Responsibilities of Directors Before Filing for Bankruptcy Under the UNCITRAL Framework

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Understanding the UNCITRAL Approach

- Background on UNCITRAL Insolvency Work
- Evolution of the UNCITRAL Approach To Director Liability
- Conceptual Framework of the Project
- Structure of the UNCITRAL Guidelines
- Connected Issues
- Examples of Best Practices
- Conclusions

Background on UNCITRAL Insolvency Work

- **UNCITRAL has Three Basic Insolvency Texts:**
  - UNCITRAL Model Law on Cross-Border Insolvency (1997)
  - UNCITRAL Legislative Guide on Insolvency Law, Parts One and Two (2004)
  - UNCITRAL Legislative Guide on Insolvency Law, Part Three: Treatment of enterprise groups in insolvency (2010)
- **UNCITRAL has also Published Explanatory Texts:**
  - UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective
  - UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation (2009)

19 States have enacted legislation based on the Model Law, including the United States, the United Kingdom and Japan

Evolution of the UNCITRAL Approach

- The Model Law and Original Legislative Guide Did Not Include Specific Recommendations on Director Responsibility
- Recommendations 110 and 114 Spoke only to the “Debtor’s” Obligations
- Furthermore, The Guide Was Limited To Obligations Upon Commencement of the Insolvency Proceedings

Evolution of the UNCITRAL Approach: 2005 Proposal

- The International Insolvency Institute (III) Proposed in April 2005 the Creation and Inclusion of Provisions on Director Responsibility in Insolvency
- Reaction to Director Actions in the WorldCom, Parmalat and Enron Insolvencies
- However, the Commission Did Not Approve the Proposal at that Time

Evolution of the UNCITRAL Approach: 2010 Proposal

- The United Kingdom Proposed in 2010, based on the 2005 III Proposal that the Commission Give Working Group V a Mandate to Create Guidelines for Director Responsibility in Insolvency

- Importantly, The UK Proposal Expanded the Scope to Include Responsibility for Actions in the Period Leading Up to Insolvency
- INSOL International Also Supported the Proposal with a Focus on The Standard Used to Determine Liability

INSOL INTERNATIONAL

Evolution of the UNCITRAL Approach: Approval

- In June 2010 The Commission Approved the UK/INSOL/III Proposal Giving Working Group V a Mandate to Address Director Responsibility in the Period Leading up to and During Insolvency Proceedings
- Working Group V Identified Its Goal as Creating Incentives for Directors to Take Pro-Active Steps to Protect the Value of the Company and Not Just Wait for Formal Insolvency Proceedings

Evolution of the UNCITRAL Approach: A Timeline

- March/April 2004: UNCITRAL Completes Work on the Legislative Guide on Insolvency Law
- April 2005: The III Proposes to Address the Issue of Director Responsibility
- July 2005: UNCITRAL Declines to Approve the Project
- April 2010: The UK takes up the III proposal and Recommends work on Director Responsibility
- April 2010: Working Group V Endorses the UK Proposal
- June 2010: The Commissions Gives Working Group V a Mandate to Develop Guidelines on Director Responsibility
- December 2010: Working Group V Begins its Work
- November 2011: Working Group V Adopts the Form of a Legislative Guide With Commentary
- May 2012 – Present: Continuing Work

Conceptual Framework of the Project: Initial Steps

- Working Group V Initially Identified Six Areas of Inquiry:
  1. Definition of Those Who Owe Duties (Identity of "Directors")
  2. Identify to Whom Duties are Owed
  3. Determine the Period Wherein Duties Arise
  4. Focus on Duties Related to "Wrongful Trading"
  5. Remedies
  6. Cross Boarder Issues

Discussions During Working Group Sessions Has Shown that this List Needed to Be Modified and Reorganized

Conceptual Framework of the Project: Present Form

- Currently the Working Group is Focusing on Five Slightly Different Areas of Inquiry:
  1. Nature of Obligations
  2. When the Obligations Arise
  3. Party Owing The Obligation
  4. Liability
  5. Enforcement

Conceptual Framework of the Project: Purpose of Work

The Working Group Undertook the Present Work to Address the Obligations Owed by Directors During the "Twilight" Period Before The Start of Formal Insolvency Proceedings.

The Goal is to Address that Period During Which the Obligations Owed By Directors Shifts From A Duty to the Company and the Shareholders to the Protection of Creditors' Interests in the Insolvent Entity.

Conceptual Framework of the Project: Nature of Obligations

- The Working Group has Focused on Two Different Types of Obligations:
  1. Duty to Take Reasonable Steps to Protect Value of the Company When Insolvency is Imminent
  2. Duty to Timely File for the Opening of Insolvency Proceedings

Even Though Working Group Recognized that there is No "One-Size Fits All" Guide for Directors Considering the Diversity of National Laws, it Created a List of "Best Practices" that Directors Could Follow, see *infra* slide 17

Conceptual Framework of the Project: When Obligations Arise

- The Working Group Adopted a Subjective Approach to Determining When Obligations Should Arise. At Present, Obligations Arise When:

The Director Knew or Should Reasonably Have Known That Insolvency was Imminent or Unavoidable

- The Other Options Were Either to Tie Obligations to Factual Insolvency or to the Filing for the Opening of Insolvency Proceedings – Both Objective Standards.

- Under Such Objective Standards, Some Participants Noted that Pre-Insolvency Obligations Would Often Not Exist in Practice Given the Requirement in Many States to Start Insolvency Proceedings When an Entity is Factually Insolvent.

Conceptual Framework of the Project: Party Owing the Obligation

- Like The Determination of When an Obligation Arises, there are Multiple Ways to Identify the Party Owing the Obligation: Formal Appointment and Actual Authority

- The Working Group Has Adopted the Formula of Actual Control Over a Company as the Definition of Formal Directors Varies from State to State

- Actual Control is not Understood to Include Banks or Other Outside Advisors if the Formal Directors Can Decline to Follow their Advice (Even When this Means the Opening of Insolvency Proceedings)

Conceptual Framework of the Project: Liability

- The Guidelines Address Four Issues Related to Director Liability
  1. Elements for Proving Liability
     - Guide Leaves This to National Law
  2. Standard Of Care Owed By Directors
     - Suggests Standard of "Average Director"
     - Suggests Greater Duty of Care for Specialized Directors
     - Notes that Some States Consider Director Action to be Reasonable by Default (Business Judgment Rule)
  3. Possibility of Joint and Several Liability
  4. Remedies
     - Payment of Damages
     - Disqualification

Conceptual Framework of the Project: Enforcement

- The Working Group has Made Three Recommendations Relating to the Enforcement of Claims Against Directors:
  1. Actions Should be Brought for the Benefit of the Insolvency Estate and Damages Paid to that Estate, not Individual Creditors
  2. Standing to bring an Action Belongs to the Estate. Creditors Should not be Able to Bring an Action Absent Approval by the Insolvency Representative or the Court
  3. The Costs of Bringing An Action Against a Director Should be Treated as an Administrative Expense

Conceptual Framework of the Project: Enforcement

The Working Group Has Noted that:

(a) Actions Should Not Be Brought Against Directors Where Doing So Would Unreasonably Delay Closure Without Recovery;

(b) The Insolvency Representative Should Evaluate the Utility of an Action on the Probability of an Effective Recovery;

(c) The Insolvency Representative Should Promote Negotiations to Settle Claims

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Droit de l'insolvabilité Obligations des administrateurs et dirigeants d'entreprises pendant la période précédant l'insolvabilité

Proposition de la délégation italienne

Régimen de la insolvencia: obligaciones de los directores en el período cercano a la insolvencia

Propuesta de la delegación de Italia

Законодательство о несостоятельности: обязанности руководителей в период, предшествующий несостоятельности

Предложение делегации Италии

破产法：临近破产期间董事的义务

意大利代表团的提案

Insolvency Law: Director's obligations in the period approaching insolvency

Proposal by the Italian Delegation

Examples of Best Practices

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

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

Examples of Best Practices: Continued

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

Examples of Best Practices: Continued

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

Examples of Best Practices: Continued

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

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

Examples of Best Practices: Continued

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

Examples of Best Practices: Continued

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

Examples of Best Practices: Continued

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

(j) The composition of the board could be reviewed to determine whether an adequate number of independent directors are included. Not all assets will necessarily require protection in all circumstances. Examples of the types of asset that might not require protection in all circumstances might be those that are worth less than the amount for which they are secured, are burdensome, of no value or hard to realize.

Conclusion

UNCITRAL Is Working on a Flexible Fact Specific Approach to Its Recommendations So that They May Be Implemented in the Different Legal Systems Around the World Without Requiring Fundamental Changes to the National Legal Framework. It is an Approach Tied to Actual Control Over the Company and Reasonable Ability to Avoid Harm to Creditors That Will Encourage Responsible Corporate Governance While at the Same Time Not Creating Disincentives for Experienced and Capable Directors to Remain and Shepard the Company Through the Crisis