Dutch law allows a company to choose a one-tier board structure. In that case, the articles of association of the company will stipulate that specific tasks are divided among one or more executive directors and one or more non-executive directors.¹¹

¹⁰ Article 2:153/263 DCC.

¹¹ Article 2:129a/239a DCC.

Unlike some legal systems, Dutch company law allows a legal person to be (part of) the board of directors of another (legal person-director). In an effort to prevent directors (natural persons) from easily escaping liability by interposing one or more (limited liability) companies between themselves and the operating company, the DCC provides that the liability of a legal person as director of another legal person also imposes joint and several liability on any (legal) person that is a director of the liable entity at the time liability arises.¹² This way, legal person-directors may have recourse against the legal person by which they were managed, while the latter itself may have a claim on its natural person-directors on the basis of internal liability.

2.2 Internal liability

Internal liability of a director under Dutch law is commonly based on either breach of the contractual (employment) relationship between the director and the company or the institutional liability of Article 2:9 DCC.¹³ For the purposes of this chapter, only the latter will be discussed. Article 2:9 DCC expresses the general standard of conduct for directors: every director has an obligation to the company to properly perform his duties. Correspondingly, internal liability on the basis of Article 2:9 DCC occurs if a director manifestly performs his management task improperly. Manifestly improper performance exists in case no reasonably-thinking director under the same circumstances would have so acted.¹⁴ The Dutch Supreme Court has held that a director is only liable for manifestly improper performance in cases where such performance constitutes serious blame attributable to him (*ernstig persoonlijk verwijt*), while taking into account all the relevant circumstances;¹⁵ for example, a case where a director violates provisions in the articles of association that are intended to protect the company. Relevant circumstances include, *inter alia*, the nature and risks of the activities carried out by the company, possibly applicable management guidelines or the understanding and care that may be expected from a director who is suitable for his duties and carries them out conscientiously.

With the introduction of the one-tier board structure in January 2013 (*see 2.1 above*), the wording of Article 2:9 DCC has been altered to facilitate the possibility of allocating duties – and correspondingly, liabilities – among the members of the board of directors to bring statute more in line with existing practice. A well-defined allocation of duties for public and private limited companies that choose a one-tier board structure is imperative to prevent non-executive directors from being exposed to significant liability risks. However, the current text explicitly states that an allocation of tasks does not affect the collective responsibility of the board of directors in regard to the day-to-day affairs of the company; directors will not be able to escape liability for such affairs simply by relying on an allocation of duties in the articles of association.

In bankruptcy, the trustee in his capacity as representative of the proprietary interests of the insolvent estate becomes exclusively authorized to invoke Article 2:9 DCC. Trustees should be aware that if the shareholders have discharged the board of directors of liability for the acts in question, it will no longer be possible to bring a claim on the basis of Article 2:9 DCC. Such discharge, however, only covers information disclosed to the shareholders in the annual accounts or during the annual general meeting of shareholders. Reliance on discharge of liability for undisclosed acts is considered to be contrary to the basic principles of reasonableness and fairness.¹⁶ It is additionally noted that discharge does not affect the trustee's authority to bring claims against a director on the basis of any of the other liability grounds discussed.

Apart from the general internal liability ground of Article 2:9 DCC, the company has several specific actions at its disposal. A recently implemented example pertains to the possibility for a private limited company, and in bankruptcy, its trustee, to hold its directors jointly and severally liable for the deficit ensuing from a profit distribution that was approved by the board of directors, while it was known or should have been known the company would not be able to settle its payable debts after such distribution.¹⁷

¹² Article 2:11 DCC. Although the DCC chain liability is assumed to only apply to DCC liability grounds, other liability bases tend to provide for similar protection. For example, tax liability under Article 36 of the Dutch Collection of State Taxes Act as will be discussed below, is considered to also impose liability on directors of bodies that are themselves directors of the body that has left a tax debt unpaid.

¹³ See H. de Groot, *Bestuurdersaansprakelijkheid*, Deventer: Kluwer 2011, p. 21.

¹⁴ Dutch Supreme Court 8 June 2001, *NJ* 2001, 454 (*Panmo Productie*).

¹⁵ Dutch Supreme Court 10 January 1997, *NJ* 1997, 360 (*Staleman/Van de Ven*).

¹⁶ Cf. Dutch Supreme Court 20 June 1924, *NJ* 1924 (*Truffino*).

¹⁷ See Article 2:216(3) DCC; see also Dutch Supreme Court 12 July 2013, *NJ* 2013/461 (*VEB c.s./KLM*) for the restrictive application of Article 2:216(3) DCC.

2.2.1 Characteristics of the liability

- (i) Dutch law considers internal liability to be civil.
- (ii) The members of the board of directors are jointly and severally liable for the losses incurred by the company. If the company challenges a single director for the total amount of the losses, the director may have recourse against the other directors on the basis of the DCC for that part of the losses that do not relate to him. Internal liability generally does not relate to losses incurred by third parties, although in theory it would be possible for the company to be forced to pay the claims of third parties which the company may then seek to recover from an individual director in person.
- (iii) The statutory principle of collective responsibility of the board of directors for the management of the company indicates that internal liability attaches to all its members jointly and severally, regardless of their involvement. Without any allocation of duties, individual directors may, however, escape liability by proving they cannot be attributed any serious blame and have not been negligent in taking measures to prevent or limit the consequences of the acts of mismanagement. The DCC considers a well-defined allocation of duties in the articles of association to contribute to such proof; if the acts of mismanagement do not fall within the remit of a given director, it should be easier to attest that any serious blame cannot be attributed to him.
- (iv) Liability on the basis of Article 2:9 DCC is not limited to a certain period of time, although one should take into account the applicable general statute of limitations (see paragraph 8).
- (v) The DCC offers directors the remedy of escaping internal liability on the basis of Article 2:9 by proving that any serious blame cannot be attributed to them and they have not been negligent in taking measures to prevent or limit the consequences of the acts of mismanagement. As explained, a well-defined allocation of duties in the articles of association is important in this respect. Furthermore, the general meeting of shareholders may discharge a director or the board of directors as a whole at the end of the financial year upon acceptance of the annual accounts. Such discharge may be relied upon to avoid liability under article 2:9 DCC. However, discharge does not apply to acts that are not disclosed in the annual accounts or during the annual general meeting and may be invalidated if considered to be in violation of the principles of reasonableness and fairness.¹⁸ Case law indicates that violation of these principles by a discharge decision is not easily accepted, even if a director has deliberately prejudiced the company's interests.¹⁹

2.3 External liability towards the bankruptcy estate

In case of bankruptcy, the DCC provides that the trustee may hold the board of directors (externally) liable towards the insolvent estate for the bankruptcy deficit (i.e. the amount of the deficiency after liquidation and distribution of assets), if the board of directors has manifestly performed its task improperly and it is likely that such improper performance constitutes an important cause of the bankruptcy (Article 2:138/248 DCC).

As this provision only applies in case of bankruptcy of the company, only the trustee is able to bring a claim on the basis of Article 2:138/248 DCC. The trustee may be supported in his claim by two statutory evidentiary presumptions if the board of directors has either breached their obligation to keep financial records of the company in accordance with Article 2:10 DCC or if the company has failed to timely publish its annual accounts pursuant to Article 2:394 DCC.²⁰ In case (one of) those circumstances exist(s), the board of directors is irrefutably presumed to have performed its duties improperly. Secondly, the presumed improper performance of duties is refutably considered to be an important cause of the bankruptcy.

In respect of the obligation to publish the annual accounts on time, Dutch case law has mitigated the consequences of untimely publication by determining that exceeding the publication term by only a few days constitutes an immaterial omission. It is further noted that a recently implemented European accounting directive has shortened the publication period in the DCC from 13 to 12 months for financial years starting on or after 1 January 2016.²¹

¹⁸ Article 2:8 DCC.

¹⁹ Dutch Supreme Court 20 October 1989, NJ 1990, 308 (*Ellem Beheer/De Bruin*); and Court of Appeal of Den Bosch, 11 September 2007, JOR 2007, 264.

²⁰ Article 2:138/248(2) DCC.

²¹ Due Accounts Directive Implementation Act applies to financial years beginning after 1st January 2016.

2.3.1 Characteristics of the liability

- (i) Dutch law considers external liability towards the bankruptcy estate to be civil.
- (ii) All members of the board of directors are personally and severally liable for the entire bankruptcy deficit under Articles 2:138/248 DCC. The court may reduce the amount for which the board of directors as a whole is held liable, if it considers liability for the entire bankruptcy deficit to be excessive with regard to the nature and gravity of the mismanagement.
- (iii) As well as internal liability, the liability of Article 2:138/248 DCC principally pertains to the board of directors as a whole, with a similar possibility for individual directors to exculpate themselves by proving they cannot be attributed any serious blame and have not been negligent in taking measures to prevent or limit the consequences of the acts of mismanagement.²² A reduction in the amount of an individual director's liability may further be provided in a case where the relevant director has only been on the board for a short period at the time of the mismanagement.²³
- (iv) Liability to the bankruptcy estate under Articles 2:138/248 DCC can only arise from mismanagement occurring within three years prior to the bankruptcy.
- (v) In cases where (one of) the circumstances described in Articles 2:138/248 DCC exist(s), it is irrefutably established that the board of directors has improperly performed its duties. However, they may be able to successfully argue that the mismanagement did not constitute the cause of the bankruptcy – or at least not to a significant extent. If it were to be established that other circumstances (e.g. the economic or commercial situation of the company) caused the bankruptcy to a significant extent, Articles 2:138/248 DCC do not apply. Other than internal liability, a decision to discharge a director does not preclude external liability under Articles 2:138/248 DCC. Furthermore, directors are unable to rely on set-off; the nature of the external liability towards the bankruptcy estate renders it impossible for directors to set-off the amount of their liability against any present or future claim they might have against the company itself.²⁴

2.4 External liability - tort

In the Netherlands, directors' liability may also be construed under the general liability provision of Article 6:162 DCC (wrongful act). Other than the common law tradition that distinguishes between different forms of unlawful conduct or torts, Dutch law provides for a general civil liability basis that aims to include all forms of wrongful acts. Application of Article 6:162 DCC generally requires (i) an act or omission infringing one's rights, violating a statutory obligation or breaching a duty of care; (ii) attribution of the act or omission to the inflictor; (iii) loss suffered by one or more third parties; and (iv) a causal relationship between the act or omission and the loss or damage.²⁵ As to directors in particular, the Dutch Supreme Court has held that personal liability under Article 6:162 DCC of a director acting in capacity additionally requires that the respective director in person can be attributed serious blame;²⁶ such, considering the fact that a director acting in capacity is primarily assumed to bind the company, even in case of an unlawful act.²⁷

One of the casebook judgments in terms of prejudice to creditors is the *Beklamel* case,²⁸ in which the Dutch Supreme Court held that personal liability in tort under Article 6:162 DCC exists if a director has entered into an agreement on behalf of the company, even though he knew or should reasonably have known that the company would not, or at least not within reasonable time, be able to fulfil its obligations under this agreement and would not provide for sufficient assets against which recourse could be taken. It concerns the situation in which a director should reasonably have resorted to filing for insolvency proceedings, but neglected to do so. A more recent case has further specified that this standard only applies if the director knew or should have known that breaching the company's obligations would actually be detrimental to the creditor; a

²² Article 2:138/248(3) DCC.

²³ Article 2:138/248(4) DCC.

²⁴ Dutch Supreme Court 18 September 2009, *JOR* 2010/29 (*Simoca*).

²⁵ Some statutory provisions (*lex specialis*) substantiate the general liability basis of Article 6:162 DCC with to regard specific circumstances. For example, Article 6:194 DCC allows for a director to be held liable towards third parties for a misleading representation of a company's financial position in its prospectus.

²⁶ Dutch Supreme Court 23 November 2012, *NJ* 2013/302 (*Spaanse Villa*); for more recent examples, see Dutch Supreme Court 5 September 2014, *NJ* 2015/21 or Dutch Supreme Court 6 February 2015, *JOR* 2015/102.

²⁷ Dutch Supreme Court 10 June 1955, *NJ* 1955, 552.

²⁸ Dutch Supreme Court 6 October 1989, *NJ* 1990, 286, (*Beklamel*).

worse security position due to the respective breach does not constitute such loss or damage.²⁹ Another case concerning prejudice to creditors is the *Driespan* case,³⁰ where Article 6:162 DCC was applied to a director actively causing or allowing the company to breach its statutory or contractual obligations.

A director may limit his liability discussed above by informing the company's creditors beforehand of its precarious financial situation or by filing for suspension of payments.³¹ The Supreme Court has acknowledged this puts directors in a quandary. Informing creditors too early of a looming state of insolvency will render bankruptcy inevitable, whereas informing them too late may lead to personal liability. To be on the safe side, the turning point (or reference date) has been determined as the date on which the director knew or should have known (objective knowledge)³² the bankruptcy of the company was unavoidable.³³

Finally, even after bankruptcy, directors are considered to remain in a special position owing a duty of care towards the insolvent company. Not taking into account such duty of care may lead to personal liability under Article 6:162 DCC. For example, a former director of a company that structured the bankruptcy sale of company assets for his own benefit, thereby prejudicing other creditors, was held personally liable for conduct in breach of his special duty of care.³⁴ This specific risk of liability will particularly come into play in so-called "pre-pack" situations where the sale of (part of the) assets and continuation of (part of) the company's business are prepared prior to the actual bankruptcy.

2.4.1 Characteristics of the liability

- (i) Dutch law considers personal liability in tort to be civil.
- (ii) Liability in tort under Article 6:162 DCC or its *leges speciales* renders a director liable for the loss that one or more third parties have suffered as a consequence of the unlawful conduct.
- (iii) Liability in tort attaches to directors individually; there is no joint and several liability as is the case with internal liability or external liability under Article 2:138/248 DCC. Attributability and, by extension, serious blame in person, is to be proved against the director individually.
- (iv) Apart from the statute of limitations, personal liability under Article 6:162 DCC or its *leges speciales* is not limited to a specific period.
- (v) The general tort liability of Article 6:162 DCC is formulated as an open standard causing the available defences to be mainly dependent on the specific circumstances of the case and the grounds of the accusation.³⁵ Commonly, liability claims under Article 6:162 DCC are contested by disputing the different requirements, i.e. the alleged unlawfulness of the conduct, the existence of damage and causality. In particular, directors may argue that they cannot be attributed any serious blame in person, in which respect it might be helpful for directors to emphasize the cautious approach courts ought to take in accepting personal liability of directors acting in that capacity.³⁶

2.5 Liability to the tax authorities

Article 36 of the Dutch Collection of State Taxes Act 1990 (CST) contains an independent tax liability basis for directors of bodies subject to corporation taxes in the Netherlands (so-called "commercial companies") that leave a tax debt outstanding. Public and private limited companies are considered to be commercial companies in this respect. Directors of such commercial companies may be held jointly and severally liable for the total amount of outstanding taxes (e.g. income taxes, turnover taxes and / or excise duty) in case of manifestly improper management. Manifestly improper management for the purpose of Article 36 CST is construed in the same way as for internal liability (see 2.2 above).

²⁹ Dutch Supreme Court 11 December 2014, *NJ* 2015, 22 (*RCI Financial Services BV/Kastrop*).

³⁰ Dutch Supreme Court 18 February 2000, *NJ* 2000/295 (*Driespan*).

³¹ Dutch Supreme Court 21 December 2001, *JOR* 2002/38 (*SOBI/Hurks*).

³² Dutch Supreme Court 26 June 2009, *NJ* 2009, 418.

³³ Dutch Supreme Court 21 December 2001, *JOR* 2002/38 (*SOBI/Hurks*), as later confirmed by the Court of Appeal of The Hague 16 September 2008, LJN: BF4107.

³⁴ Dutch Supreme Court 11 February 2011, *JOR* 2011, 114.

³⁵ In case a *lex specialis* such as Article 6:194 DCC applies, the defence must also focus on the requirements of the specific statutory provision.

³⁶ Cf. Dutch Supreme Court 4 April 2014, *JOR* 2015/1.

Whether manifestly improper management for the purpose of Article 36 CST exists in a specific case is largely dependent on whether the company has complied with its obligations to the tax authorities under the CST to give timely notice in writing when it has become apparent that the company is no longer able to pay its outstanding taxes.³⁷ Inability to pay is not only considered to exist if the company lacks financial means, but also if it does have liquidity to pay the outstanding tax debt but chooses to put its resources to other use.³⁸ Complying with the duty to report may lead to the personal liability of the directors if taxes have been left unpaid as a result of mismanagement within the period of three years prior to the notification. Not (properly) complying, moreover, gives rise to a statutory evidentiary presumption of manifestly improper management and attributability, that can only be disproved by establishing that an individual director has no fault in not (properly) complying with the company's duty to report.³⁹

2.5.1 Characteristics of the liability

- (i) Dutch law considers liability to the tax authorities under Article 36 CST to be civil.
- (ii) Directors are jointly and severally liable in person for the company's outstanding tax debt in case of mismanagement attributable to them.
- (iii) Tax liability under Article 36 CST attaches to the management collectively but allows for individual directors to exculpate themselves (also see under (v) below). Courts do not consider involvement in the mismanagement to be a factor as courts have no discretion to mitigate the amount of the liability.⁴⁰
- (iv) Liability under Article 36 CST only exists where the unpaid tax debt is as a result of attributable mismanagement taking place within a three-year period prior to the notification to the tax authorities.⁴¹ If no notice of default has been given, this three-year period is statutorily assumed to commence at the moment of default.⁴² It is noted that the initiation of insolvency proceedings is irrelevant for purposes of Article 36 CST.
- (v) Where the company has properly notified the tax authorities of its inability to pay an outstanding tax debt, an individual director will have to prove that the debt being left unpaid is not a consequence of mismanagement that can be attributed to him in order to escape personal liability. The differentiation of such defence is obviously the argument that there has been no mismanagement; or at least none that may be attributed to him personally and / or not within the three-year period prior to the notification. If the tax authorities were not (properly) notified, however, statute presumes mismanagement and attributability, which can only be refuted by proving that the failure to comply with the duty to report is not attributable to the individual director in question. If such proof is successfully provided, the defences that may be brought in the event of proper notification of the tax authorities will naturally become relevant again.

2.6 Risk of criminal liability

The Dutch Penal Code (DPC) contains several provisions that can lead to the prosecution of both companies and their directors. Criminal prosecution of companies and directors used to be rare, but the recent past has shown that criminal proceedings against directors are initiated more often. Directors may, for example, be held criminally liable for intentionally publishing false financial accounting,⁴³ falsification of correspondence⁴⁴ or fraud by intentionally misleading an accountant.⁴⁵ Breach of these provisions is punished by imprisonment of different lengths of time and / or criminal fines of different categories respectively.

³⁷ Article 36(3)(4) CST.

³⁸ Dutch Supreme Court, 4 February 2011 *JOR* 2011/170.

³⁹ Article 36(4) CST.

⁴⁰ Dutch Supreme Court 15 May 2009, *LJN* BI3747.

⁴¹ Article 36(3) CST.

⁴² Article 36(4) CST.

⁴³ Article 336 DPC.

⁴⁴ Article 225 DPC.

⁴⁵ Article 326 DPC.

Particularly important in this respect are the specific criminal standards regarding acts committed prior to or during insolvency. Articles 340 through 344 DPC contain provisions regulating culpable and fraudulent bankruptcy. Where the bankruptcy of a company is eventually declared, its directors may be held criminally liable for co-operating in or allowing transactions in breach of statutory obligations or the articles of association, co-operating in or allowing cash withdrawals under incriminating circumstances or culpably breaching the obligation to properly keep financial records; all for being possibly prejudicial to creditors (culpable bankruptcy).⁴⁶ Transactions before or during bankruptcy that intentionally and deceptively abridge creditors' rights, such as diverting goods or selectively favouring certain creditors, are liable to even graver punishment (fraudulent bankruptcy).⁴⁷ In a recent case, the Dutch Supreme Court acknowledged that fraudulent bankruptcy does not require a director to have performed the criminal acts himself: vicarious culpability suffices for criminal liability.⁴⁸ Article 347 of the DPC further punishes directors who co-operated in, or gave permission for, transactions in breach of statutory provisions or in breach of the articles of association, which acts have brought serious damage to the company. Finally, the DPC enables the court to remove a director from his office.⁴⁹

Most recently, the Dutch legislative organs have passed and accepted a proposal on revising the penalization of insolvency fraud (*Wet herziening strafbaarstelling faillissementsfraude*). The proposal entails the amendment of different Dutch criminal acts that intends to bring criminal legislation more in keeping with directors' liability under civil law as well as to strengthen the position of the bankruptcy trustee by further criminalizing improper accounting and improper retaining of accounting records. In further pursuit of these intentions, the Dutch legislator recently passed and accepted a legislative proposal on the civil disqualification of directors (*Wet civielrechtelijk bestuursverbod*). The provisions to be thereby introduced in the DBA allow the Dutch Public Prosecution and bankruptcy trustees to file for civil disqualification of the director of a bankrupt company for a maximum period of five years in case of insolvency fraud or serious misconduct prior to bankruptcy. A director so disqualified is also prohibited from occupying (supervisory) management positions in other companies than the one having gone bankrupt. Both Acts entered into force on 1 July 2016.⁵⁰

2.6.1 Characteristics of the liability

- (i) Dutch law considers directors' liability based on the DPC to be criminal.
- (ii) Criminal prosecution in the Netherlands looks to impose punitive measures on wrongdoers as a way of retribution and law enforcement, in which respect it does not attribute a prominent role to the victims. As per 1 January 2011, the possibility for victims to intervene in criminal proceedings by bringing a civil claim as injured parties has been revised, thereby easing their ability to take recourse for losses suffered directly as a result of the offence, without having to initiate separate civil proceedings. Civil claims within criminal proceedings will only be handled by the criminal court as long as such claims do not disproportionately burden the criminal trial.⁵¹ The Dutch Supreme Court has furthermore established that both legal persons and (in bankruptcy) the trustee on behalf of the insolvent estate are admissible as injured parties to bring a civil claim in criminal proceedings.⁵²
- (iii) Criminal liability attaches to a director individually in his capacity of being an offender.
- (vi) Apart from the applicable statute of limitations, directors' criminal liability is not limited to a specific period.
- (v) The defences available to directors in relation to any of the criminal charges discussed above depend on the components and elements required by the respective criminal provisions.

⁴⁶ Article 342 DPC.

⁴⁷ Article 343 DPC.

⁴⁸ Dutch Supreme Court 8 December 2015, *NJ* 2016, 23, in which the director concerned (who did not himself deceptively withdraw goods from the company's estate) was held vicariously liable for having been able to influence the acts at hand though seemingly having accepted them taking place.

⁴⁹ Article 349 DPC.

⁵⁰ *Stbl.* 2016, 154, *Stbl.* 2016, 153 and *Stbl.* 2016, 205 (Royal Decree establishing the time of entry into force of the *Wet civielrechtelijk bestuursverbod* and the *Wet herziening strafbaarstelling faillissementsfraude*).

⁵¹ Article 361(3) Dutch Code of Criminal Procedure.

⁵² See Dutch Supreme Court 2 June 2009, LjN: BI1025 and Dutch Supreme Court 15 April 2003, *NJ* 2003, 377.

QUESTION 3

3. Other persons involved with the company's affairs who may be liable in relation to their actions during the twilight period
- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company's activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?

3.1 Liability of others and differences in degree of liability

Persons other than (formal) members of the board of directors may be held liable in respect of the company's activities. First of all, the DCC explicitly provides in Articles 2:149/259 that the standards of internal liability and external liability towards the bankruptcy estate equally apply to the company's supervisory directors.⁵³ Specifically with regard to internal liability, it follows that supervisory directors, too, owe a duty towards the company to properly perform their tasks and, accordingly, liability may exist where they can be attributed any serious blame in not doing so. The inherent differences between the corporate duties of directors and supervisory directors respectively are taken into account here. An example of improper performance specifically by supervisory directors would be granting permission for company activities for which permission should have been withheld. Internal liability under Article 2:9 DCC is equally joint and several for supervisory directors and may equally be contested by arguing they cannot be attributed any serious blame and have not been negligent in taking measures to prevent or limit the consequences of the alleged breach of duty. Claims for liability towards the bankruptcy estate on the basis of Article 2:138/248 DCC may be brought against supervisory directors as well. For purposes of Article 2:138/248 DCC, it is noted that supervisory directors are not themselves obligated to comply with annual accounting duties, but do need to ensure that the company's directors do so. To this extent, they need to acquire information in order to properly advise the board and even intervene as and when necessary.⁵⁴

In addition to supervisory directors, statute extends liability towards the bankruptcy estate to *de facto* directors.⁵⁵ Consequently, *de facto* directors like formal directors run the risk of being held liable for the bankruptcy deficit and – as recently acknowledged by the Dutch Supreme Court – may rely on the same grounds for exculpation.⁵⁶ *De facto* directors are understood to be (legal) persons that – as if they were directors – give instructions then carried out by the formal directors or that influence the company's policy, thereby effectively replacing the formal board of directors. Exceptional circumstances may even cause a company's shareholder to qualify as *de facto* director, thereby crossing the general principle of Dutch company law that a shareholder is only liable up to the amount of the shares it has subscribed for.⁵⁷

Shareholders in their capacity as parent company may further be held liable in tort on the general liability basis of Article 6:162 DCC for the losses suffered by creditors of the subsidiary (piercing the corporate veil). Such liability is based on the assumption of a special duty of care of a shareholder to the creditors of its subsidiary as a result of its (prior) extensive involvement in the policy and affairs of the subsidiary. Breaching such duty may give rise to liability in tort, if a shareholder with extensive influence in the policy of its subsidiary fails to ensure that new creditors of the latter be paid, even though it knew its subsidiary would provide no opportunity for recovery.⁵⁸ Another liability of a shareholder may be accepting dividend payments, thus leaving the company with insufficient reserves to continue its business;⁵⁹ accepting security over most of the assets of

⁵³ Article 2:149/259 DCC.

⁵⁴ Dutch Supreme Court 28 June 1996, *NJ* 1997, 58 (*Bodam*).

⁵⁵ Article 2:138/248(7) DCC.

⁵⁶ Dutch Supreme Court 6 March 2015, *JOR* 2015, 107.

⁵⁷ Art. 2:80/191 DCC and art. 2:81/192 DCC.

⁵⁸ Dutch Supreme Court 25 September 1981, *NJ* 1982, 443.

⁵⁹ Dutch Supreme Court 8 November 1991, *NJ* 1992, 174 (*Nimoxi/Van den End qq*).

the subsidiary, knowing that such security would leave other creditors unpaid;⁶⁰ and allowing the subsidiary to selectively satisfy the claims of its intercompany creditors with the exception of one or more other (external) creditors.⁶¹

Finally, the trustee may initiate a so-called *Peeters/Gatzen* action on behalf of the insolvent estate against third parties.⁶² This concerns the trustee's power to challenge acts or activities of a bankrupt company itself that have been prejudicial to its creditors and to bring a claim for damages in tort on the basis of Article 6:162 DCC against a third party that has been involved in these prejudicial activities, even though the bankrupt company itself as co-inflator is entitled to bring such claim outside of bankruptcy.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 *Actio Pauliana*

Transactions (*rechtshandelingen*) concluded by a company that are prejudicial to creditors may be set aside under specific circumstances by relying on the *actio Pauliana*. The Dutch concept of the *actio Pauliana* resembles the concepts of fraudulent transfer and preferred mandatory transaction known in many other jurisdictions.

The DCC provides that each creditor that has been prejudiced in terms of recovery by a transaction of his debtor, accrues the authority to avoid such transaction if the debtor knew or ought to have known about its prejudicial nature. The DBA provides for a similar remedy which only applies in bankruptcy (with exclusion of the DCC provisions).⁶³ Both the DCC and the DBA distinguish between transactions with and without consideration, the former of which additionally requires the debtor's counterparty to have had knowledge of prejudice in order for avoidance to be possible. Two differences require discussion. First of all, whereas the general *actio Pauliana* (DCC) may be invoked by all creditors whose means of recovery have been prejudiced by a given transaction, the *actio Pauliana* in bankruptcy (DBA) is only available to the trustee. Secondly, other than the DCC, the DBA distinguishes between obligatory and non-obligatory transactions (the latter obviously being more easily avoided). It follows that the scope of transactions avoidable under the DBA is wider than under the DCC, which only applies to non-obligatory transactions.

Avoidance of a transaction on the basis of the *actio Pauliana* requires *actual* prejudice to one or more creditors, existent at the time a creditor or the trustee asserts his rights.⁶⁴ Prejudice to creditors is to be construed extensively. In an effort to further substantiate the phrase "knew or ought to have known", the Dutch Supreme Court has held (with regard to the DBA *actio Pauliana*) that knowledge of prejudice is considered to have existed if both the bankruptcy and the shortfall of assets were anticipated with a reasonable degree of probability by the debtor (and in case of transactions with consideration; by his counterparty) at the time of the transaction.⁶⁵ As this is not easily established, statute facilitates prejudiced creditors by a presumption that knowledge of prejudice existed on the part of both the debtor and his counterparty, if the transaction qualifies

⁶⁰ Dutch Supreme Court 25 September 1981, *NJ* 1982, 443.

⁶¹ Dutch Supreme Court 12 June 1998, *NJ* 1998, 727 (*Corall/Stalt*).

⁶² Dutch Supreme Court 14 January 1983 (*Peeters q.q./Gatzen*).

⁶³ Apart from the DCC and DBA *actiones paulianae*, several *leges speciales* provide for a similar remedy. For example, Article 36(8) CST states that the Dutch tax authorities may avoid non-obligatory prejudicial transactions in cases where tax liability under the said provision exists and the director is unable to pay, if it is conceivable that prejudice was intended.

⁶⁴ For Article 3:45 DCC, see Dutch Supreme Court 26 August 2003, *NJ* 2004, 549; for Article 42 DCC, see Dutch Supreme Court 24 April 2009, *NJ* 2009, 416 (*Dekker qq/Lutèce*).

⁶⁵ Dutch Supreme Court 22 December 2009 (*ABN Amro/Van Dooren qq III*).

within one of several categories and has been concluded within one year prior to either the statement of avoidance (DCC) or bankruptcy (DBA). These categories pertain to (i) transactions without substantial consideration, (ii) payment of debts or granting security for debts that have not yet become due or payable and (iii) transactions with relatives or affiliated (legal) persons.

Obligatory transactions are only vulnerable to being challenged under the DBA under exceptional circumstances. An obligatory transaction may only be avoided if (i) the underlying obligation was satisfied while the creditor knew bankruptcy had been applied for; or (ii) the trustee establishes that payment was made or security was granted as a result of consultation between the debtor and the creditor for the purpose of discriminating in favour of the latter (*samenspanning*). Case law shows that consultation in this respect is to be construed restrictively.⁶⁶ Practice shows that applications to set aside obligatory transactions hardly ever succeed.

Finally it should be noted that avoidance on the above bases may be accomplished by a simple statement to that effect and does not require application to a court, unless the avoidance is contested in which case only a court can give a definite answer. Given the nature and consequences, the majority of such extrajudicial statements of avoidance are challenged and require acknowledgement in court.

4.2 Available defences

To limit the risk of transactions being avoided afterwards by invoking the *actio Pauliana*, the debtor should be cautious in concluding non-obligatory transactions, especially those with affiliated parties and – as far as such is possible to foresee – especially in view of (the risk of) insolvency proceedings. Transactions that satisfy due and payable obligations are far less likely to be challenged.

When the *actio Pauliana* is relied upon, the debtor may argue that the transaction was not prejudicial to the creditors and the debtor and / or the counterparty did not have nor ought to have had knowledge of such prejudice. Specifically with regard to the *actio Pauliana* under the DBA, the debtor should consider arguing that the transaction concerned qualifies as obligatory so that the strict requirements for avoidance under Article 47 DBA apply.

4.3 New credit during the twilight period

In general, incurring further credit in times of crisis does not result in personal liability for directors as long as it can be justified by a well-prepared and well-documented business plan with a reasonable chance of successful reorganisation. However, incurring further credit and providing (additional) security to cover such credit, regardless of how dire the company's financial situation may be, are not considered obligatory transactions if there is no prior statutory or contractual obligation to do so.⁶⁷ And even though incurring new or further credit does not alter a company's debt burden from an accounting perspective, the risk of prejudice to creditors may still arise. For example, the Dutch Supreme Court held in a case where a company had renewed its credit against security and had used the newly acquired liquidity to pay several of its creditors, that the remaining creditors were prejudiced by the transaction, because (although there were now fewer creditors) they were prejudiced by the priority creditor rights of the bank.⁶⁸ Therefore, a transaction to incur further credit is vulnerable to being avoided by an *actio Pauliana* if it were to be established that both the debtor and lender knew or ought to have known that it would result in prejudice to creditors.

In order to limit the risk of avoidance on the basis of an *actio Pauliana*, the Dutch Supreme Court has imposed on financing parties a duty to conduct sufficient inquiry into the responsibility of providing additional credit and security arrangements for companies in stormy weather.⁶⁹ Through such inquiry, banks are supposed to ascertain whether bankruptcy and shortfall of assets are to be anticipated with a reasonable degree of probability. The required depth of this inquiry depends on the circumstances of the case. This means banks are required to monitor financial developments and analyse all available information regarding their clients. Apart from limiting the risk of avoidance, this also entails that banks may more easily be expected to have had or ought to have had knowledge of prejudice.

⁶⁶ Dutch Supreme Court 24 March 1995, *NJ* 1995, 628.

⁶⁷ Cf. Dutch Supreme Court 8 January 1937, *NJ* 1937, 431 (*Van der Feltz qq/N.V. Hoornsche Crediet- en Effectenbank*).

⁶⁸ Dutch Supreme Court 8 July 2005, *JOR* 2005, 230 (*Van Dooren qq/ABN AMRO*).

⁶⁹ Dutch Supreme Court, 22 December 2009 (*ABN AMRO/Van Dooren q.q. III*).

Banks find themselves between a rock and hard place in this respect. If a credit agreement were to be terminated too abruptly, a bank may be held liable for the losses its borrower consequently suffers. On the other hand, if a bank continues the credit agreement or even grants new credit, it could risk avoidance of the transaction on the basis of an *actio Pauliana* and possibly even liability towards the borrower's creditors for creating the appearance that the business is able to meet its obligations. Managing directors, supervisory directors and shareholders face a similar quandary. On the one hand, they risk liability for the losses suffered by creditors for obligations entered into if they knew or should reasonably have known that the company would not be able to fulfil its obligations. On the other hand, initiating insolvency proceedings prematurely where there is still a window of opportunity may also be wrongful.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

5.1 Actions brought against directors

Claims against directors and (legal) persons that run equal liability risks are generally brought by third parties in their capacity as creditors or shareholders or by the bankruptcy trustee. It has been shown above that the choice of legal basis for such claims is strongly dependent on the nature and circumstances of the case.

Some of the claims discussed earlier are reserved to one or more specific persons only. For example, (supervisory) directors' liability under Article 2:138/148 DCC for not having complied with the company's annual accounting duties may only be invoked by the trustee in case of bankruptcy.⁷⁰ Only the Dutch tax authorities are authorized to bring a claim for an outstanding tax debt under Article 36 CST. Likewise, the Dutch Public Prosecution is exclusively authorized to initiate criminal proceedings against directors, be it that creditors and other interested parties may report criminal offences with the relevant authorities in order to try and induce prosecution. Dutch bankruptcy trustees are obligated by rules of conduct to report criminal offences where this is in the interest of the insolvent estate. Outside of insolvency proceedings, no general or specific obligation to file a criminal report exists, although anyone bearing knowledge of a committed crime is competent to do so.⁷¹

An action against the (supervisory) board of directors for internal liability on the basis of Article 2:9 DCC is brought by the company itself. However, a company is normally represented by its managing directors, even for purposes of internal liability. As directors are not generally eager to invoke their own personal liability, internal liability claims tend to be brought by a successive board of directors or the bankruptcy trustee on behalf of the insolvent estate.

Actions on the general basis of liability in tort under Article 6:162 DCC are available to all parties claiming to have suffered losses as a result of an act of one or more directors or any of the other (legal) persons mentioned above. Some additional matters should be noted here as follows: Firstly, individual shareholders that wish to take action against one or more directors can only resort to liability in tort rather than internal liability. In this respect, the Dutch Supreme Court has held that the principles of reasonableness and fairness require that the raised threshold for internal liability (i.e. serious blame in person that can be attributed) equally applies in proceedings against directors brought by individual shareholders.⁷² Secondly, the trustee may bring a *Peeters/Gatzen* action under Article 6:162 DCC against third parties for having been involved in the wrongful conduct of the bankrupt company. As Dutch bankruptcy trustees are only allowed to act in the interest of all creditors jointly (and not only on behalf of some), the *Peeters/Gatzen* claim will only be available to

⁷⁰ Art. 2:248 DCC.

⁷¹ See Article 161 of the Dutch Code of Criminal Procedure.

⁷² Dutch Supreme Court, 20 June 2008, LJN: BC 4959.

the trustee if the contested act has damaged all creditors jointly.⁷³ Individual creditors are not bound by the joint creditors' interest in this respect and are independently able to take action in tort against third parties, irrespective of whether the trustee has already done so as well.⁷⁴ It is noted, however, that in case of simultaneous proceedings courts tend to first rule on the trustee's case in order to avoid an individual creditor taking recourse at the expense of the joint creditors.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

6.1 Offences and legal remedies

On a general note, the civil remedies discussed below can only be accomplished in proceedings on the merits (*bodemprocedure*); Dutch preliminary proceedings do not admit claims for damages or declaratory claims. These main proceedings may be accompanied by different sorts of attachment for both preservation and execution purposes. The given judgments may further be declared provisionally enforceable.

As discussed earlier, the criminal proceedings are initiated by the Dutch Public Prosecution deciding to prosecute, in some cases preceded by the bankruptcy trustee or third parties having filed a criminal report with the relevant authorities.

Liability basis	Possible remedy
Liability towards the company based on Article 2:9 DCC	The director may be ordered to compensate for any damage caused by breach of his duty. If a full award of damages would lead to obviously unacceptable results, the Court may reduce the amount of the compensation. ⁷⁵
Liability towards the bankrupt estate based on Article 2:138/248 DCC	The director may be ordered to compensate the entire bankruptcy deficit. The Court has a discretionary competence to reduce the amount in case the amount is deemed to be excessive, given the nature and seriousness of the improper performance of duties by the board of directors, possible other causes of the bankruptcy and the way in which the insolvent estate has been wound up.
Liability in tort based on Article 6:162 DCC	The Court may order (supervisory) directors or third parties to be held liable in tort to compensate for all damage suffered as a result of the respective wrongful conduct. If the injured party so requests, the Court may grant compensation other than monetary payment. ⁷⁶
Liability towards the tax authorities based on Article 36 CST	The Court may order the director to pay the total amount of taxes without any possibility of mitigation.
Criminal liability based on the DPC (including Article 194 DPC)	The Court may sentence the accused to imprisonment for a period up to six years and / or a fine of up to €82,000 and / or discharge from office. In addition, the sentence may include being held to compensate an injured party intervening in the criminal proceedings for all damage suffered as a result of the criminal offence.

⁷³ For a recent example, see Dutch Supreme Court 5 February 2016, *RvdW* 2016, 248.

⁷⁴ Dutch Supreme Court 21 December 2001, *NJ* 2005, 96.

⁷⁵ Article 6:109 DCC.

⁷⁶ Article 6:103 DCC.

Liability basis	Possible remedy
<i>Actio Pauliana</i> based on either the DCC or the DBA	The Court may avoid the transaction or give a declaratory decision affirming the validity of an extrajudicial statement of avoidance. The transaction is avoided only insofar as it regards the (legal) person invoking the <i>actio Pauliana</i> and only insofar as the transaction has prejudiced such person or the insolvent estate respectively (relative avoidance). ⁷⁷
Civil disqualification of directors based on the DBA	The Court may disqualify a director from occupying any (supervisory) management positions for a maximum period of five years upon request of the Dutch Public Prosecution and / or the bankruptcy trustee in case of insolvency fraud or serious misconduct prior to bankruptcy. ⁷⁸

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Co-operation by directors

The DBA in its current form imposes an obligation on a company’s managing and supervisory directors to co-operate and provide the supervisory judge, the bankruptcy trustee and – if instated – the creditors’ committee with all relevant information if and when they so requested.⁷⁹ Case law has construed the duty to inform not only to pertain to information that is explicitly requested, but also to information of which the director knows or should reasonably know is relevant to the requestor.⁸⁰

Directors cannot escape their duty to co-operate and inform under the DBA by relying on the *nemo tenetur* principle, also known as the right not to incriminate oneself.⁸¹ Reluctant directors may be forced to appear in court in order to provide information⁸² and, if remaining reluctant, may even be taken into custody.⁸³ In addition, refusing to co-operate or provide (requested) information gives rise to criminal prosecution under the DPC.⁸⁴ As far as the Dutch Supreme Court is concerned, these measures do not violate Articles 5 and 6 of the European Convention on Human Rights (ECHR) or, more specifically, the *nemo tenetur* principle.⁸⁵ Nevertheless, following European case law,⁸⁶ the Dutch Supreme Court did find that information acquired by reliance on Article 105 and 106 DBA that is dependent on the will of the bankrupt party⁸⁷ may not be used against such party in subsequent criminal proceedings.⁸⁸

⁷⁷ Article 3:45(4) DCC and Dutch Supreme Court 24 April 2009, *NJ* 2009, 416 (*Dekker qq/Lutèce*).

⁷⁸ Articles 106a through 106e DBA.

⁷⁹ Articles 105 and 106 DBA.

⁸⁰ Dutch Supreme Court 15 February 2002, *NJ* 2002, 259.

⁸¹ Dutch Supreme Court 20 February 1998, *RvdW* 1998, 54.

⁸² Article 105 DBA.

⁸³ Article 87 DBA.

⁸⁴ Article 194 DPC.

⁸⁵ Dutch Supreme Court 10 January 2014, *NJ* 2014, 116.

⁸⁶ ECHR 17 December 1996, case no. 19187/91.

⁸⁷ Use of information that is freely accessible (i.e. independent of the will of the bankrupt party) does not violate Article 6 ECHR.

⁸⁸ As Dutch statute does not contain a legal basis to this extent, it will generally be recorded in decisions granting one of the DBA measures above that information thus acquired is only to be used for the purpose of administrating and liquidating the insolvent estate and properly winding up the bankruptcy. If disregarded, the criminal court will subsequently decide upon the consequences. For a recent example, see Dutch Supreme Court 24 January 2014, *JOR* 2014, 251.

At the time of writing this chapter, a legislative proposal on strengthening the bankruptcy trustee's position is pending.⁸⁹ The proposal seeks to extend the bankrupt company's duty to co-operate with and inform the aforementioned parties. This is accomplished by *inter alia* implementing a statutory basis for several case law rules, such as the obligation to provide apparently relevant information at the bankrupt party's own volition, even if such information has not (specifically) been requested. The scope of application will also be extended; *de facto* directors, as well as former directors whose involvement has ended within a three-year period prior to the bankruptcy, will be subjected to the duty to co-operate and inform as well.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower courts?

8.1 Limitation periods

In general, it is noted that the lapse of civil limitation periods in the Netherlands causes the right to bring a claim to be prescribed, but does not affect the entitlement itself being due and payable. A natural obligation that can no longer be enforced at law will remain. The criminal statute of limitations is dependent on the different sentences by which specific criminal offences may be punished.⁹⁰

Directors' liability claims are subject to the general DCC limitation period of five years from the day on which the injured party gains knowledge of the facts and circumstances giving rise to the liability;⁹¹ subject to the understanding that the limitation period will only start running if the injured party has actually been able to file a claim for damages.⁹² For reasons of legal certainty, the claim for damages in any case expires upon the lapse of 20 years after the day on which the facts and circumstances giving rise to the liability have occurred. With regards to the liability of directors, some specific rules apply. If the (legal) person held liable is still a director at the time the above limitation period expires, the period will be extended until six months after the director's resignation.⁹³ The same extension applies in case a director deliberately conceals his liability to the company.⁹⁴

The limitation period for the avoidance of prejudicial transactions by reliance on an *actio Pauliana* is three years from the day on which the prejudicial transactions are discovered.⁹⁵ In bankruptcy proceedings, the limitation period starts to run at the time the trustee becomes aware of the prejudicial transaction and not from the day the bankruptcy is declared.⁹⁶

8.2 Availability of appeal

Directors may appeal to the competent Dutch courts of appeal against all civil lower court decisions described above within three months from the day of the lower court's decision.⁹⁷ After the decision of the court of appeal, one may generally lodge an appeal to the Dutch Supreme Court. However, the Supreme Court will only hear appeals on questions of law and has no jurisdiction to investigate factual relationships and circumstances. The period for lodging an appeal with the Supreme Court is three months from the day of the decision of the court of appeal.

⁸⁹ Legislative Proposal on the Bankruptcy Trustees (Extended Powers) Act (*Kamerstukken II* 2014-2015, 34 253, no. 2).

⁹⁰ Article 70 DPC. It goes beyond the scope of this chapter to discuss the statute of limitations for criminal offences in more detail.

⁹¹ Article 3:310(1) DCC.

⁹² See recently, Dutch Supreme Court 14 November 2014, *NJ* 2015, 207.

⁹³ Article 3:321(1)(d) DCC.

⁹⁴ Article 3:321(1)(f) DCC.

⁹⁵ Article 3:52(1)(c) DCC.

⁹⁶ See Dutch Supreme Court 24 January 2014, *JOR* 2014, 122, in which case it was confirmed that the statute of limitations provided in Article 3:52(1)(c) DCC also applies to *actiones Paulianae* brought on the basis of Articles 42 and 47 DBA.

⁹⁷ Article 339(1) DCCP.

QUESTION 9

9. Foreign corporations

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

As far as cross-border insolvency proceedings are concerned, the Netherlands has ratified Council Regulation 1346/2000 on Insolvency Proceedings on 29 May 2000 (EU Insolvency Regulation), which entered into force on 31 May 2002. Since that date, the EU Insolvency Regulation has been directly applicable in all EU Member States with the exception of Denmark. The formal application of the EU Insolvency Regulation is limited to companies that have their centre of main interest based in an EU Member State. The EU Insolvency Regulation does not govern the initiation of insolvency proceedings with regard to companies that do not have their centre of main interest in the EU, nor does it regulate the consequences of insolvency proceedings in non-EU member states. There is a rebuttable presumption that the centre of main interest of companies is in the Member State of incorporation.

In case the EU Insolvency Regulation does not apply, the applicable law is determined in accordance with the conflict rules of private international law of the respective state. As per 1 January 2012, the former Corporations Conflict of Laws Act has been incorporated in the DCC, providing for Dutch conflict law in case of foreign companies.

9.1 Actions based on Articles 2:138/248 DCC

Although the EU Insolvency Regulation leaves several questions unanswered with regard to directors' liability claims, it is generally accepted that it provides the basis for the understanding that claims against (supervisory and *de facto*) directors of other EU Member State companies are governed by the law of the Member State in which the insolvency proceedings were opened (*lex concursus*).⁹⁸ In other words, Dutch trustees may equally invoke the liability basis of Articles 2:138/248 DCC against directors of companies incorporated under the laws of other EU Member States before a Dutch court if the bankruptcy has been declared in the Netherlands.

As to non-EU cross-border situations, Dutch national conflict rules provide that a Dutch trustee may equally invoke liability for the bankruptcy deficit under Articles 2:138/248 DCC against the directors of a company governed by foreign law before a Dutch court, if the bankruptcy of such company has been declared in the Netherlands.⁹⁹ Those entrusted with operational management in the Netherlands (local managers) may be held liable on this basis as well.¹⁰⁰

The above also means that the Dutch evidentiary presumptions of Articles 2:138/248(2) DCC, regarding manifestly improper management, may be applied in cases where a Dutch trustee brings cross-border liability claims as well. However, it must be noted that, even in such cases, the law applicable to the respective foreign companies (*lex societatis*) must be taken into account in the assessment of what circumstances may constitute manifestly improper management.¹⁰¹

9.2 Actions based on Article 6:162 DCC

Even though liability in tort on the basis of Article 6:162 DCC may be invoked against directors and, therefore, seems to be connected with company law, the obligation to compensate arising from the liability follows from tort law rather than company law.¹⁰² The law applicable to cross-border directors' liability in tort in the Netherlands is, therefore, decided by Council Regulation 864/2007 on the law applicable to non-contractual obligations (Rome II) that entered into force on 11 January 2009.¹⁰³ Except in circumstances where the parties involved agree upon the choice of law, Rome II declares that the law of the state where the losses are suffered applies to the respective wrongful act (*lex loci damni*), regardless of the state in which the wrongful act was committed or where losses were indirectly suffered.¹⁰⁴ It follows that the trustee, creditors and other third parties may equally invoke the general liability basis of Article 6:162 DCC against foreign directors or any other foreign (legal)

⁹⁸ Cf. M.L. Lennarts, "Toepassing van art. 2:248 BW en art. 5 WCC na inwerkingtreding van de Europese Insolventieverordening", *TvI* 2001, p. 179 et seq. Article 10:121 DCC.

⁹⁹ Amsterdam Court of Appeal 22 December 1994, *NJ* 1996, 43 (*Maat/Helsloot qq*).

¹⁰⁰ Cf. Asser-Maeijer 2-III, Deventer: Kluwer, 2000, no. 334; also see B. Wessels, *Insolvency law*, p. 75.

¹⁰¹ Leeuwarden Court of Appeal 11 juni 2008, *JOR* 2009, 20 (*Jahani/Essent Kabelcom*).

¹⁰² In this respect, also see Article 1(2)(d) Rome II.

¹⁰³ Article 4(1) Rome II.

persons that may be held liable in tort for activities of a company in circumstances where the losses were directly suffered in the Netherlands.

9.3 The liability of a legal person as director of another legal person

In respect of possible bases for directors' liability, Article 2:11 DCC regarding the chain liability has already been discussed. It provides that liability of a legal person as director of another legal person also imposes joint and several liability on any (legal) person that is a director of the liable entity at the time liability arises. In this respect, the Dutch Supreme Court has held that, if a company is incorporated under the laws of the Netherlands, Dutch corporation law also governs the liability of its director, even if its director is a company incorporated under foreign law.¹⁰⁵ However, the corporate relationship between the respective foreign company and its directors is governed by foreign incorporation law.¹⁰⁶

9.4 *Actio Pauliana*

Under the EU Insolvency Regulation, insolvency proceedings and their effects are governed by the law of the EU Member State within the territory of which such proceedings are opened (*lex concursus*), being the member state of the company's centre of main interest. Specifically with regard to the *actio Pauliana*, Article 4(2)(m) EU Insolvency Regulation provides that the *lex concursus* is also applicable to the question as to whether transactions prejudicial to creditors are void, voidable or unenforceable.

Article 13 EU Insolvency Regulation derogates from Article 4(2)(m) by providing that the *lex concursus* does not apply if (i) the transaction itself is governed by the law of an EU Member State (*lex causae*) other than the Member State where the insolvency proceedings were opened and (ii) the law governing the transaction does not provide for its avoidance in the relevant circumstances. Consequently, cross-border prejudicial transactions in EU insolvencies may only be avoided in cases where both the *lex concursus* and the *lex causae* so allow.

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 D&O insurance

In the Netherlands, directors' and officers' insurance is available. Such insurance generally provides cover against both internal and external liability, including damages and the costs of litigation up to a specific amount.¹⁰⁷ In principle, Dutch D&O insurance provides protection against all liabilities, including gross negligence, independent of the question on what basis a particular claim is brought. However, coverage for liability arising from intentional or malicious acts, as well as imposed fines are excluded in most policies. D&O insurances are typically written on a claims made basis.

In the event of the bankruptcy of a company, all D&O policies will usually be terminated. This may give rise to large risks as the former insured is still exposed to directors' liability claims brought by the trustee or other third parties. In some cases, directors and other insured officers may overcome these risks by purchasing cover for claims brought after bankruptcy (tail coverage). Most insurance agreements provide for a limited three-month period in which the respective director or the trustee must have indicated whether they wish to make use of such post-bankruptcy coverage.

The information provided in this country chapter is correct as at 01/01/2017

¹⁰⁵ Dutch Supreme Court 18 March 2011, *NJ* 2011, 132 (*D Group Europe/Schreurs qq*).

¹⁰⁶ Dutch Supreme Court 21 June 2013, *JOR* 2013, 238 following on from Dutch Supreme Court 18 March 2011, *NJ* 2011, 132.

¹⁰⁷ A. Hendrikse & D.A.M. van den Heuvel, "*Bescherming tegen bestuurdersaansprakelijkheid in tijden van crisis*", *TvO*, 2009, 4, p.128.

THE UNITED ARAB EMIRATES

QUESTION 1

1. Directors and start and duration of the twilight period

(a) How are directors identified / defined?

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

1.1 Introduction

This chapter deals with UAE Federal Law, which also applies to Free Zones which do not have their own bankruptcy régimes. Most notably, the DIFC Insolvency Law (DIFC Law No. 3 of 2009) provides for an insolvency régime applicable within the Dubai International Finance Centre that will be familiar to UK practitioners, in particular.

1.2 Brief description of insolvency procedures in the UAE

UAE insolvency procedures have been substantially modified by UAE Federal Decree-Law No. 6 of 2016 (the Bankruptcy Law), which came into force on 29th December 2016 and has repealed the insolvency procedures set out in UAE Federal Law No. 18 of 1993, or the Commercial Code. The Bankruptcy Law applies to companies incorporated under UAE Federal Law No. 2 of 2015 (the Commercial Companies Law), which, however, contains its own provisions in relation to the dissolution of companies by the appointment of a liquidator. The Bankruptcy Law provides that “Any provision violating or contradicting the provisions of this Decree shall be abrogated”,¹ which makes it likely that the provisions of the Commercial Companies Law no longer apply. The Bankruptcy Law also applies to companies and establishments in Free Zones without their own insolvency legislation, merchants, licensed civil companies of a professional nature, and government bodies whose constitutional documents stipulate that they shall be subject to the Bankruptcy Law.²

Extracts from the relevant laws are provided in unofficial translations of the definitive Arabic texts.

The Bankruptcy Law introduces a number of new concepts to UAE insolvency procedures, notably

- (a) “Insolvency”, defined as “*The situation where a debtor’s assets would not cover, at any time, its payable obligations*”.³ This can itself be a trigger of the insolvency procedures set out in the Bankruptcy Law. Previously, “loss of assets” and suspension of payment of debts for 30 days were, broadly speaking, the only tests. Suspension of payment of debts remains a basis for commencing insolvency proceedings.
- (b) A panel of appropriately qualified experts who can apply to be appointed by the Courts to administer insolvency procedures under the supervision of the Courts.⁴
- (c) “Preventive Composition” a procedure on the lines of US Chapter 11 or UK administration, whereby a debtor in financial difficulty (but who has not suspended payment of debts for more than 30 days and is not in Insolvency) can apply to the Court for the suspension of both proceedings for and enforcement of claims against the debtor while a plan for its restructuring is put together by the trustee, appointed by the Court from the panel referred to in (b) unless an appropriate person cannot be found, when the Court may select its own appointee. The plan may include the raising of new finance, and the financier will have priority over other creditors unless he takes security over assets ranking in priority below other security holders. It may also involve rescission of valid contracts (by the Court), if necessary to enable the debtor to continue his business or if it is in the interests of the creditors and does not unduly harm the other party to the contract. The plan must be approved by the Court and subsequently a

¹ Bankruptcy Law, Article 230(3).

² Bankruptcy Law, Article 2.

³ Bankruptcy Law, Article 1.

⁴ Bankruptcy Law, Article 4(2).

majority in number of creditors owed at least two-thirds of the liabilities of the debtor. However, secured creditors do not count in ascertaining this majority unless they waive their security (although if the plan fails, the security will be restored), but remain entitled to enforce their security during the period of Preventive Composition with the permission of the Court.⁵

- (d) A change in procedural priorities, whereby the trustee appointed by the Court at the request of the debtor in Insolvency or who has suspended payment of debts for more than 30 consecutive working days, or a creditor or group of creditors owed at least AED 100,000, can, having reviewed the business, assets and liabilities of the debtor, recommend a restructuring or sale of the business over a period of not more than 5 years (which can be extended by a further 3 years with the approval of a majority of creditors holding not less than two-thirds of liabilities). The Court-approved restructuring plan is proposed by the trustee and approved by the creditors, and may include the raising of new finance and rescission of valid contracts in the same manner as in a Preventive Composition. The Court also has the power to terminate contracts of employment if need be, regardless of any terms in them to the contrary, but subject to the protections of employment law generally.⁶ Judicial and execution proceedings against the debtor will be suspended for the period between the debtor's original application and approval of the restructuring plan. This moratorium does not apply to secured creditors, who may enforce their security with the Court's approval. Only if the trustee deems restructuring impossible and the Court agrees, if the debtor has acted in bad faith or if the creditors reject the restructuring plan, will bankruptcy or liquidation procedures commence.⁷

Following commencement of bankruptcy or liquidation procedures, the Court may authorise the debtor to continue business under the supervision of the trustee for a period not exceeding six months (extendable by a further two months if there are promising prospects) in order to sell its business or assets. Otherwise, the trustee will arrange for the sale of the debtor's assets under the supervision of the Court, which must approve each such sale. Where an asset constitutes security, the secured creditor will receive the proceeds up to the amount secured, and will become an unsecured creditor in the event of a shortfall. The trustee will then distribute the proceeds of sale after deduction of his reasonable fees and expenses first to payment of privileged debts (Court fees, including trustee's and experts' fees, unpaid salaries and end-of-service gratuities up to a maximum of three months, alimony payments under Court order, amounts due to government agencies, and debts incurred to procure the continuation of the debtor's business after insolvency proceedings have been commenced, in that order) and then pro rata among unsecured creditors.

Inevitably, insolvency procedures under the Bankruptcy Law remain untried and untested for the time being, so what follows is a brief summary of the Law's provisions as apply to the questionnaire.

1.3 Twilight period(s)

1.3.1 Determining the directors

Each Limited Liability Company must have at least one General Manager whose name is registered in the Commercial Register, whose signature can bind the LLC and would be regarded in most other jurisdictions as a managing director. There may also be Managers, who would be regarded as Directors. A Public Joint Stock Company must have a Board of Directors.

However, and in the context of penalties, Article 196 of the Bankruptcy Law prescribes a wider definition of "Manager" as:

"any person working at the legal entity . . . and playing an active role in the decision-making process shall be considered as Manager. This shall include the person under whose directives and instructions the Managers operate"

which is almost certain to render more individuals than merely "directors" punishable for their actions once an insolvency event has occurred.

1.3.2 Determining the twilight period

⁵ Bankruptcy Law, Articles 5-66.

⁶ Bankruptcy Law, Article 167. This power also applies to a debtor in bankruptcy but not, apparently, to a debtor in Preventive Composition.

⁷ Bankruptcy Law, Articles 68-103.

In terms of liability of directors / managers, two different events may be considered as commencing the period:

- (a) when the entity resolves to apply for “preventive composition” or the appointment of a trustee; and
- (b) when the company becomes Insolvent or suspends payment of its debts.

However, Article 104 of the Commercial Companies Law applies the law applicable to Joint Stock Companies also to Limited Liability Companies. Article 162 (1) (which applies to Joint Stock Companies) provides that:

“The members of the Board shall be liable towards the company, the shareholders and the third parties for all acts of fraud, misuse of power, and violation of the provisions of this Law or the Articles of Association of the company or an error in management.”

Corporate officers may be liable to pay amounts owed by their corporations where the liabilities arise from any of the above acts. This provision applies regardless of whether the company is in an insolvency proceeding.

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 the director?
- (b) In relation to each act identified in (a) above:-
 - (i) Is the director’s liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or 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 giving rise to liability

2.1.1 Failure to refer decision for restructuring

If a debtor becomes Insolvent or suspends payment for more than 30 days, it must apply to the Court for restructuring.⁸ The Court will disqualify the debtor from management of any company or exercising any commercial activity for up to five years if it is proved that his act or negligence led to bankruptcy and liquidation of assets.⁹

⁸ Bankruptcy Law, Article 68.

⁹ Bankruptcy Law, Article 125.

2.1.2 Trading on own account

Where a company is put into bankruptcy procedures, any person who conducted commercial business in its name and for his account and disposed of the company's assets as if they were his own assets can himself also be declared bankrupt.¹⁰

2.1.3 Gross insufficiency of assets

Where, on a bankruptcy, the assets of the company are insufficient to pay at least 20 per cent of its liabilities, the Court may order the directors or Managers, jointly or severally, to pay the outstanding liabilities of the company.¹¹

2.1.4 Non-disclosure

Articles 198 and 201 of the Bankruptcy Law prescribe fines and imprisonment for Board members, Managers and “liquidators” (who are not otherwise defined) who, during an insolvency procedure, conceal or fail to keep proper commercial records, embezzle or conceal assets, falsify or fail to provide information required by a trustee, inflate liabilities, distribute fictitious profits or otherwise obtain Preventive Composition or restructuring by fraud.

2.1.5 Improper transactions

On a bankruptcy the Court may compel the Managers, the members of the Board or any liquidator acting outside the framework of the Bankruptcy Law to pay an amount to cover the debtor's liabilities if during the two years following commencement of insolvency proceedings any of them committed any of the following:

- (c) *“Using commercial methods of ill-considered risks, such as disposing of the goods at prices lower than their market value, in order to obtain assets, with a view to avoid bankruptcy procedures or delay the commencement thereof”;*
- (d) *“Entering into transactions with a third party to dispose of the assets at no charge or for an inadequate charge and without any certain benefit or a benefit that is commensurate with the debtor's assets”;* or
- (e) *“Fulfilling any of the creditors' debts with the intent to cause damage to other creditors, during the period of cessation of payment or during Insolvency”*

unless the Court is satisfied that the person or entity “had taken all possible precautionary measures to reduce the potential losses that may affect the assets of the debtor and his creditors”. Those who did not participate in the relevant acts or are able to prove their reservations in relation to the issue will not be liable.¹² These or similar actions may also be punished by imprisonment.¹³

2.1.6 Preference

Under Article 201 of the Bankruptcy Law, the Board members, Managers and “liquidators” of a company declared bankrupt by a final judgment will be liable to imprisonment:

“If, after cessation of payments, they have honored the debt of any creditor to the prejudice of the others, or have provided securities or special benefits to any of the creditors, by giving him preference over others, even if the purpose was to obtain a composition.”

And, if the purpose was to obtain a composition and prejudice other creditors, the Court may order restitution.¹⁴

2.1.7 Article 104 of the Commercial Companies Law

See 1.4.2 above.

¹⁰ Bankruptcy Law, Article 143.

¹¹ Bankruptcy Law, Article 144.

¹² Bankruptcy Law, Article 147.

¹³ Bankruptcy Law, Article 201.

¹⁴ Bankruptcy Law, Article 209.

2.4 Nature of liability

- (f) As can be seen from 2.1 above, liability can be either “civil” or “criminal”, although the distinction between the two is somewhat more blurred than in other jurisdictions. Moreover, the Court can bar any person subject to penalty under the Bankruptcy Law for acts such as those described in 2.1.4 and 2.1.6 above and 7.1 below from management of a company established under the Commercial Companies Law or “*exercising any other commercial activity*” for up to five years.¹⁵
- (g) A director can be personally liable under Article 104 of the Commercial Companies Law (see 1.3.2 above), and a director or Manager under 2.1.3 or 2.1.5.
- (h) The amount of individual directors’ liability is decided by the Court. While there may be an element of proportionality, the Court has full discretion.
- (i) There would appear to be no limitation in time for the liability to arise. In the insolvency context, all that seems relevant is that the act in question took place between the time the company was Insolvent or failed to pay its debts and the bankruptcy order.
- (j) Generally, a director or Manager who did not participate in the offending decision or can demonstrate that he (in effect) voted against it will have a defence.

QUESTION 3

3. Other persons involved with the company’s affairs who may be liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company’s activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?

3.1 Third party liabilities

Article 196 of the Bankruptcy Law (see 1.3.1 above) in effect includes “shadow directors” among those who can be made liable for the acts of the company. Creditors and others acting improperly during the course of insolvency procedures can also be liable to restore their advantage or to fines or imprisonment.

3.2 Nature of liability

The acts for which liability arises are set out in 2.1 above. In general terms, the liability of a manager is no different from that of a director. If another third party is liable, it will generally be for the advantage he has received, although a fine or imprisonment may also be imposed.

3.3 Extent of liability

Yes. See 2.1 above.

¹⁵ Bankruptcy Law, Article 215.

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Non-enforceability of certain transactions

Broadly speaking, any of the following are subject to challenge if they occurred within the two years preceding commencement of insolvency procedures:

1. Excessive gifts or services rendered gratis;
2. Transactions at an undervalue;
3. Early payment of debts, or their settlement by unusual means;
4. Granting of security in respect of a pre-existing debt; and
5. Any other act that harms creditors generally when the third party was aware, or ought to have been aware that the debtor had ceased payment of its debts or was Insolvent.

However, the Court may order that the relevant acts are enforceable *“taking into consideration the public interest and that of bona fide third parties”*.¹⁶

The beneficiary of any of the above which is successfully challenged must return what he received from the debtor, or the value of it, and any benefits derived from it. If the beneficiary gave value for the benefit, then that should be returned by the debtor, or the beneficiary can join the body of creditors in respect of his claim.¹⁷

4.2 Defences

If the Court considers that any alienation referred to in 4.1 was made by the debtor in good faith for the purpose of carrying on his business and, at the time of the alienation, there were good reasons to believe that the alienation was for the benefit of the business, then it will not order that the relevant act is invalid .¹⁸

4.3 Directors’ borrowing

The Bankruptcy Law specifically permits the debtor or Court-appointed trustee to borrow funds in the context of Preventive Composition or restructuring, but always with the approval of the Court. The financing will have priority over pre-existing debt, and may be secured on assets of the debtor that have not already been charged. The debtor or trustee may also charge assets which already constitute security for other debts, but in these circumstances the original security will have priority unless the creditors holding that security otherwise agree.¹⁹ The Court can also agree that security over already charged assets will rank behind that of the new lender, so long as the interests of the existing security holder are not prejudiced.²⁰

¹⁶ Bankruptcy Law, Article 168.

¹⁷ Bankruptcy Law, Article 169.

¹⁸ Bankruptcy Law, Article 170.

¹⁹ Bankruptcy Law, Article 181.

²⁰ Bankruptcy Law, Article 182.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and other persons identified in Question 3 above?

The action may be brought by creditors who are prejudiced, the Court-appointed trustee or the Court itself.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

The relevant remedies are specified under the relevant Questions, and vary from fines and imprisonment to restitution and, in two cases (see 2.1.3 and 2.1.5), damages.

QUESTION 7

7. Duty to co-operate

(a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office-holder’s investigation into the company’s affairs?

(b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 Obligation to co-operate

Any Board member, Manager or “liquidator” of a company declared bankrupt who

“refrained from providing the data required by the trustee appointed [under a restructuring procedure], or intentionally provided incorrect data”

is liable to imprisonment for up to two years .²¹

7.2 Moderation of obligations

A person who can show he was not involved in or opposed the actions under 7.1 will not be liable to imprisonment.

²¹ Bankruptcy Law, Article 201.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What rights of appeal are available from the decisions of the lower Courts?

8.1 Limitation period

In general terms, claims become time-barred after 15 years unless a specific provision states otherwise. That period is shortened to 10 years in the case of commercial transactions, which would most likely apply in relation to insolvency. Perhaps more importantly, the limitation period for a claim for a disposition by a debtor which is detrimental to a creditor is 3 years from the date upon which the claimant became aware of the cause rendering the disposition ineffective (up to a maximum of 15 years from the date on which the disposition was made).²²

8.2 Appeals

Appeals from the Federal Court of First Instance may be heard by the Federal Court of Appeal, and can in turn be appealed to the Federal Court of Cassation.

QUESTION 9

9. Foreign corporations

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

In order to conduct business in the UAE, a foreign corporation must either appoint an agent or establish a branch office. The provisions outlined above would apply to both an agency and a branch office. That said, the UAE insolvency regime would concern itself only with the local agency or branch.

QUESTION 10

10. Insurance

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

Directors' and officers' insurance is available in the UAE, although the cover available is not always as extensive as in other jurisdictions. While the insurance is likely to cover the costs of defending actions for negligence or misconduct alleged by any shareholder or third party and any damages arising, as well as the cost of any investigations into a director's or officer's conduct during the twilight period, the defence of any proceedings brought and (perhaps) any fines arising, it will generally not cover dishonesty, intentional illegal acts or illegal profits, penalties or punitive damages.

The information provided in this country chapter is correct as at 01/03/2017 on the basis of publically available information.

²² Article 400 of the Civil Transactions Law, Federal Law No. 5 of 1985.

UNITED STATES OF AMERICA

Background discussion of applicable law

A. Multiplicity of jurisdictions

Any discussion of the potential liability of officers and directors of an insolvent business entity in the United States must first recognize the multiplicity of jurisdictions whose law may apply to address the various issues.

Generally, the internal affairs of a business entity are governed by the law of its jurisdiction of formation. This proposition is commonly known as the internal affairs doctrine. Accordingly, Delaware law will govern issues pertaining to the internal affairs of a corporation formed under Delaware law, 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).

The answers in this paper are based on the corporate law of Delaware, because Delaware remains a popular jurisdiction for incorporation, and on Federal law. Federal law is of importance because many of the issues raised in this paper are litigated and resolved in the United States Bankruptcy Court, not in the state courts. This paper will highlight noteworthy State law decisions other than Delaware when appropriate.

Practice consideration

Counsel must always be aware of the state of incorporation or formation of the relevant business entity. The law of the state of incorporation (or formation in the case of a limited liability company or limited partnership) will govern many important questions relating to the potential liability of an entity's officers and directors.

Statutory references

In 1978 the U.S. Congress passed the Bankruptcy Reform Act of 1978, replacing the Bankruptcy Act of 1898. The Reform Act is commonly referred to as the United States Bankruptcy Code (the Code) and is codified at Title 11 of the United States 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 are heard in the United States Bankruptcy Court under the Code, either because insolvent business entities voluntarily seek the protection of the Bankruptcy Court or because creditors of the insolvent entity file an involuntary petition against the debtor under the Code. The Code is Federal law and is therefore uniform, in theory, throughout the United States. However, there are differences among the federal courts in their interpretation and application of the various provisions of the Code.

After the Code, two of the most significant statutory provisions of relevance in the context of an insolvent business entity are the Uniform Fraudulent Transfer Act ("UFTA"), and its more recent iteration, the Uniform Voidable Transactions Act ("UVTA"). Both UFTA and UVTA were promulgated by the Commissioners on Uniform Laws, the UVTA most recently in 2014. UFTA has been enacted in substance in 34 states, the District of Columbia, and the U.S. Virgin Islands. The more recent UVTA has been enacted in substance in ten states, and legislation proposing its enactment is currently pending in at least six states. Most of those states that have not enacted either UFTA or UVTA have an earlier version of the Uniform law known as the Uniform Fraudulent Conveyance Act. All three 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 and UVTA are state, not Federal, laws. Local variations in the enactment of UFTA and UVTA may be applicable given the ongoing migration of states from UFTA to UVTA.

Every state has enacted at least some articles of the Uniform Commercial Code (“UCC”), and all have adopted Article 9 of the UCC, as amended in 2000 (“Revised Article Nine”). The UCC is cited in the text in reference to the rights of sellers of goods to an insolvent buyer. Revised Article Nine of the UCC governs the grant and perfection of security interests in certain tangible and intangible personal property.

The corporation codes and limited liability company states of the various states also play a significant role in determining the potential liability of the officers and directors of an insolvent business entity.

QUESTION 1

1. The directors and the start and duration of the “twilight” period

(a) How are directors identified / defined?

(b) 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 Most corporations formed in one of the fifty States and the District of Columbia are governed by a Board of Directors. Some states permit the corporation to be governed directly by the shareholders, but subject to a limit on the number of shareholders in the entity. The Directors are elected by the shareholders of the corporation. The Directors set the basic policy and direction of the entity and usually must approve all material decisions, such as the incurrence of secured debt or the sale of assets. The Directors also adopt and occasionally amend the corporation’s by-laws, which are the procedural rules for the governance of the corporation. A corporation’s by-laws may have substantive significance.

The business of the corporation is managed by its officers and executed by its employees and other agents. The officers are elected or appointed by the Directors of the corporation (or the shareholders if the corporation is governed directly by its shareholders). Most states require that a corporation have a President, Treasurer and Secretary. The corporation may have numerous inferior officers, such as Vice Presidents.

The limited liability company is becoming an increasingly popular form of business entity in the United States. Like the corporation, the limited liability company generally shields its owners from liability for the debts of the entity. Also, the limited liability company is a “flow through” entity for U.S. Federal income tax purposes. The income and loss of the entity is passed through to its owners and is not taxed at the entity level. The availability of flow through tax status in the corporate form is more limited under the U.S. Internal Revenue Code and this fact alone accounts for much of the popularity of the limited liability company.

Like a corporation, the limited liability company is formed under the laws of one of the fifty states. The LLC, as it is usually referred to, may be managed by its members or by managers, depending on the terms of its Operating Agreement. The members of the LLC are analogous to the shareholders of a corporation. The managers of the LLC, if any, are analogous to the directors of a corporation. An LLC may also have officers, appointed by the members or the managers.

Control is the key concept in determining 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.

- 1.2 The “twilight” period, referring to the period during which the directors or managers of a business entity face substantially increased risk, exists for so long as the entity is insolvent or on the verge in insolvency. 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 methods of determining whether a corporation is insolvent, unless the choice is determined by an applicable statute. The balance sheet test determines that a company is insolvent if its assets, fairly valued, do not exceed the amount of its liabilities. Under the equity or cash flow test, an entity is insolvent if it is not meeting its obligations generally as they come due, regardless of the condition of the entity's balance sheet.

For example, under UFTA and the UVTA, versions of which is in effect in 46 jurisdictions, insolvency is defined using the balance sheet test, but is presumed if the equity or cash flow standard is satisfied. Under the 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 has analyzed how to determine insolvency in different contexts. Generally, insolvency in Delaware is established under the traditional balance sheet test.¹ In *Franco-Typ-Postalia Ag & Co. v. On Target Tech., Inc.*, 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.”² 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.”³ In *Odyssey Partners, L.P. v. Fleming Companies, Inc.*, the Court adopted the equity approach in defining insolvency without a discussion of any alternatives. These cases indicate that Delaware has determined that one means of demonstrating that a corporation is insolvent is by showing that it is “unable to pay its debts as they fall due in the usual course of business.”⁴ That said, whether an entity is insolvent is ultimately a question of fact that may be proved, depending on the circumstances, using various methodologies.⁵

QUESTION 2

2. Actions potentially giving rise to liability for officers and directors

- (a) In respect of which acts during the “twilight” period may a director be held personally liable or which may otherwise have adverse consequences for him?
- (b) In relation to each act identified in (a) above:
 - (i) Is any resulting liability against a director civil, criminal or both?
 - (ii) Can a director be made personally liable in respect of the whole loss caused to the company or the deficit to creditors?
 - (iii) Will liability attach to individual directors in proportion to their specific involvement?
 - (iv) Is there a specific period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director? and
 - (v) What defences, if any, will be available in relation to each offence?

¹ *Quadrant Structured Prod. Co., Ltd. v. Vertin*, 115 A.3d 535, 556 (Del. Ch. 2015) (“The great weight of Delaware authority [...] uses the traditional formulation in which a creditor’s standing to sue derivatively “arises upon the fact of insolvency,” defined under the balance sheet test as when the entity “has liabilities in excess of a reasonable market value of assets.”).

² *Franco-Typ-Postalia Ag & Co. v. On Target Tech., Inc.*, No. 16330, 1998 WL 928382, at *5 (Del. Ch. Ct. Dec. 24, 1998).

³ *Id.*

⁴ *Odyssey Partners, L.P. v. Fleming Companies, Inc.*, 735 A.2d 386, 417 (Del. Ch. 1999).

⁵ See generally *Blackmore Partners, L.P. v. Link Energy, LLC*, 2005 WL 2709639, at *3 (Del. Ch. Ct. Oct. 14, 2005) (concluding, in the summary judgment context, that the defendant was insolvent, because the only evidence on summary judgment demonstrated insolvency under each of three tests: the balance sheet test, the equity test, and a third, “unreasonably small capital” test, under which a company is insolvent unless it can either (1) successfully issue new equity; or (2) restructure existing debt).

2.1 The Trust Fund Doctrine; Director fiduciary duties in the vicinity of insolvency and the Business Judgement Rule

(i) Introduction

Counsel representing an insolvent corporation or a corporation about to undertake a transaction that may render it insolvent must now reckon with the judicially recognized duties owed by the corporation's directors to the company's creditors. The duty of directors to creditors in the context of an insolvent entity has long been recognized in the courts. The earlier cases find the duty in the elementary rules of priority: the claims of creditors take priority over the claims of equity. These cases often describe the duty in the context of the Trust Fund Doctrine, discussed further below. More recent precedents, 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. In each of these instances, the liability for breach of fiduciary duty is civil in nature.

(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.⁶

If the common law imposes a trust relationship, that relationship must exist with reference to an object, referred to as 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.⁷

Courts in the United States have recognized that the fiduciary obligations of directors "switch" from a duty owed to shareholders to a duty owed to creditors when the entity is insolvent. This means that the first allegiance of directors of an insolvent entity must be to creditors and that creditors may bring an action against the directors for breach of fiduciary duty.

(iii) The Business Judgement Rule

A majority of jurisdictions, including Delaware, provide corporate directors with a "safe harbour" known as the business judgement rule, which insulates them from liability resulting from certain business decisions.⁸ The business judgement rule is a presumption that in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest. The rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transactions were made in good faith, with due care, and within the directors' or officers' authority.⁹ Under a business judgement analysis, although directors of an insolvent corporation owe fiduciary duties to its creditors, they may continue to take ordinary operational risks in trying to save the company through methods they reasonably believe have a good chance

⁶ See e.g. Fletcher Cyclopedia Corporations, Vol. 15A §7369 - §7371; In re *Brockway Mfg. Co.*, 89 Me. 121, 126 (Me. 1896) (adopting the "plain proposition that the stock and property of every corporation is to be regarded as a trust fund for the payment of its debts, and that its creditors have a lien thereon and the right to priority of payment over any stockholder"); *Pepper v. Litton*, 308 U.S. 295, 307, 60 S.Ct. 238, 245 (1939) ("While normally [the] fiduciary obligation is enforceable directly by the corporation, or through a stockholders derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the [bankruptcy] trustee."); *Davis v. Woolf*, 147 F.2d 629, 633 (4th Cir. 1945) ("The law by the great weight of authority seems to be settled that when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors . . .", quoting with approval *Arnold v. Knapp*, 75 W.Va. 804, 811, 84 S.E. 895, 899 (1915); *F.D.I.C. v. Sea Pines Co.*, 692 F.2d 973 (4th Cir. 1982), cert. denied, 103 S.Ct. 2089, 461 U.S. 928 (1982) (same); *Automatic Canteen Co. of America v. Wharton*, 358 F.2d 587 (2d Cir. 1966) (same applying Indiana law); *U.S. v. Spitzer*, 261 F.Supp. 754 (D.C.N.Y. 1966) (same applying New York law); *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506, (2d Cir. 1981) cert. denied, 102 S.Ct. 1614, 455 U.S. 990 (under New York law, duty to creditors arises upon solvency, not merely when failure is imminent and foreseeable); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-88 (Del. Ch. 1992) (fiduciary duty arises upon insolvency, not upon bankruptcy); *Willner's Fuel Dist., Inc. v. Noreen*, 882 P.2d 399 (Alaska 1994) (same); *A.R. Teeters & Assoc., Inc. v. Eastman Kodak Co.*, 836 P.2d 1034 (Ariz. 1992) (same applying Arizona law).

⁷ In re *Hospital General San Carlos, Inc.*, 76 B.R. 10 (D.C. Puerto Rico 1987); *Coleman v. Howe*, 154 Ill. 458, 467, 39 N.E. 725, 727 (1895) ("It is the duty of the directors of a corporation to manage its capital stock as a trust fund for the benefit of its stockholders while it exists and of its creditors in case of its dissolution."); but see Section 2(a)(v), *infra* (describing how boards of corporations in the "vicinity of insolvency" owe an obligation to the corporate enterprise as a whole).

⁸ See *In re Xonics*, 99 B.R. 870, 876 (Bankr. N.D. Ill. 1989).

⁹ See Black's Law Dictionary, 192 (7th ed. 1999).

of success.¹⁰ The application of the business judgement rule shields disinterested directors from liability, in the absence of fraud or illegality, for those business decisions made in good faith for the benefit of the corporation.

The business judgement rule applied by a majority of jurisdictions is the most important legal protection available to the directors of a business entity when their decisions are challenged by those who have been harmed by the consequences of those decisions. To avail themselves of the business judgement rule, directors must:

- inform themselves with respect to the matter for determination by studying and relying upon information that a reasonable person in similar circumstances would find persuasive; and
- the directors must be free from a conflict of interest with respect to the matter for decision.

In *FDIC v. Sea Pines Co.*,¹¹ 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 inter-corporate transactions. The Court then imposed liability upon the parent corporation based upon the breach of fiduciary duty owed to creditors by the subsidiary and the substantial overlap in the make-up of the two boards of directors. The directors were not shielded by the business judgement rule in this case because the inter-corporate 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*¹² 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. 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.¹³ 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.¹⁴ Despite a complete lack of evidence indicating fraud or insider benefit by the directors, the Court held that the case should not be dismissed and noted that if the corporation was insolvent at the time of the alleged breach of fiduciary duty, "it is clear that [the] defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate creditor beneficiaries".¹⁵ 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.¹⁶

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.

¹⁰ See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

¹¹ *FDIC v. Sea Pines Co.*, 692 F.2d 973 (4th Cir. 1982).

¹² *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*, 110 N.E. 2d 397 (N.Y. 1953.)

¹³ *Id.* at 397.

¹⁴ *Id.* at 398.

¹⁵ *Id.*

¹⁶ *Id.* See also *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).

(v) The “At Risk” Transaction

In recent decades, there has been substantial confusion over the obligations, duties, and liabilities for directors of corporations in “the vicinity of insolvency”. This uncertainty traces itself back to the Chancery Court’s decision in *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*¹⁷ the directors were sued by a shareholder holding 98% of the company’s stock for breach of fiduciary duty to the shareholder. The corporation, MGM post leveraged buyout, was operating “in the vicinity of insolvency”. The shareholder complained that the directors had failed to approve a sale of assets which the shareholder sought because the proceeds of the sale would have paid down bank debt and returned control of the company from the bank to the shareholder. The directors refused to authorize the sale because they suspected that the sale price was too low and that the shareholder was principally concerned with paying down bank debt to regain control and not maximizing the value of the company’s assets. In ruling that the directors had not breached their duty to the shareholder, the Chancellor stated:

*At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise . . . [T]he MGM board or its executive committee had an obligation to the community of interest that sustained the corporation, to exercise judgement in an informed, good faith effort to maximize the corporation’s long-term wealth creating capacity.*¹⁸

The Chancery Court noted that the “possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behaviour, and creating complexities for directors.”¹⁹ 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 millions, with a one in four chance of success. Assume further that the only creditors of the company are bondholders with a \$12 millions claim. At what dollar amount should the directors settle the legal claim, assuming they have the opportunity to do so? The creditors want to get out at \$12 million. The shareholders want more, but their risk taking jeopardizes the rights of creditors. The Court stated:

*[I]f we consider the community of interests that the corporation represents, it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than [the value of the claim divided by the probability of success] and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.*²⁰

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.

Thereafter, in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,²¹ the Delaware Supreme Court clarified the rights that corporate creditors have against corporations which are insolvent. Under *Gheewalla*, creditors have no direct fiduciary duty claims against a corporation, regardless of the solvency of that entity. However, when a corporation is insolvent, creditors effectively stand in the shoes of the shareholders, and thus may maintain derivative claims on behalf of the corporation against the directors for breach of fiduciary duty. *Gheewalla* did not address whether that same right to bring derivative claims also exist for creditors of corporations which are solvent but in the “zone” or “vicinity” of insolvency.

¹⁷ *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, 1991 WL 277613 (Del.Ch. December 30 1991).

¹⁸ *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, 1991 WL 277613, at *34 (Del.Ch. December 30 1991). 9.

¹⁹ *Id.* at *5.

²⁰ *Id.*

²¹ *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (De. 2007)..

A recent decision discussing *Ghewalla* and its progeny is instructive as to its import. In *Quadrant Structured Products Company, LTD*,²² the Delaware Chancery Court summarized the state of director liability law as it relates to creditors as follows:

- There is no legally recognized “zone of insolvency” with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself.
- Regardless of whether a corporation is solvent or insolvent, creditors cannot bring direct claims for breach of fiduciary duty. After a corporation becomes insolvent, creditors gain standing to assert claims derivatively for breach of fiduciary duty.
- The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors. They do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgement that this is indeed the best route to maximize the firm’s value.
- Directors can, as a matter of business judgement, favour certain non-insider creditors over others of similar priority without breaching their fiduciary duties.
- Delaware does not recognize the theory of “deepening insolvency”. Directors cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors. *Id.* at 544-46 (citations omitted).

It is significant to note that neither the *Credit Lyonnais* case nor its progeny have enunciated any guidelines for when a corporation enters into the “vicinity of insolvency”,²³ although the continued import of that concept as it relates to director liability is uncertain at best.

There is no equivalent liability in the United States for what is referred to as wrongful trading in England and other jurisdictions. Officers and directors of an insolvent business entity, however, must carefully examine the totality of the circumstances surrounding the continued incurrence of trade debt to analyze whether the directors will be able to avail themselves of the business judgement rule if they should choose to allow the company to continue to operate. Directors should ask themselves what the likelihood is of a successful turnaround that will enable the company to meet its obligations. Directors should be certain that they are acting reasonably with respect to any financial analyses on which they are relying and they must analyze whether their decision is tainted by a conflict of interest.

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.²⁴ 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.

Furthermore, the reduction or the removal of the risk that the continued accrual of unpaid trade debt will result in liability to the directors of the entity. Upon filing, the debtor is prohibited in most circumstances for paying any pre-filing unsecured debt other than by means of a Plan of Reorganization. The freeze on paying existing trade debt inevitably creates a cash flow benefit that should enable the debtor to meet its current obligations, at least for a time. Continued failure to pay trade debt following a Chapter 11 filing, however, is not permitted and can lead to various consequences, including conversion to Chapter 7.²⁵

²² *Quadrant Structured Products Company, LTD*, 115 A.3d 535 (2015).

²³ See Gregory Scott Crespi, Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm, 55 S.M.U. L. Rev. 141, 153 n. 33 (2002) (canvassing various law review articles commenting on the ambiguity and difficulty of applying the “vicinity of insolvency” test). Attorneys advising corporate boards should be aware of this uncertainty and advise their clients accordingly. See generally Douglas G. Baird and M. Todd Henderson, Other People’s Money, 60 Stanford L. Rev. 1309, 1325-26 (March 2008) (discussing the distinction and tension between the default rights of creditors and the obligations of a corporate board to the corporation’s shareholders).

²⁴ See 11 U.S.C. § 363.

²⁵ In a Chapter 7 or straight liquidation proceeding, a trustee is appointed to assemble and liquidate the debtor’s assets. In a Chapter 11 or reorganization proceeding, although a trustee can be appointed for cause, the debtor ordinarily retains possession and control of its assets. The debtor-in-possession has the powers of a trustee and is a fiduciary of the bankruptcy estate. The trustee or debtor-in-possession controls the administration of the bankruptcy estate during the proceeding.

(vi) In re *Healthco*²⁶ 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.²⁷
- When a transaction renders a corporation insolvent or brings it to the brink of insolvency, “the rights of creditors become paramount”.²⁸
- 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”.²⁹
- Unreasonably small capital, within the meaning of the fraudulent transfer statutes, means a condition in which insolvency, in the liquidity sense, is reasonably foreseeable.³⁰
- Under Delaware law, the business judgment rule essentially requires a showing of gross negligence before a director can incur liability for her business decision. Several of the Healthco directors, however, could not rely upon the business judgment rule, because they had a material financial interest in the outcome of the transaction on which they voted. Instead, those directors had the burden of proving that their actions did not render the corporation insolvent or with unreasonably small capital.
- An additional prerequisite to a defence based on the business judgment rule is that the director has adequately informed 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.

2.2 Director liability under the Uniform Fraudulent Transfers Act

The Uniform Fraudulent Transfer Act and its successor uniform statute, the Uniform Voidable Transaction Act have, in one form or another, been enacted in 44 jurisdictions, with some local variation. UFTA and UVTA govern those circumstances under which the transfer of property or the incurrance 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 and UVTA 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. Remedies under UFTA and UVTA are all civil in nature.

2.2.1 Transfers avoidable by existing creditors

Under both UFTA and UVTA, a transfer of property or the incurrance 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 incurrance of the obligation or was rendered insolvent thereby. Also, transfers to insiders of the Debtor are avoidable if the transfer was made without reasonably equivalent value and the debtor was insolvent at the time and the insider had reasonable cause to believe that the debtor was insolvent.

²⁶ In re *Healthco Intern., Inc.*, 208 B.R. 288 (Bankr. D. Mass. 1997).

²⁷ *Id.* at 300.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.* at 302.

2.2.2 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.

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 buyout". 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.

2.3 Director liability for unlawful dividends and redemptions

Each state's corporations 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 civil liability for the wilful or negligent violation of the applicable provisions of Delaware's corporations law governing the redemption of stock or the issuance of dividends. In either case, the directors are each jointly and severally liable to the corporation and its creditors for the full amount paid out in dividends or on account of the redemption.

Delaware law provides that a corporation may not redeem outstanding shares when its capital is impaired or would be impaired by the redemption. This means that the corporation may only use capital surplus to effect a redemption. Capital surplus may generally be thought of as the amount by which the total assets of the company exceed its total liabilities. If a promissory note or other debt instrument is given as payment for a redemption, the legality of the redemption is determined at the time the debt instrument is delivered, not at the time it is payable. Delaware law provides generally that dividends also may only be paid from surplus or from net profits of the current or preceding year.

Directors of Delaware corporations should value assets on a current basis to determine if surplus exists to pay a dividend or redeem stock. Directors acting in good faith and subject to a standard of reasonableness are entitled to rely upon reports, appraisals and other information provided to the corporation in determining the value of the corporation's assets.

The issue of what constitutes a “dividend” is another important consideration. Whether a distribution by a corporation to shareholders constitutes a “dividend” is not controlled by how that distribution is denominated.³¹ Rather, courts generally examine the substance of a transaction, rather than its nominal form, in assessing how to properly characterize a given distribution, and will recharacterize improperly styled transactions as being “constructive dividends”³². Inter-corporate transfers which are neither loans, purchases, repayments of corporate debt, charitable expenditures, ordinary and necessary business expenses, or other disbursements made in pursuit of corporate goals or pursuant to corporate duties will, necessarily, be deemed “dividends” by a reviewing Court.³³

Constructive dividends can give rise to director liability. In re: Buckhead America Corp.,³⁴ the Court addressed the question of whether liability under Section 174 of the Delaware General Corporation Law could be properly predicated on an allegedly improper constructive dividend. In rejecting the defendant’s motion to dismiss, the Court noted, *inter alia*, that the factual record was insufficiently developed to warrant dismissal at that juncture of the proceeding. Thus, the Court, at least implicitly, embraced the notion that a claim under S 174 could, in appropriate circumstances, be based on an allegedly improper constructive dividend.³⁵

A dividend by an insolvent or struggling business entity is obviously suspect and directors who vote for such a dividend may incur personal liability in the amount of the dividend. Counsel must review the relevant State corporation law to study the standards that must be met before the entity may legally make a distribution to its owners. Counsel should also look for any safe harbours that may exist under the State corporation law with respect to actions based upon financial statements prepared by the auditors of the business.

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.³⁶

2.4 Liability for “trust fund” taxes

Under 26 U.S.C. § 6672(a), any person required to collect, account for, and pay over any federal tax who wilfully fails to do so, or wilfully attempts to evade the tax, is liable for the entire amount of the trust fund tax owed. This liability is in addition to other penalties provided by law.³⁷ Liability may be assessed against more than one person, and each person is liable for the entire amount of unpaid tax.³⁸ 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.³⁹

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”.⁴⁰ 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.⁴¹

³¹ See generally Fletcher Cyc. Corp. § 5381 (permanent ed.) (“The characterization of a distribution, while relevant to the determination of whether or not it will be treated as a dividend, is not conclusive.”).

³² See *Rogers v. United States*, 58 F.Supp. 2d 1235, 1240-42 (D. Kan. 1999) (tax case discussing the ability of a Court to recharacterize a transaction as being a constructive dividend); *United States v. Mews*, 923 F.2d 67, 68 (7th Cir. 1991) (“By ‘constructive dividend’ the law means simply a corporate disbursement that is a dividend in the contemplation of law though not called such by the corporation making the disbursement.”).

³³ *Mews*, 923 F.2d at 68.

³⁴ Re: Buckhead America Corp., 178 B.R. 956 (Bankr. D. Del. 1994).

³⁵ See also *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992 (Bankr. S.D.N.Y. 1991) (“If plaintiff’s allegations [regarding constructive improper dividend] are true, as must be assumed on these motions to dismiss, the economic substance of the transactions in question brings them within the purview of the relevant sections of the Delaware General Corporation Law.”).

³⁶ See *Calkins v. Wire Hardware Co.*, 267 Mass. 52, 165 N.E. 889 (1929) (although shareholder directors of a corporation did not vote in favour of a dividend, they are found liable as directors for assenting to an unlawful distribution where they actually received the proceeds of the distribution).

³⁷ See 26 U.S.C. § 6672(a).

³⁸ See *Harrington v. U.S.*, 504 F.2d 1306, 1312 (1st Cir. 1974); *Gadoury v. U.S.*, 187 B.R. 816, 823 (D.R.I. 1995); In re Bourque, 153 B.R. 87, 92 (Bankr.D.Mass. 1993).

³⁹ See 26 U.S.C. § 6672(d).

⁴⁰ 26 U.S.C. § 6671(b).

⁴¹ 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”.⁴² Rather, it extends broadly to persons with authority and responsibility to avoid the default.⁴³ The First Circuit has indicated that factual “*indicia 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*”.⁴⁴ 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*”.⁴⁵ Delegation to other officers or employees of tax compliance duties is no defence against liability⁴⁶. An outside entity may be deemed a responsible person if the entity exerts sufficient control over the financial affairs of the delinquent taxpayer.⁴⁷

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. § 7501⁴⁸. These most prominently include withheld employee social security taxes⁴⁹ and withheld employee income taxes⁵⁰ but also include federal excise taxes⁵¹ and collections on gambling winnings,⁵² interest and dividend payments subject to backup withholding,⁵³ distribution from retirement plans⁵⁴ payments of interest and dividends to non-resident aliens and foreign corporations,⁵⁵ and disposition of United States real property interest by foreign persons.⁵⁶

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”.⁵⁷ 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.⁵⁸ Where the taxpayer fails specifically to designate allocation of the voluntary payment, the IRS may allocate it.⁵⁹ 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 obligations⁶⁰.

Regardless of whether the payments are voluntary or involuntary, the Supreme Court has held that a bankruptcy Court has the authority in a Chapter 11 reorganization to order the IRS to allocate the payments first toward trust fund taxes, if the Court deems such designation “necessary for a reorganization’s success”.⁶¹ 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.⁶² Courts have split over whether a bankruptcy Court may also direct allocation in a Chapter 11 liquidation plan.⁶³

Finally, the misappropriation of trust fund taxes can be the predicate for criminal liability. 26 U.S.C. § 7202, for example, provides for imprisonment and fines for the wilful failure by a responsible person to “pay over” amounts due under the tax laws, including trust fund taxes.

⁴² *Harrington*, 504 F.2d at 1312 (citations omitted).

⁴³ *See id.*

⁴⁴ *Thomsen v. U.S.*, 887 F.2d 12, 16 (1st Cir. 1989) (citing *George v. U.S.*, 819 F.2d 1008, 1011 (11th Cir. 1987)).

⁴⁵ *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)).

⁴⁶ *See Thomsen*, 887 F.2d at 16.

⁴⁷ *See, e.g., Merchants Nat’l Bank of Mobile v. U.S.*, 878 F.2d 1382 (11th Cir. 1989) (bank exercised almost complete control over corporate taxpayer); *Sokaogon Chippewa Community Tribal Council v. U.S.*, 959 F.Supp.1032 (E.D.Wis.1997) (tribe owned business and council oversaw hiring and certain financial transactions).

⁴⁸ *See Harrington*, 504 F.2d at 1311.

⁴⁹ *Harrington*, 504 F.2d at 1311 n.2.

⁵⁰ *Thomsen*, 887 F.2d at 14.

⁵¹ 26 U.S.C. §§ 4001-4682.

⁵² 26 U.S.C. § 3402(q).

⁵³ 26 U.S.C. § 3406).

⁵⁴ 26 U.S.C.A. § 3405(e).

⁵⁵ 26 U.S.C. §§ 1441-42.

⁵⁶ 26 U.S.C. § 1445.

⁵⁷ *See In re Energy Resources Co., Inc.* 871 F.2d 223 (1st Cir. 1989) affirmed 495 U.S. 545 (1990); *In re Kaplan*, 104 F.3d 589, 596 n.16 (3rd Cir. 1997).

⁵⁸ *See Energy Resources*, 871 F.2d at 228 (citations omitted).

⁵⁹ *See Sotir v. U.S.*, 978 F.2d 29 (1st Cir. 1992).

⁶⁰ *See New Terminal Stevedoring, Inc. v. M/V Belnor*, 728 F.Supp. 62 (D.Mass.1989).

⁶¹ *In re Energy Resources Co., Inc.*, 495 U.S. 545, 551 (1990).

⁶² *See, e.g. In re Oyster Bar of Pensacola, Inc.*, 201 B.R. 567 (Bankr. N.D.Fla. 1996) (argument that debtor/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 (Bkrty D.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).

⁶³ *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).

Depending on the jurisdiction, there may be state law corollaries relating to unpaid state trust fund taxes, such as sales tax.

Responsible person liability for unpaid trust fund taxes should be avoided at all costs. The liability can be criminal in nature, and civil cannot be discharged even in a personal bankruptcy proceeding. The lesson is do not borrow from the United States Internal Revenue Service.

2.5 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/UVTA. Both sources provide for civil preference liability only.

2.5.1 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.⁶⁴ The definition of insider is found at 11 U.S.C. § 101(31) and includes, with respect to corporations, an officer, director, person in control of the debtor, a partnership in which the debtor is a general partner, a general partner of the debtor, and a relative of any of the foregoing. An avoidable preference may exist in the context of the payment of a debt and it may exist if the debtor secures an otherwise unsecured or under-secured debt within the relevant preference period. The preference period for non-insider transfers is 90 days. A debtor is presumed to be insolvent during that 90-day period. For claims against insiders, however, the Trustee must prove that the debtor was insolvent during the period preceding the non-insider 90-day preference period.

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 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.

2.5.2 Insider preferences under state law

UFTA provides that a transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt at the time the debtor was insolvent and the insider had "reasonable cause" to believe that the debtor was insolvent. UFTA claims are not limited by the one-year look back period that exists in the bankruptcy context. This means that a creditor of the debtor entity can recover the amount of the preference from the insider. As set forth in the Uniform Act, the statute of limitations for such a claim is four years, although practitioners should check each state's version of UFTA to confirm that the 4-year limitations period specified in the Uniform Act applies in that jurisdiction.

2.6 Director liability under federal securities laws

2.6.1 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.

⁶⁴ See 11 U.S.C. § 547.

The primary defence to Section 11 liability is due diligence. To establish that defence, the director must show that, after reasonable investigation, the director had reasonable grounds to believe, and did believe, that the registration statement did not contain any materially misleading statements or omissions.

Section 12(a) 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(b) 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. Section 3301 of the United States criminal code, 18 U.S.C. § 3301, criminalizes securities fraud, which can be based on wilful violations of the Securities Act.

2.6.2 Securities Exchange Act of 1934 (the “Exchange Act”)

The Exchange Act contains a general antifraud provision at S 10(b) which, when combined with Rule 10b-5 promulgated by the Securities Exchange Commission, prohibits the employment of any device, scheme or artifice to defraud, the making of any untrue statement of material fact or the omission of material facts which are necessary to make a statement not misleading in connection with the purchase of sale of a security. Section 10(b) and Rule 10b-5 applies to any purchase or sale of a security that involves any means of interstate commerce, the use of the United States mails or a national exchange and is not limited to claims relating to the content of a registration statement or the failure to register an offering. Since 1946, federal courts have recognized a private right of action in favour of the purchaser or the seller of a security under Section 10(b) of the Exchange Act. As with the Securities Act, wilful violations of the Exchange Act can give rise to criminal liability.

Merely negligent conduct by an officer or director will not give rise to liability under Section 10(b) of the Exchange Act. The United States Supreme Court has ruled that a plaintiff must prove by a preponderance of the evidence that the defendant acted with “*scienter*”, a mental state that encompasses knowing or intentional deception, manipulation or fraud.

2.6.3 The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act, Public Law No. 107-204, was adopted in 2002 with the intent of improving corporate accountability and transparency. It applies primarily to public companies registered under the Exchange Act of 1934, although certain provisions extend to non-public entities. Among other things, the Sarbanes-Oxley Act increases penalties for violations of securities laws and regulations, and may define or inform the duties owed by corporate officers and directors to corporations and corporate shareholders. For a good overview of the Sarbanes-Oxley Act’s effect on corporate directors and officers, see *Now its Personal: The Real Impact of Sarbanes-Oxley on Directors and Officers*.⁶⁵ Certain wilful violations of *Sarbanes-Oxley* can give rise to criminal liability.⁶⁶

2.7 Liability under federal environmental laws

United States courts have been willing to impose personal civil and criminal 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, which provides responsibility and remedies for the disposal and clean up of uncontrolled hazardous waste sites. One other regime that may result in personal liability is the Resource Conservation and Recovery Act (RCRA), which governs the handling, storage, treatment, transportation and disposal of solid waste, including hazardous waste. Many states have also adopted state-law counterparts to the Federal environmental statutes.

⁶⁵ Dan A. Bailey and J. David Washburn, *Now its Personal: The Real Impact of Sarbanes-Oxley on Directors and Officers*, 6(4) Wall Street Lawyer 9 (2002).

⁶⁶ See 18 U.S.C. §§ 1349, 1350.

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.

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.

2.8 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*,⁶⁷ 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.”

Business entities in financial distress are seldom in a position to take advantage of a new business opportunity, but that will not prevent a representative of the failed company’s creditors from seeking damages from an officer or director that misappropriates a corporate opportunity. An insider of a struggling business entity risks liability (or at least the cost of defending a suit) if his basis for appropriating a corporate opportunity is the financial ill health of the corporation that he serves.

QUESTION 3

3. **Other persons involved with the debtor’s affairs that may have liability in respect to their actions during the twilight period**
 - (a) **In addition to those persons referred to in 1(a) above, can others be held liable for their action or inaction during the relevant period?**
 - (b) **In respect of which acts or failure to act may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?**
 - (c) **Can those other persons be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?**

⁶⁷ *Equity Corp. v. Milton*, 221 A.2d 494 (Del. 1966).

3.1 Officer liability

Many of the causes of action discussed in Question 2 also extend to company “officer” liability – a concept that generally extends to those persons with decision making authority over matters material to the acts at issue. A corporate chief financial officer who oversees a company’s payroll process and either causes or permits the company to misuse Federal trust fund taxes for company purposes could face liability for that misconduct to the same extent as an actively involved director.

3.2 Lender liability and equitable subordination

Lender liability is the generic term used to describe those circumstances under which a lender to the debtor may incur liability on account of its conduct. Lender liability claims run the gamut, from breach of contract to slander. In the context of an insolvent business entity, a lender’s risk is more specific: equitable subordination due to misconduct. The Bankruptcy Court has the power under Code § 510(c) to readjust the priorities of claims and therefore subordinate one claim to another due to misconduct by the creditor.

3.2.1 Equitable subordination of non-insider claims

Lender’s claims against an insolvent entity are not frequently subordinated. Those instances leading to subordination usually involve misconduct by the lender to the detriment of the debtor’s unsecured creditors. Some courts have suggested that such misconduct must be tantamount or similar to fraud on the part of the lender. The classic example involves a situation where the debtor operates solely for the purpose of liquidating the secured creditor’s collateral and the debtor fails to pay its trade debt during the period of liquidation.

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.

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.

3.2.2 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.

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.

3.3 Aiding and abetting liability

As discussed 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.

3.4 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”.⁶⁸ 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 owners of the entity. Counsel should be aware of the factors courts evaluate in determining whether to impose entity liabilities upon owners of the entity. While counsel cannot control in detail the activities of our business clients, they can advise as to what is high-risk conduct and seek 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. inadequate capitalization;
5. non-observance of corporate formalities;
6. absence of corporate records;
7. no payment of dividends;
8. insolvency at the time of the litigated transaction;
9. siphoning away of corporate assets by the dominant shareholders;
10. non-functioning of officers and directors;
11. use of the corporation for transactions of the dominant shareholders; and
12. use of the corporation in promoting fraud.

The language and role of fraud in cases addressing corporate veil piercing has created confusion. Case law, however, indicates 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*”.⁶⁹ The Maine Supreme Judicial Court has ruled that the corporate veil may be pierced where (i) the shareholder misused the corporate form and (ii) “an unjust or inequitable result would occur if the Court recognized the separate corporate existence”.⁷⁰

The practice of establishing a new subsidiary or affiliate entity to undertake a new venture has many advantages, including that if the subsidiary fails, 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. To avoid liability, parents and subsidiaries must ensure that the separateness of the two entities is maintained by adherence to all applicable corporate formalities and that the entities deal with one-another on an arm’s length basis in all circumstances.

⁶⁸ *Crane v. Green & Freedman Baking Co.*, 134 F.3d 17, 21(1st Cir. 1998).

⁶⁹ *Wm. Passalacqua Builders v. Resnick Developers*, 933 F.2d 131, 138 (2nd Cir. 1991).

⁷⁰ *Johnson v. Exclusive Properties Unlimited*, 720 A.2d 568, 571 (Me. 1998).

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period be set aside?
- (b) What defences, if any, are available to a party seeking to protect such a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

Recipients of transfers from entities that are either insolvent or rendered insolvent as a result of the challenged transfers may face both “preference” liability and fraudulent / avoidable transfer liability under both applicable state law and Federal bankruptcy law. Section 548 of the Bankruptcy Code provides for avoidance of “fraudulent transfers” made within the two years preceding a bankruptcy filing that are either intentionally fraudulent or that were made for less than reasonably equivalent value and (i) was insolvent at the time of the transfer; (ii) was rendered insolvent by the transfer; or (iii) made the transfer to an insider under an employment contract outside the ordinary course of business.⁷¹ Each of those bodies of law allow for remedies spanning from recovery of the property transferred to damages based on the value of the property transferred (with some state laws providing for double damages).⁷² Barring outright actionable fraud (as opposed to statutory fraudulent transfer liability), state laws generally regard avoidable transactions as just that – “avoidable,” or subject to avoidance, but otherwise valid, meaning that the transactions is good under the law unless and until a judgment is entered avoiding the transaction.

Defences to preference and avoidable / fraudulent transfer liability are provided for in the statutes giving rise to those causes of action. The most common of those are summarized here.

4.1 Bankruptcy preference defences

The Bankruptcy Code provides nine defences to the avoidance of preferential payments.⁷³ Payments falling within one or more of these defences may not be recovered by the trustee. Creditors asserting one or more of these defences bear the burden of proof at trial. See 11 U.S.C. § 547(g). The defences to preference claims are set forth in 11 U.S.C. § 547(c). Several of these defences are highly specialized, and have little application to most business creditors. For example, a transfer which is the fixing of a statutory lien, see 11 U.S.C. § 547(c)(6), a transfer which is a payment made pursuant to a divorce decree, separation agreement, or child support agreement, see 11 U.S.C. § 547(c)(7), or a transfer involving payments of less than \$600 for consumer debts, see 11 U.S.C. § 547(c)(8), or a transfer involving payments of less than \$6425 (an amount which adjusts annually) for business debts, see 11 U.S.C. § 547(c)(9), are not preferential and may not be recovered by the trustee. Two other defences apply only to secured creditors. See 11 U.S.C. §§ 547(c)(3) and (c)(5).

The final three defences have the broadest application to unsecured business creditors. These are known as the contemporaneous exchange for new value defence, § 547(c)(1), the ordinary course of business defence, § 547(c)(2), and the new value defence, § 547(c)(4).

⁷¹ See 11 U.S.C. section 548(a)(1).

⁷² See, e.g., 11 U.S.C. section 550; UFTA/UVTA section 7; 14 Maine Rev. Stat. section 3578(1)(C) (providing for awards of damage “in an amount not to exceed double the value of the property transferred or concealed.”).

⁷³ There is conflicting case law regarding whether defendants can raise other, non-statutory defences to preference claims, including equitable defences such as laches, estoppel, and the like. While this discussion will focus on the statutory defences afforded by section 547 of the Code, attorneys representing defendants to preference claims cannot assume that the statutory defences are the only defences in their arsenal.

4.1.1 Contemporaneous exchange for new value

The contemporaneous exchange for new value defence, set forth in 11 U.S.C. § 547(c)(1), states that the trustee cannot avoid a transfer which was intended by the parties to be a contemporaneous exchange for new value, provided the transfer was in fact a substantially contemporaneous exchange. The simplest example of when this defence applies is when goods are delivered or services provided C.O.D. In such cases, the creditor and the debtor both intend that the goods or services be paid for upon delivery, and in fact they are paid for upon delivery. The case law allows for other situations to be deemed contemporaneous exchanges, such as when payment is made within a day or two of delivery, either immediately before or after. The controlling factor is that no meaningful credit is issued; for all practical purposes, the exchange of goods and payment happen at the same time. The policy behind this defence is that the transaction leaves the estate of the debtor in exactly the same position immediately after the transaction as it was immediately before the transaction; the only difference being that the debtor has exchanged a sum of money for goods or services. Because there has been no net difference in the value of the estate, there was no preference, and the trustee cannot recover the payments.

4.1.2 Ordinary course

The ordinary course defence is set forth in 11 U.S.C. § 547(c)(2). Under this defence, the trustee cannot avoid a transfer having the following characteristics: (A) the transfer was made in payment of a debt where the debt was incurred by the debtor in the ordinary course of the business or financial affairs between the debtor and the creditor, and (B) such transfer was either (i) made in the ordinary course of business between the debtor and the creditor; or (ii) made according to ordinary business terms. The first condition is usually not contested. Most debts between the debtor and the creditor arise in the ordinary course. A clear example where a debt may not arise in the ordinary course may be where a supplier of logs to a paper mill, which previously was only engaged in the wood products industry, loans money on an unsecured basis to a cash-strapped debtor. The debt incurred in that case would not have arisen in the ordinary course, because it would result from an extraordinary transaction. In most cases, though, purchases are made pursuant to long-standing patterns of conduct, and this first condition is met.

The second condition can present more difficulty, because the interactions between troubled debtors and their creditors are often unordinary. To assert this defence, a creditor must either demonstrate parity between the debtor's conduct surrounding the challenged transfers and the parties' past business relations, or consistency with industry practices, the latter of which may, depending on the circumstances, require presentation of expert testimony.

4.1.3 Subsequent new value

The subsequent new value defence is set forth in 11 U.S.C. § 547(c)(4). This defence is available when the creditor gave new value (either as goods or services or as additional credit) to or for the benefit of the debtor subsequent to the challenged transfer, and the new value given either remained unpaid or was not an otherwise avoidable transfer to the creditor. In the simplest case, if after the debtor makes a payment to the creditor, the creditor makes a delivery of new goods or services on credit, the value of those goods or services, to the extent they remain unpaid or are otherwise unavoidable, can be used to offset the prior payment. New value analyses involving multiple payments and ongoing provision of goods or services require care, and regard to issues such as timing of payment, timing of new value, and consideration of what "new value" does or does not remain unpaid.

4.1.4 Combining defences

The defences set forth above may be applied in conjunction with each other. For example, if ten payments were made during the preference period, it may be that one payment was for a contemporaneous exchange for new value, seven were made consistently with prior practices between the debtor and the creditor and thus are not avoidable under the ordinary course defence, while the remaining two payments may be offset by unpaid new value in the form of goods delivered after the last payment was made.

4.2 Fraudulent / avoidable transfer defences

4.2.1 Section 8 of both UFTA and UVTA provide defences to transferees of avoidable transfers. While practitioners should review the local law of the jurisdiction in which the claim arises, that section:

(i) provides protections for recipients of intentionally fraudulent transfers who took in good faith and for reasonably equivalent value, and for subsequent transferees or opligees; (ii) limits the judgment amount to that necessary to satisfy the creditor's claim; (iii) limits the persons against whom judgment can be entered to first transferees and subsequent transferees other than good faith transferees of such persons who gave value for the subsequent transfer; and (iv) provides certain protections for good faith transferees to the extent they gave value for the transfer.

4.2.2 Also, both UFTA and UVTA, while broad in their scope, do include some protections that are not obvious from the statute. For example, both statutes provide for avoidance of "transfers", but the term "transfer" encompasses any means of parting with an "asset or an interest in an asset", but the term "asset" excludes property to the extent it is encumbered by a valid lien. Thus, for example, a conveyance of a fully encumbered item of property, even one undertaken for fraudulent purposes or that otherwise falls squarely within the statutory language, will not be avoidable because it is not an asset and is, thus, not a "transfer" subject to avoidance.⁷⁴

4.3 Other protections

4.3.1 Trade creditors

Trade creditors are well advised to do business on a cash-on-delivery only basis if they have reason to believe that they are selling to an insolvent entity. A C.O.D. transaction is never a preference under the Bankruptcy Code. UCC S 2-702 expressly authorizes a seller of goods to refuse delivery to an insolvent buyer other than upon cash payment. Recent amendments to the Bankruptcy Code give trade creditors an administrative priority claim (meaning it is entitled to be paid as a post-petition expense) equal to the value of goods received by the debtor within 20 days before the commencement of the case, if those goods were sold to the debtor in the ordinary course of business.⁷⁵

4.3.2 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 S 2-702.

Somewhat recent amendments to the Bankruptcy Code provide a new, 45-day reclamation right in the bankruptcy context, although such rights are expressly subject to the prior rights of secured creditors, and thus will be quite limited in most contexts. A seller's right to reclamation under the UCC is subject to the rights of a buyer in the ordinary course or other good faith purchaser. Most courts have ruled that the seller's right to reclamation is inferior to the rights of a lender with a "floating" lien on the debtor's inventory.

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.

4.3.3 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?

⁷⁴ See UFTA and UVTA section 1.

⁷⁵ 11 U.S.C. § 503(b)(9).

Buyer's of the assets of a failing enterprise often require that the Seller file under chapter 11 of the Bankruptcy Code so that the transaction can be consummated in the Bankruptcy Court. Although this procedure results in higher transactional costs, the buyer is far safer with an order of the Bankruptcy Court conveying the assets of the seller to the buyer free and clear of liens, claims and encumbrances, because the transfer will not be susceptible to subsequent avoidance by the bankruptcy trustee.

4.4 Incurring further credit during the twilight period

Directors of companies that are either insolvent or teetering on the edge of insolvency should use extreme caution to avoid making false or fraudulent statements for the purpose of obtaining credit or maintaining a credit relationship with a vendor or lender. Most of the risk associated with the extension of credit to troubled companies falls on the lenders, rather than the corporate directors utilizing those credit relationships to further the good faith ongoing operations of the enterprise.

Directors who in good faith determine that a company is otherwise viable but must secure additional credit, over the short or long term, to survive and thrive should be mindful of the possible use of the Federal bankruptcy process as an available tool in that effort.

4.4.1 Chapter 11 of the United States Bankruptcy Code

(a) Sources of law: Introduction

The Bankruptcy Code is found at Title 11 United States Code. Chapter 11 refers to sections 1101, et seq. of Title 11. Chapter 11 contains the specific rules for business reorganization. However, the provisions of Chapters 1, 3, 5 and 7 apply to proceedings under Chapter 11.

Although the bankruptcy code is federal law, state law plays an important role in bankruptcy cases. The property interests of the debtor and the interests of the debtor's secured creditors in the property of the debtor are, for the most part, governed by state law. State law will provide the rule of decision with respect to numerous other issues that may arise in a reorganization proceeding.

The provisions of the Bankruptcy Code are interpreted and applied by the Judges of the United States Bankruptcy Court. Their published decisions and the respective appellate rulings comprise a sizable body of case law to assist counsel.

This section of the materials is intended to provide only an overview of Chapter 11. The purpose is to assist counsel in understanding the circumstances where a filing under Chapter 11 may be a viable alternative for the client. Accordingly, these materials are not intended as an exhaustive analysis of the many detailed and complicated provisions of Title 11 that pertain to business reorganizations. Nor do these materials attempt to amass or collate the considerable case law that has developed with respect to practice and procedure under the Bankruptcy Code in general or Title 11 in particular.

The terms debtor and debtor in possession are used interchangeably in these materials. Reference to the Code means Title 11 of the United States Code.

(b) Who and what can seek relief under Chapter 11?

Individuals and business entities can seek relief under Chapter 11 of the Bankruptcy Code. Code sections 109(d) and 101(41). An entity must be properly authorized to file a petition by appropriate board, shareholder, member or partner action.

An individual should always consider eligibility under chapter 13, which relates to individual debt adjustment, before resolving on a filing under chapter 11. 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.

The timing of a filing can matter a great deal. The trustee or debtor-in-possession can recover certain payments made by the debtor on account of an existing debt to an unsecured or under-secured creditor made within 90 days preceding the filing, or within one year with respect to insiders. Recovery of preferences can help fund a plan of reorganization, in appropriate cases. The threat of the recovery of preferences can help the debtor negotiate more favourable Plan terms. The recovery of preferential payments is governed by 11 U.S.C. sections 547 and 550.

(c) Why might a business entity file for relief under Chapter 11?

- If a secured creditor is taking enforcement action to take possession of assets or to foreclose liens in real or personal property of the debtor, the automatic stay imposed by Code § 362 will stop such action.
- If the debtor is unable to pay its unsecured creditors in accordance with terms and creditors are commencing collection actions and / or seeking to attach assets, Code § 362 will force creditors to stop their collection actions.
- If the debtor is facing costly litigation due to a product failure or warranty claims.
- If the debtor wishes to consummate a going-concern sale of assets, but attachments or the threat of attachments makes the buyer unwilling or unable to close.
- If the debtor needs working capital financing, but 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.

(d) Why file under Chapter 11 rather than Chapter 7 or Chapter 13?

- Chapter 13 is only available to individuals and then only individuals whose secured and unsecured debts do not exceed a stated level. See Code § 109(e). Business entities may not use Chapter 13.
- Chapter 7 results in the appointment of a trustee whose job is to liquidate the assets of the debtor and distribute the proceeds in accordance with the priorities set forth in the Code. A Chapter 7 trustee is not ordinarily interested in operating a business. If the goal is to maintain ongoing business operations, Chapter 7 is probably not a viable option.
- Chapter 11 affords a business an opportunity to restructure its debts into a more feasible payment schedule.
- Chapter 11 affords a business an opportunity to sell its assets in a setting superior to a foreclosure.
- Absent special circumstances, a Chapter 11 debtor remains in possession and control of its property. Such a debtor is known as a debtor-in-possession.

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 S 1104.

(e) Examples of debt restructure that may be obtained under Chapter 11, subject to compliance with the requirements of Chapter 11.

- A term loan to a bank which has been accelerated is put back onto a monthly payment schedule.
- A line of credit which has matured is restructured to an amortizing term loan.
- Unsecured debt is paid from future profits of the debtor's operations.

- (f) Other obligations / assets may be preserved by a timely filing under Chapter 11.
- Defaults under a lease of an important site may be cured and the leasehold preserved, provided the petition is filed before the lease is terminated.
 - Defaults under a significant license, franchise or similar arrangement may be cured and the contractual rights preserved, provided the petition is filed before the contractual rights are terminated.

Counsel must study the terms of important contracts, licenses, distribution agreements and leases very carefully. If the debtor's rights under the agreement are terminated in accordance with the terms of the agreement before the debtor files in bankruptcy, the filing may be unable to alter the termination or restore the debtor's rights. Haste, even great haste, is sometimes necessary in this context.

- (g) Chapter 11 affords an opportunity to sell the assets of a going-concern free and clear of liens and claims.

One of the principal benefits and uses of chapter 11 is the ability to obtain a Bankruptcy Court Order under 11 U.S.C. § 363 authorizing the sale of a debtor's assets free and clear of liens and claims. In this manner, a going concern business can consummate a sale of assets free of the claims of secured and unsecured creditors. Such a Court Order may be required by a buyer so that the buyer knows that its use and possession of the debtor's assets will not be disturbed by unsatisfied creditors of the seller. Moreover, such a Court Order may be a practical necessity to clear the assets of consensual or non-consensual liens.

The benefit of Code S 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.

Lenders often co-operate with and benefit from a sale under Code S 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.⁷⁶ A successful credit-bid by the lender will, of course, prevent the going concern sale from proceeding. The burden is on the debtor and its counsel to convince the lender that the price offered for the assets is more than the Lender would receive if the lender foreclosed its liens.

- (h) Chapter 11 affords an opportunity to obtain financing on a senior secured basis. Under Code S 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 S 552 which cuts off floating liens and Code S 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.

⁷⁶ See Code § 363(k).

QUESTION 5

5. Enforcement

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

Enforcement actions may involve civil or criminal proceedings and may be based upon Federal or state law or both. For example, criminal penalties exist for certain violations of the Federal environmental and securities laws. Most enforcement actions under these laws, however, are 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, either directly or derivatively on behalf of all 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 and Federal law. Liability for failure to pay “trust fund” taxes is enforced by the respective taxing entities. Rights of enforcement are discussed in more detail in the following section.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

6.1 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.

6.2 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.
- (vi) In some jurisdictions, damages in an amount up to two times the value of the property transferred.

6.3 Unlawful dividends or redemptions

Under Delaware law, the directors who vote for an unlawful dividend or redemption face joint and several personal liability for the amount unlawfully distributed by the corporation

6.4 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.

6.5 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.

6.6 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.

6.7 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, and the scope of the potential indemnity, varies among jurisdictions.

The authority of a Delaware corporation to indemnify its officers and directors is found at Del. Code Ann. tit. 8, § 145. Section 145 authorizes indemnification against expenses, including attorney's fees, judgments, fines and amounts paid in settlement actually and reasonably incurred "if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation and, with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful". The bylaw provision may also separately mandate the advancement of expenses, because Delaware courts have ruled that mere indemnification does not require the advancement of expenses.

6.8 Involuntary proceedings under the Bankruptcy Code

Unsecured creditors of an insolvent business entity sometimes resort to the commencement of an involuntary proceeding under the Bankruptcy Code against the debtor. If the debtor has fewer than 12 unsecured creditors, one or more unsecured creditors with claims aggregating \$13,475 may commence an involuntary petition against the debtor. If the debtor has twelve or more creditors, three or more unsecured creditors whose claims aggregate \$13,475 may commence the involuntary proceeding. Claims that are in bona fide dispute are not eligible as petitioning claims.⁷⁷

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.⁷⁸

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.

Bankruptcy Code chapter 15 provides a mechanism by which United States Bankruptcy Courts can be used to administer assets subject to the jurisdiction of United States courts.

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. 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.

⁷⁷ 11 U.S.C. § 303.

⁷⁸ 11 U.S.C. § 303(h).

QUESTION 7

7. Duty to Co-operate

- (a) To what extent are directors and other persons identified in Question 3(a) above obliged to co-operate with the insolvency office-holder's investigation into the company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self-incrimination? Are any human rights laws applicable to such obligations?

7.1 In the Bankruptcy Court

7.1.1 Schedules

Bankruptcy Code S 521(a)(1) requires that the debtor file a list of creditors, and unless the Court orders otherwise, a schedule of assets and liabilities, a schedule of current income and current expenditures and a statement of the debtor's financial affairs. Official forms are prescribed for each of these filings. Absent a Court order extending the deadline, the filings must be made within fifteen days of the order for relief under the Bankruptcy Code. In the case of a filing involving a corporation, the Court may order the appropriate corporate officers, directors, or other persons in control of the corporation to complete the schedules.⁷⁹

7.1.2 Co-operation

Bankruptcy Code S 521(a)(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. Co-operation may also involve assisting the trustee in evaluating claims against the debtor or claims in favour of the debtor. If the debtor is an entity, the duty to cooperate may be compelled from a corporate officer.⁸⁰

7.1.3 Turnover

Bankruptcy Code S 521(a)(4) requires that the debtor surrender to the trustee all property of the estate and any recorded information, including books, documents, records, and papers related to property of the estate. 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.

7.1.4 Appearance

Bankruptcy Code S 343 requires that the debtor appear at an examination under oath conducted by the trustee (in a chapter 7 case) or by the United States Trustee (in a case under chapter 11). Creditors of the debtor are also entitled to attend the examination.

(b) Protection from self-incrimination

Bankruptcy Code S 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.

⁷⁹ Fed. R. Bankr. P. 9001(5).

⁸⁰ *Matter of Ron San Realty, Inc.*, 457 F. Supp. 994 (S.D.N.Y. 1978).

7.2 Human rights

The United States does not have a corollary to the European Convention for the Protection of Human Rights and Fundamental Freedoms, and none of the laws noted above implicate human rights considerations. It may be that fraudulent or other improper conduct vis a vis a consumer could implicate state consumer protections or unfair trade practices laws, but a discussion of those laws is beyond the scope of this article.

QUESTION 8

8. Appeals and limitation periods

(a) What limitation period, if any, applies to the actions referred to above?

(b) What appeals are available from the decision of the lower courts?

Limitations periods vary from state to state, so practitioners should review limitations issues on a case-specific basis. As a general rule, however, with respect to cause of action arising under state law, under the so-called Erie doctrine, federal courts apply the statute of limitations that the forum state would apply.⁸¹ Typically, when a conflict arises between two states' statutes of limitations, the limitations period of the forum state will apply, even if the action is barred in another jurisdiction.⁸² Practitioners should confirm the application of those general principles to their particular case. Also, even if the statute of limitations of the forum jurisdiction applies, that does not foreclose the application of the laws of another jurisdiction to the substantive issues in the case. As noted earlier in this chapter, conflict of laws questions are complicated, and the rules vary among jurisdictions, so practitioners should think carefully about how conflict-of-law rules apply to a particular case, including limitations issues.

Appeals, at least to a lower level appellate Court, are generally available as a matter of right from State and Federal courts in the United States. Rules and deadlines regarding appeals are constantly in flux and vary between jurisdictions. Consequently, practitioners should confirm the appellate rules and deadlines in the contest of a particular case.

QUESTION 9

9. Foreign corporations

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

A foreign corporation or other foreign business entity may be a debtor under the United States Bankruptcy Code if it has a place of business in the United States or if it has assets in the United States. Accordingly, a foreign corporation doing business in the United States may seek relief under chapter seven (liquidation) or chapter 11 (reorganization) of the Code and creditors of the entity may file an involuntary petition under the Code against the foreign entity.⁸³ 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.

⁸¹ See *Guar. Trust Co. v. York*, 326 U.S. 99, 109-10 (1946).

⁸² See Restatement (Second) of Conflicts of Law § 142(2).

⁸³ 11 U.S.C. sec. 109.

Entities that are the subject of a foreign insolvency proceeding or their representative may also seek relief under the Code to have the foreign proceeding recognized in the United States.⁸⁴ Such relief may include issuance of a preliminary injunction, pending a final hearing on recognition. Once a foreign proceeding is formally recognized following notice and hearing to creditors (a process which is largely ministerial if all procedural requirements are satisfied), the automatic stay imposed by Section 362 of the bankruptcy code applies automatically.

A representative of a foreign entity undergoing insolvency proceedings in a foreign jurisdiction may also seek dismissal of a bankruptcy proceeding under the Code on the basis that factors including the interests of creditors in a timely distribution of assets of the debtor, the convenience or difficulty in establishing claims against the debtor in the foreign proceeding, the prevention of preferences and fraudulent conveyances and the distribution priorities applicable under the foreign insolvency scheme) weigh in favour of the single insolvency proceeding pending in the foreign jurisdiction.⁸⁵

Once the Bankruptcy Court formally recognizes a foreign proceeding, then the foreign representative of the debtor may, except in very limited circumstances, prosecute claims seeking the recovery of preferences, fraudulent conveyances and the turnover of the debtor's property.⁸⁶ In practice, that means that officers and directors of foreign entities will be subject to the same substantive law that applies to officers and directors of domestic business entities. For this reason, officers and directors of foreign business entities should expect that unpaid creditors of the foreign entity in the United States will have access to the same rights and remedies against officers and directors as they would have against officers and directors of domestic business entities.

Officers and directors of foreign business entities doing business in the United States should also understand that state and federal laws regulating the affairs of businesses generally will apply to the foreign entity and to its officers and directors. Accordingly, state and federal laws with respect to environmental regulation and protection, anti-trust, employment, wage hour laws, workplace safety, consumer protection, the issuance of securities and other laws will all apply with equal force to a foreign business engaged in commerce in the United States.

QUESTION 10

10. Insurance

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

10.1 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.

⁸⁴ See generally 11 U.S.C. sec. 1501 et seq.

⁸⁵ 11 U.S.C. sec. 305.

⁸⁶ See 11 U.S.C. sec. 1523(a).

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
- insured v. insured
- claims noticed under a prior policy
- claims arising under ERISA and retirement, welfare and benefit plans*
- bodily injury and property damage*
- libel and slander*; and
- violation of § 16(b) of the Securities Exchange Act of 1934.

(*These excluded risks are usually insured against under separate policies.)

Litigation surrounding D&O policies focuses on the application for coverage, payment of interim defence costs and interpretation of the policy exclusions. Since the D&O policy is claims made, the insurer will require that the insured dictate all known claims and potential claims in the insurance application. If a claim later arises based on conduct prior to the date of the application, the insurer will likely deny coverage.

A policy application is ordinarily signed by the President of the company.

Courts have held that innocent directors without knowledge of facts relating to a possible claim will nonetheless lose coverage if the corporation's President had knowledge of such a claim and failed to disclose it on the policy application. To protect against this eventuality, the company may purchase a policy with a severability provision. A policy with a severability provision means that the insurer takes a separate application from each insured officer and director and that the failure of any single officer or director to reveal facts pertaining to a potential claim will not void the coverage of an innocent insured.

The greatest challenge with respect to D&O insurance may come at the policy purchase / negotiation stage. Insurers will inevitably seek to make exclusions broad so as to exclude most covered claims. Directors assisting a company in purchasing such policies will want to work closely with the company's agent to ensure the coverage is as broad as possible, so as to protect the company and its officers and directors in the event a claim arises.

The information provided in this country chapter is correct as at 31/01/2017

VIETNAM

QUESTION 1

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

(a) How are directors identified / defined?

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

1.1 “Director” under Vietnamese law

Vietnamese law does not provide for a specific definition of “director”. Under the law on enterprises No. 68/2014/QH13 dated 26 November 2014 (Law on Enterprises), directors are identified by their rights and obligations. The respective role, authority, and obligations of the various directors and officers of limited liability companies (LLCs) and joint stock companies (JSCs) are set out in the law on enterprises as well as its implementing regulations and certain sector - specific legislation (i.e., the securities regulations applying to listed and / or public JSC, banking laws applying to credit institutions, etc.). By way of example, Article 160 of the Law on Enterprises provides that the members of the board of management, the general director, and other managers of a JSC are under the obligation to, *inter alia*, exercise his delegated powers and perform his delegated obligations strictly in accordance with the law, the charter of the company, and the resolutions of the general meeting of shareholders; to exercise his delegated powers and perform his delegated obligations honestly and prudently to their best ability in order to assure the maximum legitimate interests of the company; to be loyal to the interests of the company and shareholders; not to use information, know - how, business opportunities of the company; not to abuse his position and powers and not to use assets of the company for his own personal benefit or for the benefit of other organisations or individuals; to notify the company in a timely manner, and fully and accurately of enterprises in which he or his related person own or have contributed capital or controlling shares.

1.2 Introduction and overview

1.2.1 The main legal instruments governing enterprise¹ insolvency in Vietnam are the Law on Bankruptcy No. 51/2014/QH13 by the National Assembly dated 19 June 2014 which took effect on 1 January 2015 (Law on Bankruptcy) as well as its implementing regulations, including Decree No. 110/2013/ND-CP of the Government dated 24 September 2013 on penalties for administrative breaches committed during the process of bankruptcy proceedings, as amended by Decree 67/2015/ND-CP of the Government dated 14 August 2015 (Decree 110).

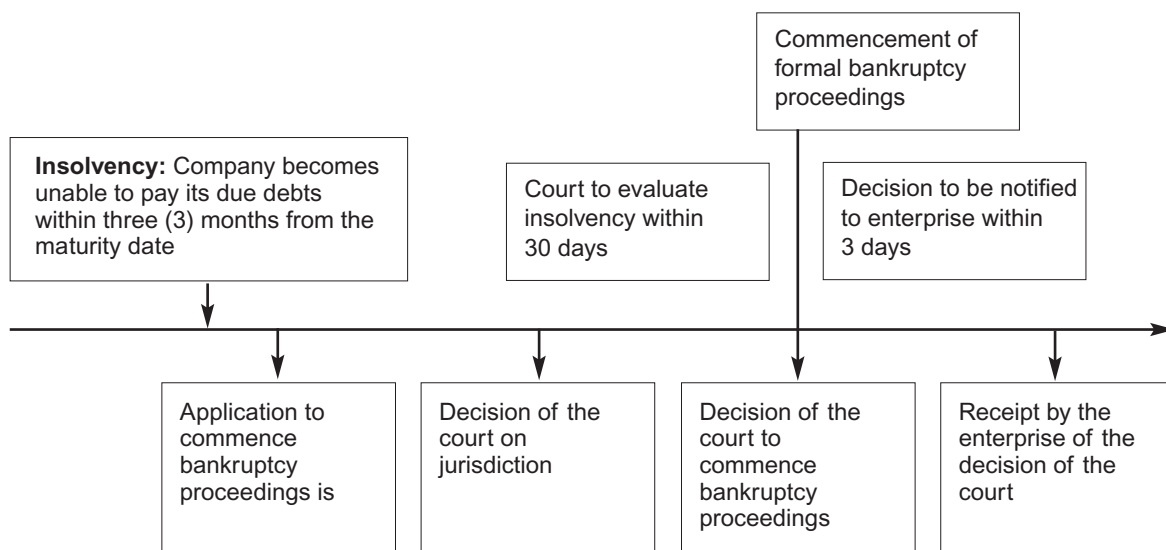
1.2.2 Under the Law on Bankruptcy, formal insolvency proceedings commence with the bankruptcy court’s decision to commence bankruptcy procedures,² which the court will issue if it has determined that the enterprise is insolvent. Prior to this, after an application to commence bankruptcy proceedings has been made, the court considers whether it has jurisdiction over the case and issues a notice accepting jurisdiction over the bankruptcy case and then has 30 days to evaluate whether the enterprise is indeed insolvent and to issue a decision whether or not to commence bankruptcy proceedings.³

¹ The Law on Bankruptcy also governs co-operatives, partnerships and other commercial businesses, but does not include personal bankruptcy for which no framework currently exists in Vietnam. A number of special regulations apply to specially regulated enterprises (such as banks, insurance companies and other financial institutions). These are not separately addressed in this chapter.

² Article 42.1 of the Law on Bankruptcy.

³ Article 42.1 of the Law on Bankruptcy. The 30 days-period commences from the date of payment of court fees, unless the applicant is exempt from these.

Graphic: Timeline of bankruptcy court proceedings



- 1.2.3 Under Article 4.2 of the Law on Bankruptcy, any enterprise or co-operative which is unable to pay its due (unsecured or partially unsecured) debts within three months from the maturity date shall be deemed to have become insolvent.⁴ The law therefore applies a “cash - flow” test only.
- 1.2.4 There is no “balance - sheet” test (as, for example, under English or German law) where an enterprise may also be deemed insolvent once its liabilities exceed its asset base.
- 1.2.5 “Clawback” provisions and transactions vulnerable to be attacked under the Law on Bankruptcy are set out in S 1.3 below. Transactions that may be attacked on grounds that are not necessarily based on insolvency, but which, in practice, have a high relevance when an enterprise becomes bankrupt, are addressed in S 1.4 below. Personal liability of directors and other officers of the company is addressed under question 2 below.

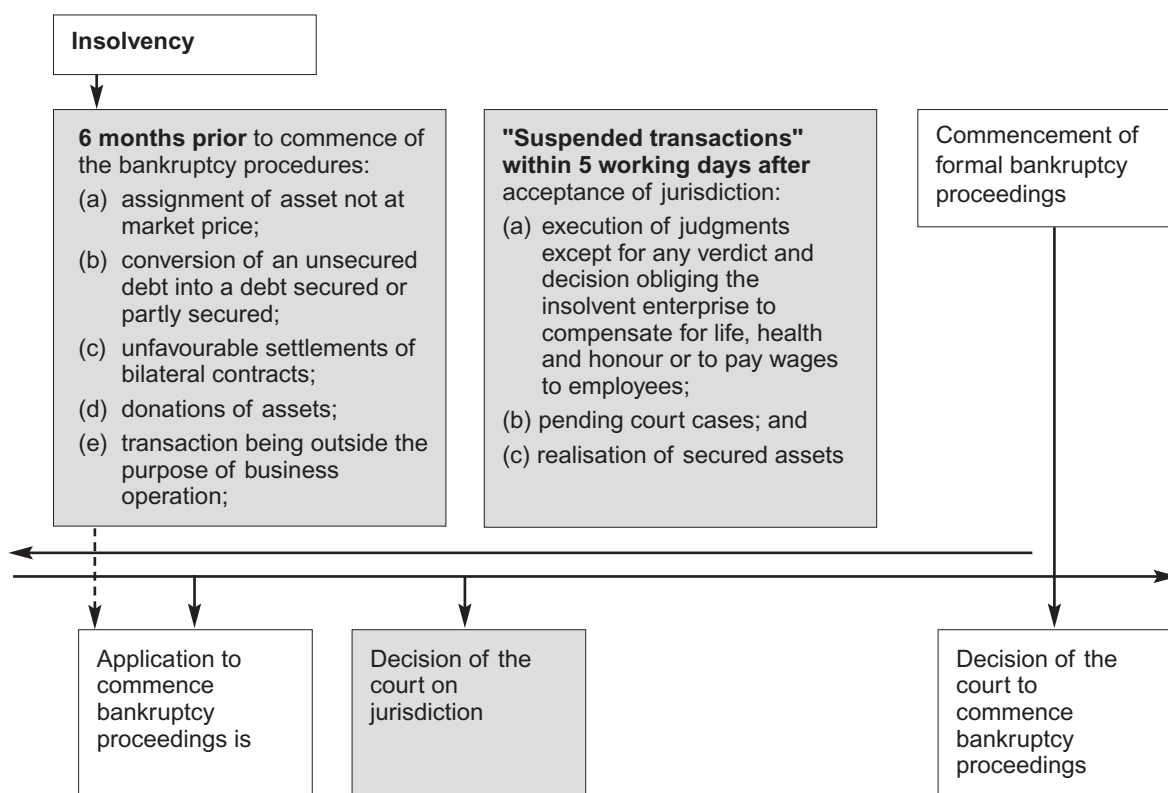
1.3 Clawback provisions and transactions vulnerable to attack under the law on bankruptcy

Voidable transactions entered into before the acceptance of jurisdiction by the bankruptcy court

- 1.3.1 The main “clawback” provision relating to transactions during the “twilight period” is set out in Article 59.1 of the Law on Bankruptcy. According to the provision, the following transactions may be voided by the bankruptcy court if they were conducted by an enterprise that has become insolvent within a period of six months prior to the date on which the court issues a decision commencing the bankruptcy procedures. These transactions are as follows:
 - (a) Transactions under which assets are assigned for less than their market price.
 - (b) Conversion of an unsecured debt into a debt secured or partly secured by the assets of the enterprise.
 - (c) Payment or set - off which benefits a creditor in respect of a debt that has not yet become due or with a sum that is larger than a debt which has become due.
 - (d) Donation of assets for no consideration.
 - (e) Transactions outside the normal course of the business operations of the enterprise or co-operative.
 - (f) Other transactions that have the effect of alienating assets of the enterprise or co-operative.

⁴ Article 4.2 of the Law on Bankruptcy.

Graphic: Voidable transactions under the Law on Bankruptcy



1.3.2 The key date to determine a voidable transaction is therefore the date on which the bankruptcy court issues a decision to commence the bankruptcy procedures in respect of the debtor and transactions that meet the above criteria may be challenged if entered into within the six months prior to the commencement of the bankruptcy procedures by the court. Transactions that the insolvent enterprise has entered into before the six - month period are immune against attack under the Law on Bankruptcy, although, in the circumstances set out under S 1.4 below, the asset management officer or asset management and liquidation enterprise or a participant in the bankruptcy procedure may still be able to rely on non - bankruptcy specific grounds to attack such transactions and to recover assets or value for the insolvent enterprise's parcel of assets.

1.3.3 Although the bankruptcy court is required to issue a decision to commence the bankruptcy procedures within the 30 days following the date the court accepts the jurisdiction, in practice it can take a substantial time for the court to accept its jurisdiction. Creditors' rights with regard to voiding unfavourable transactions are therefore limited.

1.3.4 What is more critical for creditors is that the law does not distinguish between transactions that were deliberately carried out to the detriment of the company and its creditors and other transactions that may simply prefer a particular creditor in comparison to other unsecured creditors (such as providing security to a creditor that is becoming concerned about the financial situation of an enterprise and demands security). Tests that are common in other more developed jurisdictions (e.g. whether a director had or should have had knowledge of the insolvency or of the precarious financial condition that the enterprise was in at the time of the transaction, or whether the director should have known that the enterprise was about to become insolvent) are not reflected in the Law on Bankruptcy. However, the Law on Bankruptcy provides for longer periods (i.e. 18 months) during which a transaction listed in S 1.3.1 may be attacked where the transaction was between the enterprise and certain related persons.⁵ Related person includes:-

- (a) With regard to a subsidiary company: the parent company, a manager of the parent company or any person who has the power to appoint such managers.
- (b) With regard to a parent company: any subsidiary company; with regard to a cooperative: any enterprise established by the cooperative.

⁵ Article 59.2 of the Law on Bankruptcy.

- (c) Persons or a group of persons capable of controlling the decision making of and operations of an enterprise or cooperative via its management bodies.
- (d) With regard to an enterprise or cooperative: a manager of the enterprise or cooperative.
- (e) The spouse, parent or foster parent, child, adopted child, or sibling of a manager of an enterprise or co-operative, or of a member or shareholder who holds the controlling capital contribution or shares.
- (f) Any individual authorised to represent those described in sub clauses (a), (b), (c), (d) and (e) above.
- (g) Any group of persons who agree to orchestrate together in order to take over a proportion of capital contribution, shares or interests in the company or in order to control the decision-making process thereof.
- (h) Any enterprise in which any of the persons described in sub clauses (a), (b), (c), (d), (e), (f) and (g) above hold interests to the extent that they control the decision - making process of the management bodies of the enterprise.

1.3.5 An application to the court to declare a voidable transaction invalid may only be made by either the asset management officer or asset management and liquidation enterprise or a participant in the bankruptcy procedure (which includes creditors).⁶

Voidable transactions entered before the decision to commence bankruptcy proceedings is issued

1.3.6 In addition to the voidable transactions set out above, the following transactions or discharge of asset obligations may also be attacked pursuant to Article 41 of the Law on Bankruptcy if they are conducted during the period after the court has accepted jurisdiction of a bankruptcy matter but before the official decision to commence bankruptcy procedures has been issued:

- (a) execution of civil judgments over assets where the enterprise or co-operative is the judgment debtor except for any verdict and decision obliging the insolvent enterprise to compensate for life, health and honour or to pay wages to employees;
- (b) resolution of any court case including a claim that the enterprise or co-operative discharge its asset obligations; and
- (c) realisation of secured assets of the enterprise or co-operative for a secured creditor.

1.3.7 The Law on Bankruptcy requires that these be “temporarily suspended”; however, it is understood that any transaction or discharge of an asset obligation (e.g. the realisation of security by a secured creditor) may be challenged if taken in violation of the provisions of Article 41 of the Law on Bankruptcy.

1.4 Transactions vulnerable to attack under non-bankruptcy specific regulations

1.4.1 Additional grounds for attacking civil transactions that the insolvent company may have entered into exist outside of the Law on Bankruptcy. While these are not dependent on insolvency proceedings having commenced, such transactions tend to become increasingly relevant in the event that a company becomes insolvent and, in practice, there is an increased risk of such transactions being carried out to the detriment of creditors when an enterprise becomes financially troubled.

⁶ Article 60.1 of the Law on Bankruptcy.

1.4.2 By way of an overview, the most relevant scenarios (and their respective vulnerability periods) include:

	Legal basis	Vulnerability period
(a)	<p>Unauthorised related - party transactions</p> <p>Certain related - party transactions between the company and related parties of the company that were not approved by the relevant corporate bodies (pursuant to Article 162 of the Law on Enterprises for JSCs and Articles 67 and 86 of the Law on Enterprises for LLCs).</p>	The law on enterprises does not provide for a specific period during which the transaction may be challenged; possibly, a two - year period may be applied pursuant to Article 132.1 of the Civil Code.
(b)	<p>Transactions that are "ultra vires" for the company</p> <p>Transactions that the company has entered into beyond its licensed scope of operations (pursuant to Article 123 of the Civil Code).</p>	No specific period
(c)	<p>Transactions beyond the scope of authority of the legal representative</p> <p>Certain transactions where the so - called legal representative (the concept is explained in additional detail in sections 1.4.9 and 1.4.10 below) acts beyond the scope of authority set out in the charter of the company.</p>	The law on enterprises does not provide for a specific period during which the transaction may be challenged; possibly, a two - year period may be applied pursuant to Article 132.1 of the Civil Code.
(d)	<p>Transactions beyond the scope of authority of the person entering into the transaction on behalf of the company</p> <p>Transactions where a director or employee acts on behalf of the company but beyond the power to represent the company (pursuant to Articles 142 and 143 of the Civil Code). Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions.</p>	No specific period
(e)	<p>Dividend payments that were made in breach of the conditions for dividend payments and / or payments made for the redemption of shares by the company (e.g. in violation of the company's obligation to be able to meet its obligations to creditors under Article 133 of the Law on Enterprises for JSCs and Articles 52 and 69 for LLCs).</p>	No specific period

1.4.3 The above-mentioned transactions are invalid⁷ per se without the requirement that they are specifically challenged. However, if such transactions have been entered into, they may appear to be valid unless the grounds that render such transaction invalid are actively raised by a creditor or asset management officer or asset management and liquidation enterprise in the event of a bankruptcy. The issue of personal liability of the directors and officers of the company in the context of these transactions is addressed in S 2 below.

Unauthorised related - party transactions

1.4.4 Related-party transactions between the company and certain related parties (including, for example, its shareholders, directors, and related persons of these) are subject to the approval by different corporate bodies depending on the form of the company and the value of the transaction. The approval requirements are as follows:

- (a) in a JSC, these transactions would be subject to the approval by the board of management unless the value of the transaction equals at least 35 per cent of the value of the company's assets (or a lesser amount if so provided in the company's charter) in which case the general meeting of shareholders must approve the transaction;⁸

⁷ The transactions under 1.4.2(c) and (d) may still form a valid contract between the person who has exceeded his authority in acting on behalf of the company and the counter-party and may then be challenged by the counter-party who thought to contract with the company.

⁸ Article 162 of the Law on Enterprises.

- (b) similarly, in an LLC with at least two members, the so-called members' council is required to authorise any related - party transactions;⁹ and
- (c) in a one - member LLC (essentially a company with a single shareholder), related - party transactions must be approved by way of a vote among the company chairman (or members' council, where a members' council has been established), the general director and the so - called "inspector(s)".¹⁰

1.4.5 If these formal requirements are not complied with, the relevant transaction is void and may be challenged by a creditor or the asset management officer or asset management and liquidation enterprise. Of note, unless the charter provides otherwise, there is no requirement for these transactions to be carried out at proper arm's length so the approval requirement *per se* does not necessarily abolish the risk of abuse.

1.4.6 The Law on Enterprises does not provide for a specific period during which a related - party transaction that has not been properly approved may be challenged. There is an argument that the two - year period that Article 132.1 of the Civil Code provides for certain invalid transactions may be applied by way of analogy; however, this is not tested under Vietnamese law.

Transactions that are "ultra vires" for the company

1.4.7 Under Vietnamese law, a company may only enter into commercial transactions that fall within the licensed scope of activities of the company. Contracts and transactions that are outside of the permitted scope are deemed invalid¹¹. This may provide grounds for a creditor or the asset management officer or asset management and liquidation enterprise to challenge commercial transactions, for example, where the company has provided credit to related parties outside of a regular commercial transaction within its regular scope of activities.

1.4.8 Neither the Law on Enterprises nor the Civil Code provide for a specific period during which the invalidity of the transaction would have to be raised. As the requirement to act within the permitted scope of operations is a matter of public order, we believe that it is less likely that the two - year period set out in Article 132.1 of the Civil Code would be applied.¹²

Transactions beyond the scope of authority of the legal representative

1.4.9 In Vietnamese companies, the so - called legal representative represents the company in entering into transactions, dealing with State authorities and acts overall on behalf of the company. The charter of a JSC determines whether the legal representative is the chairman of the board of management or its general director¹³. For LLCs, the charter provides the managerial position of the legal representative¹⁴, and for one-member LLCs whether the company chairman / chairman of member's council holds this function¹⁵. The authority of the legal representative is based, in part, on Vietnamese laws and regulations (such as the Law on Enterprises) and may also be more closely defined in the company's charter. Vietnamese law is not clear on whether limitations that the charter imposes on a legal representative (e.g. in the form of approval requirements for certain transactions) render a transaction automatically invalid. However, there have been precedents, in particular where the legal representative acted fraudulently, where the Vietnamese court have determined that transactions exceeding the authority provided in the charter were void. Creditors or the asset management officer or asset management and liquidation enterprise may be able to rely on this, for example where the legal representative has disposed of assets, provided credit or carried out other transactions to the detriment of the company which were outside of the scope of authority granted to the legal representative in the charter.

⁹ Article 67 of the Law on Enterprises.

¹⁰ Article 86 of the Law on Enterprises.

¹¹ Article 123 of the Civil Code. The New Civil Code is now in force.

¹² In this context, Article 132.3 of the Civil Code provides that transactions in breach of Vietnamese laws are invalid and that there is no time-limit to challenge these. This may, for example, be the case where the purpose of the transaction is unlawful.

¹³ Articles 134 of the Law on Enterprises.

¹⁴ Articles 13.2 of the Law on Enterprises.

¹⁵ Article 78 of the Law on Enterprises.

- 1.4.10 The Law on Enterprises does not provide for a specific period during which such a transaction may be challenged. There is an argument that the two - year period that Article 132.1 of the Civil Code provides for certain invalid transactions may, by way of analogy, also be applied in this context; however, this is not tested under Vietnamese law. If the legal representative acted fraudulently, Article 132.3 of the Civil Code clarifies that no time-limit to challenge such a fraudulent transaction exists.

Transactions beyond the scope of authority of the person entering into the transaction on behalf of the Company

- 1.4.11 Under Vietnamese law, while a power of attorney may be given to other directors or employees of the company, the formal requirements for representation are relatively strict. It is therefore common to see transactions attacked that were entered into by a person other than the legal representative but where either (i) the authority given to the authorised person did not comply with these formal requirements or was not exercised in accordance with all formal requirements (such as the use of the company's seal), or (ii) where the authorised person acted beyond the power to represent the company.¹⁶

- 1.4.12 In these circumstances, Vietnamese law does not provide for a specific period during which the transaction would have to be challenged.

Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions

- 1.4.13 Dividend payments to shareholders and any distribution of profits to members of an LLC may only be made if the company is still in a position to meet its obligations to creditors following the distribution of dividends.¹⁷ Shareholders (respectively members) that have received payments in breach of these requirements are required to reimburse the distributions to the company.¹⁸

- 1.4.14 Similar considerations apply where the company has redeemed shares (in the case of a JSC) or the company has reduced its charter capital (in the case of a multi - member LLC).¹⁹

- 1.4.15 There is no specific time during which the unlawful distribution of dividends or the redemption of shares / capital would have to be challenged.

¹⁶ Articles 142 and 143 of the Civil Code.

¹⁷ Article 132 of the Law on Enterprises for JSCs and Article 69 of the Law on Enterprises for LLCs.

¹⁸ According to Articles 133 and 70 of the Law on Enterprises respectively.

¹⁹ According to Articles 131.1, 133 and 68.3 and 70 of the Law on Enterprises respectively.

QUESTION 2

2. Actions potentially giving rise to liability for directors

- (a) In respect of which acts during the twilight period may a director be held personally liable or which may otherwise have adverse consequences for the director?
- (b) In relation to each act identified in (a) above:-
- (i) Is the director's liability considered to be civil, criminal or both?
 - (ii) Can a director be made personally liable for all or part of the company's losses or for all or part of the deficit to creditors?
 - (iii) Will liability attach to all the directors or to individual directors in proportion to their specific involvement?
 - (iv) Is there a specified period before commencement of a subsequent insolvency procedure within which the relevant act must have been undertaken in order for liability to attach to a director? and
 - (v) What defences, if any, will be available in relation to each offence?

2.1 Overview of company forms and types of directors and officers in Vietnam

- 2.1.1 Legal entities and company forms permitted under the Law on Enterprises include LLCs, JSCs, partnerships and private enterprises. LLCs and JSCs are by far the most common types of enterprises in Vietnam.
- 2.1.2 The Law on Enterprises provides for two types of LLCs, namely, multi - member LLCs and one - member LLCs (where a single member has contributed capital to the company).
- Multi - member LLCs
- 2.1.3
- (a) A multi - member LLC must have at least two members and may not have more than 50. Members may be organisations or individuals. A multi - member LLC is managed by a so - called members' council (which includes all of the members - who may be individuals or representatives of corporate members), the chairman of the members' council, and its general director.
 - (b) The general director is responsible for the company's day - to - day operations while the members' council provides oversight of the general director's management and the affairs of the company. The members' council also retains substantial decision - making authority over the company's strategy and fundamental decisions.
 - (c) An LLC with 11 members or more must have an inspection committee (sometimes referred to as a supervisory board). Even where no inspection committee is required, the company's charter may provide that a 'voluntary' inspection committee be established within the company's corporate governance framework. The inspection committee has a role that is, in part, similar to that of an audit committee, although its reports are submitted directly to the members.
 - (d) Whilst the broader corporate governance system of LLCs thus more closely resembles that of a unitary company structure, LLCs with a larger number of members or those that have opted to establish an inspection committee bear certain elements of a two - tiered management structure. It is also important to note that the members' council has a dual function, including elements of a 'general meeting of shareholders' (or congregation of the owners of an LLC) as well as certain direct management functions. As such, it has certain rights and obligations that go beyond those of a traditional board of directors.

- (e) In order to separate the members' council from its management role, larger LLCs, in particular those with foreign investment often establish a board of directors that more closely resembles that of the board of directors of companies established in common law jurisdictions, thereby filling the corporate governance gap between the members' council and the general director.
- (f) Lastly, as noted above, the legal representative fulfils certain specific responsibilities of the company, in particular in entering into transactions and contracts, in representing the company before the court, signing financial statements of the company, interacting with the authorities, and so forth.

One - member LLCs

- 2.1.4 (a) A one - member LLC is an LLC with a single investor, such as a 100 per cent foreign - owned enterprise with only one parent company. A one - member LLC owned by an organisation can follow one of two forms. The first one comprises chairman of the company, general director and inspectors. The second form comprises members' council, general director and inspectors.
- (b) If the charter of a one-member LLC owned by organisation does not provide for the managerial position of a legal representative, the chairman of the member's council or the chairman of the company (the chairman being the owner's representative) shall be the legal representative of the company.²⁰ The LLC owner shall decide on the number of inspectors, the appointment of inspectors for a term not exceeding 5 years, and on the establishment of an inspection committee.

Joint Stock Companies (JSCs)

- 2.1.5 (a) A JSC (or shareholding company) is a company whose charter capital is divided into shares. Shareholders may be corporate entities or individuals. The minimum number of shareholders is three and there is no restriction on the maximum number of shareholders. JSCs may take the form of either closely - held companies as well as listed or public companies in Vietnam (only JSCs may be listed and / or public companies).
- (b) The highest decision - making body of a JSC is its general meeting of shareholders. A JSC is managed by a board of management²¹ and a general director. JSCs can take on of two forms. The first form comprises a general meeting of shareholders, a board of management, an inspection committee and a general director or director. If a JSC has less than 11 shareholders and the shareholders being organizations own less than 50 per cent of the total shares of the company, it is not required to have an inspection committee.²² The second form comprises a general meeting of shareholders, a board of management and a general director or director. In this case, at least 20 per cent of the members of the board of management must be independent members²³ and there must be an internal auditing committee under the board of management. Independent members shall perform the function of supervision and organize implementation of control of the management and operation of the company.²⁴ The chairman of the board of management or the general director – as determined by the company's charter – is the legal representative of the company. If the charter is silent then the chairman of the board of management is the legal representative of the company. If the company has more than one legal representative, both the chairman of the board of management and the general director are legal representatives of the company.²⁵

²⁰ Article 78 of the Law on Enterprises.

²¹ Although referred to as a 'board of management' in Vietnam, such board of management is similar to the board of directors in common law jurisdictions. For the sake of consistency with Vietnamese legal terminology, the term 'board of management' is used throughout this chapter when reference to the board of a JSC is made.

²² Article 134 of the Law on Enterprises.

²³ Independent member means a member not being a person: (i) currently working for the company or any subsidiary of the company, (ii) having worked for the company or any subsidiary of the company for at least the three preceding years, (iii) who is currently entitled to salary or remuneration from the company, except for allowances which members of the board of management are entitled to in accordance with regulations, (iv) whose spouse, parent, adoptive parent, child, adopted child or sibling is a major shareholder of the company, or a manager of the company or its subsidiary, (v) directly or indirectly owning at least 1% of the total voting shares in the company, and (vi) having been a member of the board of management or the inspection committee of the company for at least five preceding years (Article 151.2 of the Law on Enterprises).

²⁴ Article 134 of the Law on Enterprises.

2.2 General comments on liability of directors in Vietnam

- 2.2.1 In practice, the issue of directors' liability remains largely untested in Vietnam. This is in part because in Vietnam, the owners are largely the company's directors. In addition, the overall application of the Law on Bankruptcy remains extremely limited. There is no system of binding precedents and court rulings are normally not published in Vietnam and precedents has just recently been published. It thus remains challenging in Vietnam to put forward a firm presentation of the (possible) application of the law by the court or, for that matter, any empirical evaluation with a reliable degree of precision. There have, however, been a small number of reported cases of directors who have been held liable personally and have faced administrative or criminal prosecution. Civil cases, in particular actions brought by the company against a current or former director, seem rare.
- 2.2.2 Nevertheless, it is becoming more common to appoint external directors and managers and the Law on Enterprises and other regulations include more specific provisions on the liability of directors than was previously the case. It is therefore expected that these matters will be put to the test sooner rather than later.
- 2.2.3 A particular development in this regard is Circular 121/2012/TT-BTC dated 26 July 2012 by the Ministry of Finance providing regulations on corporate governance applicable to public companies (Circular 121) which sets out specific additional requirements, and corresponding liabilities, for directors of public companies (including listed JSCs as well as other public companies, i.e. JSCs with at least 100 shareholders). These are discussed in more detail in S 2.9(c) below.

2.3 Voidable transactions under the Law on Bankruptcy entered into during the “twilight period”

Currently, directors, in particular the company's legal representative, are not liable to the company or to creditors for having entered into voidable transactions under the Law on Bankruptcy during the “twilight period” except in the following circumstances: -

- (a) The voidable transaction coincides with a breach of the director's labour contract or services agreement with the company (this scenario is described in more detail in S 2.8 below).
- (b) The voidable transaction coincides with a breach of the director's fiduciary duties or other duties of care owed to the company (this scenario is described in more detail in S 2.9 below).
- (c) These have involved transactions that constitute fraud against creditors or fraud against customers (these scenarios are described in more detail in sections 2.12 and 2.13 below).

Current Vietnamese bankruptcy regulations allow for the enterprise itself to be fined in the event that it enters into certain prohibited transactions without reporting to the asset management officer or asset management and liquidation enterprise after it has received the decision of the court that bankruptcy proceedings will be commenced (i.e. after the “twilight period” has ended).²⁶ However, these relate to obligations of the enterprise as such and not to its directors personally.

2.4 Unauthorised related - party transactions

- (a) The legal representative as well as the relevant “related person” with whom the unauthorised transaction has been entered into (which may include a member / shareholder or a director of the company as well as other related persons) are liable to compensate the company for any damages arising from the unauthorised transaction and return to the company any benefits gained from the performance of such contract or transaction.
- (b) (i) Liability is civil.

²⁵ Article 134 of the Law on Enterprises.

²⁶ Article 57 of Decree 110.

- (ii) Personal liability extends to the full loss incurred by the company and is generally joint and several together with any other related person that is liable to the company (i.e. the related person that has entered into the unauthorised transaction). However, the Vietnamese court have substantial discretion in determining the extent of the loss and any allocation among the obligors.
- (iii) The court may therefore decide that the liability of the legal representative should be proportionate to his involvement (e.g. of a lesser extent where the legal representative was not directly involved and the unauthorised transaction was carried out by another director or employee under a power of attorney). The legal representative also has recourse against the related parties that are jointly liable with the legal representative to the extent of their respective contribution.²⁷
- (iv) There is no specified period.
- (v) Under the Law on Enterprises, the liability for entering into an unauthorised related-party transaction attaches to the legal representative irrespective of whether the legal representative acted with intent or only negligently (e.g. where the legal representative did not know that the contracting party was a related person). It is not clear under Vietnamese law whether the legal representative could successfully invoke that he was not directly involved in the transaction (as in the example above where the legal representative did not act directly).

2.5 Transactions that are *ultra vires* for the company

In these circumstances, the legal representative may be liable for misrepresentation to the counterparty that has entered into the transaction. In addition, in the event that the company has incurred any damages or losses, the legal representative may also be liable for breach of the labour contract or director's service agreement with the company (this scenario is addressed in more detail under S 2.8 below).

2.6 Transactions beyond the scope of authority of the legal representative

The liability of the legal representative is identical to those set out under S 2.5 above. In addition, where the legal representative colluded with the counterparty against the interests of the company, the legal representative and the counterparty are jointly liable to the company.²⁸

2.7 Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions

- (a) The Law on Enterprises²⁹ provides that members of the board of management of a JSC are jointly liable together with shareholders for debts of the company up to the amount of dividends or payments for redemptions of share capital that have been distributed to shareholders unlawfully but which cannot be recovered. There is no corresponding provision for LLCs and it is unclear under Vietnamese law whether a comparable liability would be imposed on the members of a members' council or the company chairman in the event that an unlawful distribution of profits has been made (or where capital has been redeemed in contravention of the legal requirements for a redemption of capital). However, there is no reason to treat these two scenarios differently and this may simply have been an oversight of the legislator.
- (b) (i) Liability is civil.
- (ii) The personal liability of members of the board of management is limited to the lower of the amount that has been distributed and the debt of the company that cannot be serviced as a consequence of the distribution. The law is not clear on whether the obligation is owed to the company (i.e. repayment is to be made to the company) or whether creditors would have a direct claim, although the wording of the law suggests the latter. Accordingly, the company and the members of the board of management would then become joint and several debtors until and unless the members have satisfied one or more creditors' claims up to the amount that has been unlawfully distributed.

²⁷ Article 288.2 of the Civil Code.

²⁸ Article 143.4 of the Civil Code.

²⁹ Article 133 of the Law on Enterprises.

- (iii) The Law on Enterprises provides that the members of the board of management are jointly liable. A member has recourse against other members of the board of management who are jointly liable to the extent of their respective contribution.³⁰
- (iv) There is no specified period.
- (v) Under the Law on Enterprises, the liability for distributing dividends without the company meeting the legal requirements for the distribution initially attaches to all members of the board of management irrespective of whether they were involved in the decision (e.g. even where a member of the board of management was absent from the meeting when the distribution was resolved). It is not clear under Vietnamese law whether a member could successfully invoke that he was not involved in the decision or whether this would only mean that the member would be given full recourse to other members (but would remain liable to creditors nevertheless).

2.8 Breach of labour contract / service agreement

- (a) Certain acts carried out by the legal representative and / or other directors of the company during the “twilight period” may constitute a breach of their respective labour contracts (where there is an employment relationship with the director) or the service agreement with the director. This may, for example, occur where the management fails to file on time for bankruptcy or where preferences are granted. The legal representative and / or other directors may then be liable for breach of their contractual arrangements with the company.
- (b) (i) Liability is civil.
- (ii) Where more than one director has acted in concert with another (or has failed to act), they would be jointly liable to the company.
- (iii) A director has recourse against other directors that are jointly liable to the extent of their respective contribution.³¹
- (iv) There is no specified period.
- (v) There are no specific defences. However, please see the section on indemnity at question 10 below.

2.9 Breach of other directors’ duties

- (a) Directors owe certain fiduciary duties to the company with the details depending on the type of director and the type of company. Broadly, directors must act in a fiduciary and diligent manner and in the best interests of the company. Labour contracts with directors (respectively service agreements between them and the company) will typically incorporate a director’s obligations under Vietnamese law as part of the contractually owed duties (and as such, breaches of these are also breaches of the underlying contractual arrangement, as discussed in S 2.8 above). However, where this is not the case, a director still owes these duties to the company under Vietnamese law and may be held personally liable in the event of a breach.
- (b) (i) Liability is civil.
- (ii) Where more than one director has acted (or has failed to act), they would be jointly liable to the company.
- (iii) A director has recourse against other directors that are jointly liable to the extent of their respective contribution.³²
- (iv) There is no specified period.
- (v) There are no specific defences. However, please see the section on indemnity at question 10 below.

³⁰ Article 288.2 of the Civil Code.

³¹ Article 288.2 of the Civil Code.

³² Article 288.2 of the Civil Code

Directors' duties in public companies

Circular 121 on the corporate governance of public companies lists in comparatively more detail the responsibilities and duties of various directors of public JSCs, including:

- (i) for members of the board of management - “to implement their duties in an honest and diligent manner in the best interests of the shareholders and the company”;³³ and
 - (ii) for the inspection committee - “to supervise the financial situation of the company, the legality of activities of the members of the board of management, of the executive Director (General Director) and other managers, the co-ordination of activities between the inspection committee and the board of management, the executive Director (General Director) and the shareholders, and other duties stipulated by law and the company charter in order to protect the legitimate interests of the company and its shareholders”.³⁴
- (d) Although Circular 121 as such does not provide much detail on the ensuing liability of directors from these responsibilities, Article 36.1 of the Model Charter for Public Companies attached to Circular 121 provides that - “Members of the Board of Management, members of the Inspection Committee, the executive Director (General Director) and other managers who breach their obligations and responsibilities for honesty and prudence or fail to fulfil their obligations with due diligence and professional capability must be responsible for any loss and damage caused by their breach”.
- (e) The Model Charter is not, *per se*, mandatory for public companies and public companies may adopt charters that include provisions that differ from the above. However, the Model Charter (i) sets out the expectation of the regulator of public companies (the Ministry of Finance and its agency, the State Securities Commission, which directly supervises public companies) and (ii) tends to be a benchmark in practice when the regulator reviews filings for IPOs and / or listings on Vietnam’s stock exchanges. As such, it is likely that the specific liabilities of directors of public companies as set out in the Model Charter will substantially shape directors’ liability in public companies.

2.10 Failure to file a petition to commence bankruptcy proceedings

- (a) Where the legal representative fails to file a petition for bankruptcy proceedings upon becoming aware that the company has become insolvent, the legal representative is subject to an administrative fine³⁵. The administrative fine that may be applied ranges from VND 1 million to VND 3 million (about USD 44 to USD 133) - too low to act as a real deterrent.
- (b) (i) Liability is administrative.
- (ii) The legal representative is personally liable for the full amount of the administrative penalty.
- (iii) A fine may also be imposed on the owner of the private enterprise, chairman of the board of management of a JSC, chairman of the members’ council of a multi - member LLC, owner of a one-member LLC, or an unlimited liability partner of a partnership company. However, in the event that two fines are issued, the owner of the private enterprise, the chairman of the board of management of a JSC, chairman of the members’ council of a multi - member LLC, owner of a one-member LLC, or an unlimited liability partner of a partnership company and the legal representative are both personally liable.
- (iv) The legal representative must file a petition to commence bankruptcy proceedings when the enterprise becomes insolvent.³⁶
- (v) There is no specific defence available to the legal representative. However, in light of the two main conditions that (i) the legal representative had to be aware that the company was insolvent and (ii) has to comply with the obligation to file for bankruptcy when the enterprise becomes insolvent, the scope of application of the provision is very narrow (in addition to the fact that the range of administrative fines is very small).

³³ Article 13.2 of Circular 121.

³⁴ Article 21.1 of Circular 121.

³⁵ Article 5.3 of the Law on Bankruptcy, Article 54 of Decree 110.

³⁶ Article 5.3 of the Law on Bankruptcy.

2.11 Falsification of accounting records

- (a) Decree 105/2013/ND-CP dated 16 September 2013 of the Government on sanctioning of administrative violations in the accounting domain and independent audit sets out a number of accounting - related administrative violations, including the falsification of records for accounting purposes, making or instructing incorrect accounting entries and so forth. If these violations are committed by a director, the director is subject to various administrative penalties, although for each infraction, the maximum administrative fine that may be applied is capped at VND 30 million (about USD 1,333).
- (b) (i) Liability is administrative.
- (ii) The director who was involved in the violation is personally liable for the full amount of the administrative penalty.
- (iii) In the event that more than one fine is issued to different persons involved in the violation, each person is personally liable for the administrative fine issued to them.
- (iv) There is no specified period.
- (v) There is no specific defence available to the director involved, although Decree 105 recognises a number of mitigating circumstances that, if present, must be considered when the amount of the fine is determined (such as self - reporting of the violation, the violation being a first - time offence and others).

2.12 Transactions in fraud of creditors

- (a) Under Article 174 of the Criminal Code,³⁷ a director who appropriates property through fraud commits a criminal offence. This can include property or assets obtained by the company, which was already insolvent at the time of the transaction.
- (b) (i) Liability is criminal.
- (ii) The offence is punishable by imprisonment. The maximum term of imprisonment is dependent on the value of the property or assets that were defrauded. Offenders may also be banned from holding certain posts, such as directorships from one to five years.
- (iii) A civil action may be linked to a criminal action in Vietnam but only where there are specific civil grounds to claim damages that relate to the same subject matter that is being dealt with by the criminal court. This would typically be the case in a fraud - related matter as the offender would also be liable under civil law to reimburse the victim pursuant to Article 584 of the Civil Code.
- (iv) There is no specified period.
- (v) There is no specific defence available to the director involved, although the Criminal Code recognises a number of mitigating circumstances.

2.13 Transactions that defraud customers

- (a) Under Article 198 of the Criminal Code, a person who defrauds customers for at least VND 5 million (about USD 222) commits a criminal offence. This can include, for example, a situation where a materially insolvent company takes deposits or prepayments from customers but is then unable to deliver the products or services for which the deposits have been taken.
- (b) (i) Liability is criminal.

³⁷ The Criminal Code No. 100/2015/QH13 dated 27 November 2015, which was due to enter into force on 1 July 2016. The National Assembly postponed the effectiveness of the new Criminal Code. Prior to the new effective date, the Criminal Code No. 15/1999/QH10 (as amended) and provisions of the Criminal Code No. 100/2015/QH13 removing a crime, a sentence, an aggravating factor or providing for a less severe sentence, a new mitigating factor, or increasing the scope of probation, exemption or conviction expungement of criminal responsibility, exemption from sentence, commutation, additional parole, or conviction expungement, and other provisions which is more favourable are effective. Please note that the substance of the provisions of the Criminal Code No. 100/2015/QH13 cited in this Chapter are not different from the corresponding ones of the Criminal Code No. 15/1999/QH10 save for an article cited in Section 6.2(b) (please refer to footnote 56).

- (ii) The offence is punishable by imprisonment and / or a fine. The maximum term of imprisonment is five years. Offenders may also be banned from holding certain posts, such as directorships from one to five years.
- (iii) A civil action may be linked to a criminal action in Vietnam but only where there are specific civil grounds to claim damages that relate to the same subject matter that is being dealt with by the criminal court. This would typically be the case in a fraud - related matter as the offender would also be liable under civil law to reimburse the victim pursuant to Article 584 of the Civil Code.
- (iv) There is no specified period.
- (v) There is no specific defence available to the director involved, although the Criminal Code recognises a number of mitigating circumstances.

2.14 Criminal liability applicable to directors of State - Owned Enterprises (SOEs)

Selected provisions under which directors of SOEs may be criminally liable

- 2.14.1 Vietnam's Criminal Code includes a number of offences that provide for the criminal liability of State officials in the area of economic management. These may include (without limitation):
- (a) Article 219 of the Criminal Code: Acting against the regulations on management and use of State - owned property, causing losses or wastefulness. This Article criminalises the abuse of power or position (e.g. of directors in SOEs) that causes losses to the State;
 - (b) Article 356 of the Criminal Code: Abusing positions and / or powers while performing official duties. This Article criminalises the abuse of position or powers by State officials for self - seeking purposes causing damage to the State and / or to the legitimate rights and interests of citizens;
 - (c) Article 357 of the Criminal Code: Abusing powers while performing official duties. This Article may apply where State officials (including directors of SOEs), for self - seeking or other personal motivation, act beyond their powers and contrary to their official duties, causing damage to the interests of the State and / or the legitimate rights and interests of citizens;
 - (d) Article 359 of the Criminal Code: Forgery in the course of employment. Under this Article, a director who, for reasons of personal motivation, falsifies or forges documents or signatures, commits a criminal offence. Of note, there needs to be an element beyond the falsification of company records, such as the intent to obtain a personal gain; and
 - (e) Article 360 of the Criminal Code: Negligence of responsibility causing serious consequences. Under this Article, State officials may be criminally liable for negligent mismanagement of State assets.
- 2.14.2 In practice, there have been a number of cases where directors who were State officials have been convicted of the mismanagement of assets (including in the recent high - profile bankruptcy of Vietnam's largest State - owned shipbuilding conglomerate, Vinashin). While a number of these offences require that the director must be a State official, other provisions apply irrespective of this and only require that the director is involved in the management of SOEs (but need not be a State official).

2.15 Incurring further credit

There is no separate concept or provision that would forbid the company or its directors from incurring further credit unless in the context of the above grounds for civil, administrative or criminal liability of the director (most notably, fraud). This issue is further discussed under question 4.4 below.

QUESTION 3

3. Other persons involved with the company’s affairs who may become liable in relation to their actions during the twilight period

- (a) In addition to those persons referred to in 1(a) above, can others be held liable in respect of the company’s activities during the twilight period?
- (b) In respect of which acts may other persons be held liable and to what extent does the liability of those other persons differ from that for directors identified in Question 1(a) above?
- (c) Can those other persons be made personally liable for all or part of the company’s losses or for all or part of the deficit to creditors?

3.1 No *de facto* or shadow directors in Vietnam

In Vietnam, only formally appointed or elected directors have the status of directors and are subject to the respective provisions holding them liable. There is no concept of *de facto* or shadow directors.

3.2 Liability of other persons

3.2.1 A number of the legal grounds for personal liability set out under question 2 above apply to the person who was acting in the circumstances irrespective of whether such person was a director of the company or not.

3.2.2 Overview of liability of other persons

Offences / activity	Persons liable (other than directors)	Extent of liability
Unauthorised related-party transaction	Related party	Same as for legal representative
Transactions beyond the scope of authority of the legal representative	Counterparty to the transaction if the counterparty colluded with the legal representative	Same as for legal representative
Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions	Member or shareholder that has received dividends or payments for redemption of shares / capital	Same as for members on the board of management
Falsification of accounting records	Person falsifying accounting records	Same as for director
Transactions in fraud of creditors	Person committing fraud	Same as for director
Transactions in fraud of customers	Person committing fraud	Same as for director

3.2.3 Counterparties to a voidable transaction may be liable to rescind the transaction. This is addressed in more detail under question 4 below.

3.3 Extent of liability of other persons

The liability of the non - directors set out under S 3.2 is, in each case, identical to that of the director(s).

QUESTION 4

4. Transactions during the twilight period

- (a) On what basis may transactions with the company in the twilight period being set aside?
- (b) What defences, if any, are available to a party seeking to protect a transaction from being attacked?
- (c) On what basis may directors and other persons involved with the company's affairs properly incur further credit during the twilight period?

4.1 Introduction

4.1.1 As noted under sections 1.3 and 1.4 above, certain transactions entered into during the twilight period may be voidable under the Law on Bankruptcy or they may never have had legal effect in the first place; this will only become apparent in a bankruptcy when the operations of the company become subject to scrutiny.

4.1.2 In the case of voidable transactions under the Law on Bankruptcy, the law deems that the contracting party to these transactions enjoys less protection than the bankruptcy estate of the insolvent company and, ultimately, its creditors. Given the limited scope of application of the clawback provision (in terms of both the limited duration of the clawback period and the limited cases in which a transaction may be attacked by the asset management officer or asset management and liquidation enterprise or an unsecured creditor), this appears justified.

4.2 Transactions which may be set aside under the Law on Bankruptcy

4.2.1 Transaction relating to asset assignment which is not at market price³⁸

Where a transaction relating to an asset assignment during the clawback period was not at market price, the counterparty enjoys no protection and the transaction may be attacked. These transactions may take the form of (i) a sale for less than the asset's market value and (ii) a purchase of something at a greater consideration than its value, thus moving money to another party.

There is no specific defence available to the counterparty. If the transaction involved moveable assets that have already been acquired by a *bona fide* third party, the assets cannot be reclaimed.³⁹ It is not clear whether the proceeds from such transaction would automatically substitute for the assigned assets and would have to be provided to the insolvent company. This does not apply to immovable property which may be not be acquired by a third party *bona fide* purchaser or acquirer unless the acquisition took place by way of a public auction or based on a State decision (such as the enforcement of a court order).⁴⁰

4.2.2 Conversion of an unsecured debt into a debt secured or partly secured by the assets of the company⁴¹

A creditor that obtained (additional) security during the clawback period would have to return such security (respectively release the security) provided by the insolvent company.

In the event that the creditor has already enforced the security prior to the court's decision to accept jurisdiction over the bankruptcy, a *bona fide* third party buyer would be entitled to keep the assets. It is not clear whether the proceeds from such a transaction would automatically substitute for the debt and would have to be provided to the insolvent company.

³⁸ Article 59.1(a) of the Law on Bankruptcy.

³⁹ Article 133.1 of the Civil Code.

⁴⁰ Article 133.2 of the Civil Code.

⁴¹ Article 59.1(b) of the Law on Bankruptcy.

4.2.3 Donations of moveable or immoveable property to another person⁴²

- (a) The bankruptcy court may rule that the donation of any moveable or immoveable property from the company to another person was unlawful if it occurred during the six months prior to the issuance of a decision commencing the bankruptcy procedures of the company. The counterparty who received the assets is required to return such property if the transaction is attacked. The enforcement of the decision of the bankruptcy judge must be carried out by the asset management officer or an asset management and liquidation enterprise (employing the civil enforcement authorities where the order is not voluntarily complied with).
- (b) There is no specific defence available to the counterparty. However, if the transaction included the donation of moveable assets and the counterparty has already sold (or even donated) these to a *bona fide* third party, the assets cannot be reclaimed.⁴³ It is not clear whether the proceeds from such transaction would automatically substitute for the donated property and would have to be provided to the insolvent company. This does not apply to immoveable property which may not be acquired by a third party *bona fide* purchaser or acquirer unless the acquisition took place by way of a public auction or based on a State decision (such as the enforcement of a court order).⁴⁴

4.2.4 Settlement of a debt with a sum that is larger than a debt which has become due⁴⁵

- (a) Where a transaction has occurred that is clearly unfavourable to the (now insolvent) company during the clawback period, the counterparty also enjoys no protection and the transaction may be attacked. The provision intends to capture “fire sales” or transactions that may have taken place under particular duress from the perspective of the bankrupt company. The entire transaction would be voided and it would not be maintained at a level which would be seen as balanced or adequate.
- (b) There is no specific defence available to the counterparty. If the transaction involved moveable assets that have already been acquired by a *bona fide* third party, the assets cannot be reclaimed.⁴⁶ It is also not clear whether the proceeds from such a transaction would automatically substitute for the other party and would have to be provided to the insolvent company.

4.2.5 Payment of undue debts⁴⁷

- (a) In the event that the (now insolvent) company has paid an undue debt to the counterparty during the clawback period, the counterparty will be required to repay the debt.
- (b) There is no specific defence available to the counterparty.

4.2.6 Transaction being outside the purpose of business operation of the company⁴⁸

- (a) The court may rule that transactions outside the purpose of business operation of the company be voidable. Parties may return to each other what they have received.
- (b) There is no specific defence available to the counterparty.

4.2.7 Other transactions for the purpose of disposing of assets of the enterprise or co-operative⁴⁹

- (a) While the voidable transactions set out under sections 4.2.1 to 4.2.6 above do not require any intent on the part of the company (respectively, its management) that later becomes insolvent, Article 59.1(e) of the Law on Bankruptcy allows transactions to be voided that were entered into for the purpose of disposing of assets of the company.

⁴² Article 59.1(d) of the Law on Bankruptcy.

⁴³ Article 133.1 of the Civil Code.

⁴⁴ Article 133.2 of the Civil Code.

⁴⁵ Article 59.1(c) of the Law on Bankruptcy.

⁴⁶ Article 133.1 of the Civil Code.

⁴⁷ Article 59.1(c) of the Law on Bankruptcy.

⁴⁸ Article 59.1(dd) of the Law on Bankruptcy.

⁴⁹ Article 59.1(e) of the Law on Bankruptcy.

- (b) There is no specific defence available to the counterparty. It is, however, not clear whether the provision is to be construed so that both parties to the transaction had to act with intent and, in particular, had to be aware of the impending bankruptcy or whether it is sufficient that the company (respectively, its management) was aware at the time of the transaction that the company was already in financial distress.

4.3 Transactions which may be set aside under non-bankruptcy specific regulations

Unauthorised related - party transactions

- 4.3.1 (a) Please refer to sections 1.4.4 to 1.4.6 above.

- (b) There is no specific defence available to the counterparty. It is irrelevant whether the related party was unaware that the transaction was not authorised. The comments on *bona fide* third parties under S 4.2.1(b) equally apply.

Transactions that are “*ultra vires*” for the company

- 4.3.2 (a) Please refer to sections 1.4.7 and 1.4.8 above.

- (b) There is no specific defence available to the counterparty. It is irrelevant whether the related party was unaware that the transaction was not within the permitted scope of activities. The comments on *bona fide* third parties under S 4.2.1(b) equally apply.

Transactions beyond the scope of authority of the legal representative

- 4.3.3 (a) Please refer to sections 1.4.9 and 1.4.10 above.

- (b) There is no specific defence available to the counterparty. It is irrelevant whether the counterparty was unaware that the transaction was not within the permitted scope of authorisation of the legal representative. The comments on *bona fide* third parties under S 4.2.1(b) equally apply. However, the counterparty may have recourse to damages directly against the legal representative.⁵⁰

Transactions beyond the scope of authority of the person entering into the transaction on behalf of the Company

- 4.3.4 (a) Please refer to sections 1.4.11 and 1.4.12 above.

- (b) There is no specific defence available to the counterparty. It is irrelevant whether the counterparty was unaware that the transaction was not within the permitted scope of authorisation of the person claiming to act on behalf of the company. The comments on *bona fide* third parties under S 4.2.1(b) equally apply. However, the counterparty may have recourse for damages directly against the person claiming to represent the company.⁵¹

Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions

- 4.3.5 (a) Please refer to sections 1.4.13 to 1.4.15 above.

- (b) There is no specific defence available to the shareholder / member. It is irrelevant whether the shareholder / member was unaware that the distribution of dividends / redemption of shares / capital was unlawful.

4.4 Risks for directors

- 4.4.1 The key risks for directors acting during the twilight period are set out under questions 1 and 2 above. Under Vietnamese (bankruptcy) law generally, the obligations and duties of the director owed to the company do not change during the twilight period such that the director would have to have additional regard to the safety of creditors once the director becomes aware of the distressed financial situation of the company.

⁵⁰ Articles 142 and 143 of the Civil Code.

⁵¹ Articles 142 and 143 of the Civil Code.

- 4.4.2 However, in certain circumstances there is a risk that a director would become criminally liable in the event that the transaction includes the appropriation of property through fraud under Article 174 of the Criminal Code. The details as to what obligations a director has *vis-à-vis* the company's (new) creditors remain largely unclear, in particular whether a director would have to disclose certain information on the delicate financial health to the counterparty. However, if the counterparty requests particular information or a review of documents (e.g. as part of a due diligence review of the borrower), information that is provided would have to be complete and truthful to avoid criminal liability under Article 174 of the Criminal Code.
- 4.4.3 A transaction in fraud of creditors must be committed with intent in order for it to qualify as a crime. Pursuant to Article 10 of the Criminal Code, a person acts with criminal intent where either the person is aware that their - "acts are dangerous to society, foresee the consequences of such acts and wish such consequences to occur" or, alternatively, where the offender does "not wish, but consciously allows, such consequences to occur".
- 4.5 Risks for directors**
- 4.5.1 The risks for unrelated third parties that enter into transactions during the twilight period are discussed under question 3 above. However, it is important to note that providing new credit under a balanced transaction (which does not include any of the preferences or other factors that would make the transaction voidable) would not be subject to attack if entered into during the twilight period. This would also be the case where the transaction is secured and the security is provided for new credit.
- 4.5.2 Where the counterparty providing new or additional credit is aware of the distressed situation that the borrower is in, however, it would typically require more comfort and, accordingly, a higher degree of security than would be the case when dealing with non - distressed companies. There may then be certain risks that such a transaction would later be regarded as potentially voidable if it appears that the primary objective was not to extend new credit but rather to dispose of assets of the distressed company in favour of the creditor.
- 4.5.3 Where the counterparty is not aware of the special circumstances that the borrower is in, its protection is extremely limited and any counterparty will have to carefully evaluate the commercial risks of a transaction with another company (which encounters further difficulty because, in Vietnam, credit ratings and independent credit checks are not generally available and the quality of financial statements is limited).
- 4.5.4 Ultimately, this also puts borrowers at a disadvantage, as creditors (in particular banks) may be more reluctant to provide essential credit to a distressed but potentially viable company if the banks decide not to take on these risks for lack of protection provided to them under the bankruptcy laws.

QUESTION 5

5. Enforcement

By whom may action be brought against directors and others person identified in Question 3 above?

5.1 Civil proceedings

- 5.1.1 Within three working days from the date of issuing a decision to commence the bankruptcy procedure (see S 1.2.2 above), the court also appoints an asset management officer or an asset management and liquidation enterprise to manage the company and liquidate its assets during the proceedings.⁵² The asset management officer or the asset management and liquidation enterprise supersedes the former management whose authority to manage or decide on the affairs of the company ceases upon the appointment of the asset management officer or the asset management and liquidation enterprise.

⁵² Article 45.1 Law on Bankruptcy.

- 5.1.2 In addition to the asset management officer or asset management and liquidation enterprise, creditors of the company have certain additional rights under the Law on Bankruptcy to protect their positions and ensure their involvement in the bankruptcy proceedings.

Clawback provisions under the Law on Bankruptcy

- 5.1.3 Applications to the bankruptcy court to declare a transaction void under the Law on Bankruptcy may be made by any participant in bankruptcy procedure, the asset management officer or the asset management and liquidation enterprise.⁵³

Transactions vulnerable to attack under non - bankruptcy specific regulations

	Legal basis	Person able to commence proceedings
(a)	Unauthorised related - party transactions	Asset management officer or the asset management and liquidation enterprise, related party (counterparty) It is not clear but unsecured creditors may also be entitled to bring proceedings.
(b)	Transactions that are "ultra vires" for the company	Asset management officer or the asset management and liquidation enterprise, counterparty It is not clear but unsecured creditors may also be entitled to bring proceedings.
(c)	Transactions beyond the scope of authority of the legal representative	Asset management officer or the asset management and liquidation enterprise, counterparty It is not clear but unsecured creditors may also be entitled to bring proceedings.
(d)	Transactions beyond the scope of authority of the person entering into the transaction on behalf of the Company	Asset management officer or the asset management and liquidation enterprise, counterparty It is not clear but unsecured creditors may also be entitled to bring proceedings.
(e)	Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions	Asset management officer or the asset management and liquidation enterprise It is not clear but unsecured creditors may also be entitled to bring proceedings.

5.2 Administrative proceedings

Failure to file a petition to commence bankruptcy proceedings

- 5.2.1 The administrative fine may be imposed by the bankruptcy court.⁵⁴

Falsification of accounting records

- 5.2.2 Local people's committees (administrative agencies at the level where the company is registered and headquartered) and financial inspectorate may apply the administrative penalty⁵⁵.

5.3 Criminal proceedings

Criminal matters may involve the police (for investigation), the People's Procuracy (for prosecution) and the court (for trial).

⁵³ Article 60.1 of the Law on Bankruptcy.

⁵⁴ Articles 70 and 72 of Decree 110.

⁵⁵ Article 55 and 56 of Decree 105.

QUESTION 6

6. Remedies available

In respect of the acts identified in Questions 2, 3 and 4 above, what remedies are available?

6.1 Orders available to the civil court

	Offence	Orders available to the domestic court
(a)	Unauthorised related - party transactions	Bankruptcy court may order that the director (together with the related party) is fully liable (jointly and severally) to the company for damages or may apportion that liability.
(b)	Transactions that are "ultra vires" for the company	See S 6.1(e) below.
(c)	Transactions beyond the scope of authority of the legal representative	See S 6.1(e) below.
(d)	Unlawful distribution of dividends / profits and unlawful payments for the redemption of shares or capital contributions	Bankruptcy court may order that the members of the board of management of the JSC (together with the shareholders) are fully liable (jointly and severally) to the company to the lower of the amount that has been distributed and the debt of the company that cannot be serviced as a consequence of the distribution.
(e)	Breach of labour contract / service agreement	Bankruptcy court may order that the director is fully liable to the company for damages. Where more than one director has acted in concert with another (or has failed to act), they would be jointly and severally liable to the company.
(f)	Breach of other director's duties	See S 6.1(e) above.

6.2 Orders available to the criminal court

	Offence	Orders available to the domestic court										
(a)	Transactions in fraud of creditors, Article 174 of the Criminal Code	- Imprisonment: <table border="1" data-bbox="726 1534 1428 2016"> <thead> <tr> <th>Value of the property</th> <th>Term of imprisonment</th> </tr> </thead> <tbody> <tr> <td>VND 2 mn (USD 88) up to but not including VND 50 mn (USD 2,222)</td> <td>6 months to 3 years (or non-custodial reform of up to 3 years)</td> </tr> <tr> <td>VND 50 mn (USD 2,222) up to but not including VND 200 mn (USD 8,888)</td> <td>2 years to 7 years</td> </tr> <tr> <td>VND 200 mn (USD 8,888) up to but not including VND 500 mn (USD 22,222)</td> <td>7 years to 15 years</td> </tr> <tr> <td>VND 500 mn (USD 22,222) or more</td> <td>12 years to 20 years, imprisonment for life</td> </tr> </tbody> </table>	Value of the property	Term of imprisonment	VND 2 mn (USD 88) up to but not including VND 50 mn (USD 2,222)	6 months to 3 years (or non-custodial reform of up to 3 years)	VND 50 mn (USD 2,222) up to but not including VND 200 mn (USD 8,888)	2 years to 7 years	VND 200 mn (USD 8,888) up to but not including VND 500 mn (USD 22,222)	7 years to 15 years	VND 500 mn (USD 22,222) or more	12 years to 20 years, imprisonment for life
Value of the property	Term of imprisonment											
VND 2 mn (USD 88) up to but not including VND 50 mn (USD 2,222)	6 months to 3 years (or non-custodial reform of up to 3 years)											
VND 50 mn (USD 2,222) up to but not including VND 200 mn (USD 8,888)	2 years to 7 years											
VND 200 mn (USD 8,888) up to but not including VND 500 mn (USD 22,222)	7 years to 15 years											
VND 500 mn (USD 22,222) or more	12 years to 20 years, imprisonment for life											

	Offence	Orders available to the domestic court						
(a)		<ul style="list-style-type: none"> - The criminal court may also issue a fine of between VND 10 mn (USD 444) and VND 100 mn (USD 4,444), confiscate part or whole of the convicted person's property, issue a ban from holding certain posts and practicing certain occupations or performing certain jobs for a period of 1 to 5 years; - In addition, the criminal court may order full civil restitution of the defrauded person or company. 						
(b)	Transactions in fraud of consumers, Article 198 of the Criminal Code	<ul style="list-style-type: none"> - Imprisonment: <table border="1" data-bbox="726 542 1423 786"> <thead> <tr> <th>Value of the property</th> <th>Term of imprisonment</th> </tr> </thead> <tbody> <tr> <td>VND 5 mn (USD 222) up to but not including VND 50 mn (USD 2,222)</td> <td>non-custodial reform of up to 3 years</td> </tr> <tr> <td>VND 50 mn (USD 2,222) or more</td> <td>1 years to 5 years</td> </tr> </tbody> </table> - The criminal court may also issue a fine of between VND 20 mn (USD 888) and VND 100 mn (USD 4,444), issue a ban from practicing certain occupations or performing certain jobs for a period of 1 to 5 years;⁵⁶ - In addition, the criminal court may order full civil restitution of the defrauded consumer. 	Value of the property	Term of imprisonment	VND 5 mn (USD 222) up to but not including VND 50 mn (USD 2,222)	non-custodial reform of up to 3 years	VND 50 mn (USD 2,222) or more	1 years to 5 years
Value of the property	Term of imprisonment							
VND 5 mn (USD 222) up to but not including VND 50 mn (USD 2,222)	non-custodial reform of up to 3 years							
VND 50 mn (USD 2,222) or more	1 years to 5 years							

QUESTION 7

7. Duty to co-operate

- (a) To what extent are directors and other persons identified in Question 3 above obliged to co-operate with the insolvency office - holder's investigation into the company's affairs?
- (b) Is this obligation modified by any rules in relation to the defence against self - incrimination? Are any human rights laws applicable to such obligations?

7.1 Obligation to co-operate with investigation into company's affairs

Obligation to provide data or present documents upon filing a petition for bankruptcy

- 7.1.1 The bankruptcy court may require data and information from the person (such as the legal representative) who has filed an application for bankruptcy in order to evaluate whether the company has indeed become bankrupt. Under Article 55 of Decree 110, the court may apply a fine of between VND 1 mn (USD 44) and VND 3 mn (USD 133) to the person who has filed the petition but does not comply with the request by the court to provide such data or documents. The same applies where such information is not provided promptly within the time limit determined by the court in the request or where the information is incomplete. In addition to a fine, the court may order a decision to handover to the court known data or information.
- 7.1.2 The data and documentation that may be requested relates to the information that is required by the court to make an assessment of whether the company is insolvent and can relate to the items that are required to be included in the bankruptcy filing, including (without limitation):⁵⁷

⁵⁶ This provision of Article 198 of the Criminal Code No. 100/2015/QH13 is more severe than the provision of Article 162 of the Criminal Code No. 15/1999/QH10 which provides that the criminal court may also issue a fine of between VND 3mn (USD 133) and VND 30 mn (USD 1,333) (as opposed to VND 20 mn (USD 888) and VND 100 mn (USD 4,444).

⁵⁷ Under Article 28.3 of the Law on Bankruptcy.

- (a) the financial statements of the company for the past three years or the entire operation period in case the company has been established and operating for less than three years;
- (b) an explanation of the cause resulting in insolvency;
- (c) report on the results of measures that have been taken by the company to remedy its inability to pay its debts;
- (d) a detailed list of assets including their location;
- (e) a list of creditors, their claims and the status of their claims (unsecured / secured);
- (f) a list of debtors, claims by the company against them and their status (unsecured/secured);
- (g) constitutional documents of the company; and
- (h) results of appraisal and valuation of remaining assets (if any).

Obligation to provide data or present documents after acceptance of jurisdiction by the court

- 7.1.3 The bankruptcy court may also require the legal representative of the company to provide data and information relating to the items set out in S 7.1.2 above. Under Article 55 of Decree 110, the court may impose a fine of between VND 1 mn (USD 44) and VND 3 mn (USD 133) on the legal representative in the event that the legal representative does not comply with the court's request. In addition to a fine, the court may order a decision to handover to the court known data or information.

Extent of the obligation

- 7.1.4 The obligation is, as such, not limited to data and information that would not incriminate the legal representative (or other person filing the application for bankruptcy).
- 7.1.5 Neither the Vietnamese constitution, nor the Criminal Code nor the Criminal Proceedings Code explicitly entitle an accused person to refuse to co-operate with orders of the court or State agencies on the basis that such person may incriminate himself (please see further discussion on this point under S 7.2 below).

7.2 Human rights

- 7.2.1 Vietnam's Constitution includes a section⁵⁸ on, and a commitment by the State to protect, certain basic human rights. The Constitution provides that:

"Article 20

1. Everyone has the right to physical inviolability and to have their health, honour and dignity protected by law; not to suffer from torture, violence, coercion, corporal punishment or any other form of treatment which involves physical violation or violation of health, honour and dignity.
2. No one may be arrested without a decision from the People's Court, or a decision or ratification by the People's Inspectorate except in the case he or she is caught in flagrante delicto [conducting a flagrant offence]. Arrest and detention are provided by law.

Article 31

1. An accused person shall not be considered guilty until proven to be guilty in accordance with the procedures stipulated by law and a guilty verdict has been reached by the court and has come into effect.
2. An accused person must be tried by the court on a timely, fair and public basis within the deadline stipulated by law. Where there is a closed trial in accordance with law, the verdict must be announced publicly.

⁵⁸ Articles 14 to 49 of the Constitution.

3. No one is sentenced twice for one crime.
4. People who are arrested, held in custody, detained, made subject of proceedings, investigated, prosecuted or tried are entitled to be defended either by a lawyer or by some other person.
5. People who are arrested, detained, temporarily detained, made subject of proceedings, investigated, prosecuted, judged or subject to judgement enforcement unlawfully are entitled to physical and spiritual compensation and to rehabilitation of their honour. Anyone who breaches the law on arrest, detention, investigation, prosecution, trial or judgement enforcement causing loss and damage to other people must be dealt with in accordance with law.”

7.2.2 In addition, Vietnam signed the ASEAN Human Rights Declaration in November 2012, Article 20 of which provides that:

- “20. (1) Every person charged with a criminal offence shall be presumed innocent until proven guilty according to law in a fair and public trial, by a competent, independent and impartial tribunal, at which the accused is guaranteed the right to defence.
- (2) No person shall be held guilty of any criminal offence on account of any act or omission which did not constitute a criminal offence, under national or international law, at the time when it was committed and no person shall suffer greater punishment for an offence than was prescribed by law at the time it was committed.
- (3) No person shall be liable to be tried or punished again for an offence for which he or she has already been finally convicted or acquitted in accordance with the law and penal procedure of each ASEAN Member State.”

7.2.3 While the Constitution and the ASEAN Human Rights Declaration recognise the right to due process of law and a number of judicial basic rights relating to criminal proceedings, their provisions are not clear on whether these include a person’s right not to incriminate themselves. In particular, it is debatable whether the ASEAN Human Rights Declaration includes a person’s right not to incriminate himself and the right to silence where the provision of information or the giving of statements would risk that person becoming subject to, or providing evidence against himself, in criminal proceedings.⁵⁹

QUESTION 8

8. Appeals and limitation periods

- (a) What limitation period, if any, applies to the actions referred to above?
- (b) What rights of appeal are available from the decisions of the lower court?

8.1 Limitation periods

Limitation period for criminal proceedings

8.1.1 The statute of limitation for commencing criminal proceedings is as follows:

- (a) Five years for “less serious crimes” (which carry a maximum term of imprisonment of three years).
- (b) Ten years for “serious crimes” (which carry a maximum term of imprisonment of up to seven years).

⁵⁹ See, for example, commentary on page 13 of the Joint Submission to the ASEAN Intergovernmental Commission on Human Rights on the ASEAN Human Rights Declaration dated 12 September 2012 by Civil Society Organisations and people’s movements participating in the Civil Society Forum on ASEAN Human Rights Declaration, 10-11 September 2012, requesting clarification on this issue in Article 20 of the ASEAN Human Rights Declaration. On the contrary, the Expert’s Note issued by the Rule of Law Initiative of the American Bar Association on the ASEAN Human Rights Declaration dated May 2012 appears to suggest that Article 20 of the ASEAN Human Rights Declaration as well as the Vietnamese Constitution already include such right to “remain silent” (see page 15).

(c) 15 years for “very serious crimes” (which carry a maximum term of imprisonment of up to 15 years).

20 years for “extremely serious crimes” (which carry more than 15 years of imprisonment up to life imprisonment or capital punishment).

Typically limitation periods commence when the crime was committed.⁶⁰

8.1.2 Accordingly, depending on the value of the fraud, the limitation period for transactions in fraud of creditors under Article 174 Criminal Code may range from five to 20 years (see S 6.2 above). The limitation period for transactions in fraud of consumers under Article 198 Criminal Code may be five years or ten years (see S 6.2 above).

Limitation period for administrative actions

8.1.3 The statute of limitation for bankruptcy - related administrative penalties is one year from the date on which the offence was committed.⁶¹

Limitation period for civil actions

8.1.4 The limitation period for initiating legal action in relation to claims for damages is three years.⁶² A three - year limitation period also applies to breaches of a contractual obligation.⁶³ This would apply, for example, to breaches of contractual duties of directors under labour contracts or service agreements.⁶⁴

8.1.5 The limitation period commences when the infringed party knows or should have known that its rights are infringed.⁶⁵

8.2 Appeals

Appeals in criminal proceedings

8.2.1 Judgments and decisions issued by the criminal court of first instance (typically the district - level people’s court for the offences outlined above, unless the offender is a foreign national, in which case the provincial - level people’s court would have jurisdiction over the matter) may be appealed.⁶⁶ The higher court (the court of appeal at the provincial - level people’s court for appeals against judgments and decisions from the district-level people’s court and the court of appeal of the superior people’s court for appeals against judgments and decisions of the provincial - level people’s court) will typically review both the facts and the application of the law by the lower - level court. The appellate court may also extend the review beyond the part of the judgment or decision against which the appeal is directed.⁶⁷

Appeals in administrative proceedings

8.2.2 A director or other addressee of an administrative sanction issued by the bankruptcy court may lodge a complaint against the administrative decision with the bankruptcy court for self review and, if the administrative decision is not amended, with the appellate court.

⁶⁰ Article 27 of the Criminal Code. The limitation period may be stayed in certain cases, e.g. where the offender has left the country.

⁶¹ Article 6 of Law on Handling Administrative Violations.

⁶² Article 588 of the Civil Code.

⁶³ Article 429 of the Civil Code.

⁶⁴ The labour code of Vietnam shortens the limitation period for certain of these claims to between 6 months and 12 months, Article 202 of the Labour Code.

⁶⁵ Article 154.1 of the Civil Code.

⁶⁶ Article 27 of the new Criminal Procedure Code No. 101/2015/QH13 dated 27 November 2015, which was supposed to enter into force from 1 July 2016 (the Criminal Procedure Code). The National Assembly however by Resolution No. 144/2016/QH13 dated 29 June 2016 postponed the effectiveness of the Criminal Procedure Code No. 101/2015/QH13 until when the Law on amendment to and supplement of some articles of the Criminal Code No. 100/2015/QH13 comes into effect. Prior to the effective date of the Law on amendment to and supplement of some articles of the Criminal Code No. 100/2015/QH13, the Criminal Procedure Code No. 19/2003/QH10 (as amended) and provisions of the Criminal Procedure Code No. 101/2015/QH13 implementing the more favourable provisions of the Criminal Code No. 100/2015/QH13 are effective. Please note that the substance of the provisions of the Criminal Procedure Code No. 101/2015/QH13 cited in this Chapter are not different from the corresponding ones of the Criminal Procedure Code No. 19/2003/QH11.

⁶⁷ Article 345 of the Criminal Procedure Code.

Appeals in civil proceedings

- 8.2.3 Judgments and decisions issued by the civil court of first instance (typically⁶⁸ the provincial-level people's court would have jurisdiction over the matter) may be appealed.⁶⁹ The review of the higher court in civil matters (the court of appeal of the superior people's court for appeals against judgments and decisions of the economic court at the provincial-level people's court) comprises, as in criminal matters, both the facts and the application of the law by the lower - level court.

QUESTION 9

9. Foreign Corporations

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

- 9.1 Vietnamese law only recognises enterprises established and registered under Vietnamese law as being domiciled in Vietnam. The bankruptcy regulations therefore only apply to Vietnamese enterprises and co-operatives.⁷⁰ These may include purely domestic Vietnamese companies, as well as enterprises or SOEs that have received foreign investment. The scope of application of the Law on Bankruptcy would not extend to foreign entities incorporated under foreign law offshore that had not traded in Vietnam.
- 9.2 Criminal liability under Vietnamese law applies to both natural persons, including foreign nationals (acting for foreign companies or for Vietnamese companies) and commercial legal entities in the territory in Vietnam. However, commercial legal entities only have criminal liabilities for specific crimes listed in the Criminal Code, which does not include the criminal offences set out under S 2 above. It is therefore possible that foreign nationals (or Vietnamese nationals acting as directors for foreign companies in Vietnam) may be prosecuted for the criminal offences set out under S 2 above.
- 9.3 The above also does not exclude that foreign companies may become involved in Vietnamese bankruptcy proceedings as, for example, creditors, debtors or counterparties to a voidable transaction.

QUESTION 10

10. Insurance

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

- 10.1 As with the concept of directors' and officers' liability, D&O insurance is only gradually becoming available in Vietnam. Previously, mainly companies with foreign investment provided D&O insurance coverage for their management personnel in Vietnam with the insurance policies being part of a regional D&O insurance arrangement and underwritten by international insurers rather than Vietnamese insurers. Since roughly 2004/2005, Vietnamese insurers have commenced offering D&O insurance coverage directly to domestic and foreign-invested enterprises in Vietnam. Despite this, it is not yet common for domestic Vietnamese enterprises to take out D&O insurance coverage for their directors and senior management personnel. D&O insurance typically excludes wilful and intentional breaches by the director.

⁶⁸ Where the dispute is solely based on a breach of the director's labour contract, the labour court would have jurisdiction.

⁶⁹ Article 346 of the Civil Procedure Code.

⁷⁰ Article 2 of the Law on Bankruptcy.

10.2 For listed and public JSCs, Article 13.6 of Circular 121 provides that:

“A public company may purchase liability insurance for members of the board of management after obtaining approval from the general meeting of shareholders. Such insurance shall not include insurance for liabilities of members of the board of management in relation to any breach of law and the company charter.”

For these JSCs, the approval by the general meeting of shareholders is therefore required before any D&O insurance may be obtained by the company for its directors.

10.3 Vietnamese law does not apply any mandatory minimum deductible for D&O insurance coverage (as is, for example, the case under the German law on joint stock companies for members of the board of directors of joint stock companies).

10.4 There is no general statutory indemnification of a director who is held liable by the company or third parties. However, the company and its director may agree on specific details of the director's appointment in the director's labour contract, appointment letter or service contract. It is common for the company and the director to agree that the director is to be indemnified by the company if held liable by third parties for debts or obligations that were initially those of the company (although in an insolvency situation, the indemnity would provide limited protection to the director). Article 13.6 of Circular 121 currently only limits the extent to which such an indemnity may be agreed for members of the board of management of public or listed JSCs. It remains to be seen whether these restrictions will be extended to D&O coverage that may be provided to other directors of public or listed JSCs and / or of other company form.

The information provided in this country chapter is correct as at 30/03/2017

Member Associations

American Bankruptcy Institute
Asociación Argentina de Estudios Sobre la Insolvencia
Asociación Uruguaya de Asesores en Insolvencia y Reestructuraciones Empresariales
Association of Business Recovery Professionals - R3
Association of Restructuring and Insolvency Experts
Australian Restructuring, Insolvency and Turnaround Association
Bankruptcy Law and Restructuring Research Centre, China University of Politics and Law
Business Recovery and Insolvency Practitioners Association of Nigeria
Business Recovery and Insolvency Practitioners Association of Sri Lanka
Canadian Association of Insolvency and Restructuring Professionals
Canadian Bar Association (Bankruptcy and Insolvency Section)
Commercial Law League of America (Bankruptcy and Insolvency Section)
Especialistas de Concursos Mercantiles de Mexico
Finnish Insolvency Law Association
Ghana Association of Restructuring and Insolvency Advisors
Hong Kong Institute of Certified Public Accountants (Restructuring and Insolvency Faculty)
Hungarian Association of Insolvency Practitioners
INSOL Europe
INSOL India
INSOLAD - Vereniging Insolventierecht Advocaten
Insolvency Practitioners Association of Malaysia
Insolvency Practitioners Association of Singapore
Instituto Brasileiro de Estudos de Recuperação de Empresas
Instituto Brasileiro de Gestão e Turnaround
Instituto Iberoamericano de Derecho Concursal
International Association of Insurance Receivers
International Women's Insolvency and Restructuring Confederation
Japanese Federation of Insolvency Professionals
Korean Restructuring and Insolvency Practitioners Association
Law Council of Australia (Business Law Section)
Malaysian Institute of Certified Public Accountants
National Association of Federal Equity Receivers
Nepalese Insolvency Practitioners Association
NIVD – Neue Insolvenzverwaltervereinigung Deutschlands e.V.
Recovery and Insolvency Specialists Association (BVI) Ltd
Recovery and Insolvency Specialists Association (Cayman) Ltd
REFOR-CGE, Register of Insolvency Practitioners within “Consejo General de Economistas, CGE”
Restructuring and Insolvency Specialists Association of Bermuda
Restructuring Insolvency & Turnaround Association of New Zealand
Russian Union of Self-Regulated Organisations of Arbitration Managers
Society of Insolvency Practitioners of India
South African Restructuring and Insolvency Practitioners Association
Turnaround Management Association (INSOL Special Interest Group)



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