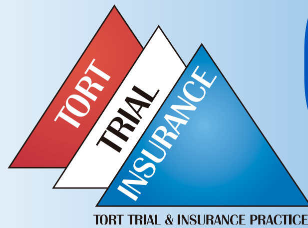

Committee News

ABA Defending Liberty Pursuing Justice

Winter 2010

INTERNATIONAL COMMITTEE

INSOLVENCY AND D&O LIABILITY AROUND THE WORLD

By: Perry S. Granof, Outgoing Chair, TIPS International Committee

In my professional endeavors and as Chair of the TIPS International Committee I have had the good fortune of maintaining strong relationships with attorneys located throughout the world. One of the benefits of maintaining these relationships is to have access to legal experts from various countries, to offer brief summaries of a particular area of law in their respective jurisdictions. In our last newsletter and in this we have utilized our connections to offer descriptions of the insolvency laws of select jurisdictions, and how they impact D&O liability.

As I reviewed the selection of insolvency articles from our panel of lawyers located throughout the world, I noticed that, as respects D&O liability, the insolvency laws fall into two categories. The first group of countries has laws that emphasize liability against Directors and Officers for incurring expenses or trading when a company is in the zone of insolvency. The second group of countries has laws that emphasize director and officer liability for wrongful conduct from the time a company is in good standing.

The countries that fall into the first category include: Australia, England, and Germany. The countries that fall into the second category include: Canada, France, India, Italy and the Netherlands. It's noteworthy that the emphasis on trading when a company is in the zone of insolvency vs. trading when a company is in good standing transcends the countries' common law vs. statutory legal systems.

Australia, England and Germany all have laws establishing liability for financially obligating a company when it is faced with possible insolvency. Canada, France, India, Italy and the Netherlands, on the other hand, all have laws establishing liability for purported wrongful conduct while a company is in good standing, preceding its insolvency. I have set forth below a short summary of insolvency provisions in select jurisdictions. These are all expanded upon in the various articles we have published in this newsletter and the previous newsletter.

I. Australia: (Insolvent Trading)

Under Section 588G of the **Corporations Act 2001**, and other key statutory provisions, a director of a company is under a duty to prevent the company from trading when it is insolvent. The failure to do so will give

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B.B. Wolf vs. Curly Pig

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The ABA Tort Trial and Insurance Practice Section invites you to join us during the 2010 ABA Midyear Meeting in exciting Orlando, FL for a must-see special performance. Hear first-hand the high profile case in which Curly Pig is charged with attempting to cook B.B. Wolf.

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Time: 4pm-6pm

Where: Orlando, FL

For: Everyone, bring the kids!

Brought to you by the American Bar Association Tort Trial and Insurance Practice Section, Public Relations Committee and the ABA Standing Committee on Public Education

LIABILITY OF DIRECTORS UNDER AUSTRALIAN LAW FOR TRADING WHILE INSOLVENT

By: Professor Reg Graycar of Sydney University, Australia, Peter Harkin of Colin Biggers & Paisley, Sydney, Australia, and Perry Granof, Esq., Granof International Group, LLC

Under Section 588G of Australia's **Corporations Act 2001**, and other key statutory provisions, a director of a company is under a duty to prevent the company from trading when it is insolvent. The failure to do so will give rise to possible civil penalties and civil claims by liquidators against directors and others who took part in the company's management, including shadow directors. The liquidator is entitled to seek recovery on behalf of the creditors for the losses sustained while the Company traded when insolvent.

This provision arose out of concern for the welfare of creditors who are otherwise subject to the limited liability protections of a corporation at a time when the prospects of a company incurring a loss to its creditors has become real." *Woodgate v Davis*, (2002) 55 NSWLR 222; [2002] NSWLR 616 at [36]

There are a number of elements that go to establishing liability for trading while insolvent under Section 588G. They tend to address the, "who, what, why and when" of a situation when a Director is trading while the company is insolvent. They are:

6.1. The person **is a director** at the time when the company incurs a debt

6.2. The company **incurs a debt** at the relevant time

6.3. The company is **insolvent** at the relevant time

6.4. There are **reasonable grounds for suspecting** that the company was or would become insolvent

The current law expressly applies to directors; this includes 'shadow' or de facto directors. In *Condon v Commissioner of Taxation; Condon v Holliday-Smith and ors,* NSWSC 745 [2006], the court determined that a liquidator's claim could be sustained against a person who was not formally a director of the insolvent company where he made all management and policy decisions and was a signatory to the checks. He signed documents relating to factoring agreements, entered into for the purposes of the company, purporting to be a director. In addition to applying to directors, Section 588V also imposes liability for insolvent trading on a holding company, of a subsidiary, that breaches the provisions of Section 588G.

It is clear that an obligation to pay a liquidated amount is a debt, but there is some uncertainty about other forms of obligations that may involve certain kinds of contingent liabilities, such as guarantees. In *Hawkins v Bank of China,* (1992) 26 NSWLR 562; 7 ACSR 349, the court noted that the: "undertaking of liabilities by way of guarantee is such an obvious means by which companies come to owe debts that it is unlikely that it was intended to be beyond the purview of Section 556 [*the predecessor to s 588G*]". By contrast, a liability to pay unascertained damages is not a debt for the purposes of Section 588G, see *Jelin Pty Ltd v Johnson,* (1987) 5 ACLC 463.

Section 588G(1A) sets out a range of transactions that deem certain types of debts to have been incurred at particular times. The types of transactions referred to include paying a dividend, reducing share capital, buying back shares, redeeming preference shares in certain situations; assisting a person to acquire shares, and entering into a non-commercial transaction. In a case involving a lease, it was held that the company incurred a debt at the time the lease was entered into and not each time the periodic payment of rent is due. *Russell Halpern Nominees Pty Ltd v Martin* [1987] WAR 150.

In relation to contracts for the sale of goods "it will be the order which in substance and commercial reality renders the company liable for the price of the goods, even if that price is not actually payable until delivery…" *Leigh-Mardon v Wawn* (1995) 17 ACSR 741 at 749.

In order for a director to be liable due to trading while insolvent, the company must be insolvent at the time the relevant debt is incurred. Therefore under Australian law, a company is insolvent if it is unable to pay all of its debts as and when they become due and payable. The law takes a commercially realistic view in determining what resources are available to a company to enable it to pay its debts and when they fall due. Proof of insolvency is also assisted by a number of statutory presumptions that, by virtue of Section 588E, apply in recovery proceedings. These include a reputable presumption that if a company was insolvent at a particular time during the 12 months before the application for "winding up", it remained insolvent throughout the period.

The onus of proof lies on the person seeking to establish that a relevant director is in breach of the provisions of Section 588G. Generally speaking, this will

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INSOLVENCY IN BRITAIN: THE COST OF "ASSISTING WITH ENQUIRIES…"[1]

By: Francis Kean, Esq., Partner, Roderic Mclauchlan, Esq., Partner, and Ross Chipperfield, Esq., Associate, all of Barlow Lyde & Gilbert, London, England

Often, the first occasion on which a director will have to put his or her hand in his or her pocket to pay for legal representation is in the context of an investigation following an insolvency procedure. This article examines the reasons for this and asks how effective D&O insurance is as a protection in respect of this type of exposure.

The trigger point

The trigger point for an investigation under the Insolvency Act 1986 is the point at which the company in question is put into any form of administration or liquidation. As soon as that occurs, the officeholder (be he administrator, administrative receiver, provisional liquidator or liquidator) is immediately vested with powers of investigation under sections 235 and 236 of the Insolvency Act 1986. Under section 235 of the Act, an officeholder is empowered to obtain information from (among others) directors as well as from employees over the last 12 months of trading as to the "…promotion, formation, business dealings, affairs, or limitation on these powers is that the information has to be "reasonably required". In practice, however, since on the day of appointment the information base on which the officeholder will be operating is likely to be low, the extent of the information he is likely to "reasonably require" will be correspondingly high. The scope for refusing to cooperate with an officeholder pursuing his enquiries under section 235 is, thus, severely limited. The requests for information need not be limited to the provision of documentation. They can, and frequently do, extend to the requirement to attend meetings with the officeholder to answer questions. Although the procedure is supposed to be "informal", lawyers can be present and the atmosphere, nature and tone of the investigation can seem anything but informal. It should be remembered in this context that, although the primary responsibility of an officeholder is the collection and realization of a company's assets and the settlement of its liabilities, there is also an obligation on all officeholders to report to the Secretary of State if it appears that there has been any misfeasance on the part of the directors such as, for instance, a breach of the Company Directors Disqualification Act. In order to discharge this obligation, officeholders need to consider, for example, whether there is evidence of wrongful trading.

Section 236 Investigations

Officeholders have even wider powers of investigation under section 236 of the Insolvency Act 1986. In the first place, these powers are not limited to directors, auditors and employees, but extend to any individuals who are in possession of company property or who are indebted to the company or, indeed, anyone else in the discretion of the court. Unlike section 235 investigations, section 236 investigations require a formal application to the court. If an order under section 236 is made, a director or officer may be required to make a sworn statement as to the nature of his activities in the lead up to the insolvency and may be subject to cross examination in the witness box in relation to any such statement. A section 236 order is draconian in nature and it is in the discretion of the court as to whether an appropriate order will be made. In deciding this question, the judge is required to balance the need for information with a requirement not to be "unduly oppressive". If, for example, it is the case that the officeholder has a settled intention to pursue the director in any event, say for wrongful trading proceedings, or indeed if the director in question is likely to face criminal proceedings, these are good grounds for refusing to make an order under section 236. In reality, and in most cases, an officeholder's preference will be to proceed under section 235 on the basis that this is a much simpler and more informal procedure than that laid out under section 236. No application to the courts is necessary. An effective tactic which is often deployed by officeholders is to request information under section 235 and to couple this request with the threat that unless the director in question cooperates, a formal application under section 236 will follow.

FSA Investigations and Enquiries

Although the risk of Financial Services Authority (FSA) investigations will not be relevant for every company, it is those companies in the regulated sector which have been hardest hit by the impact of the recession. Such companies may also find themselves the object of an FSA investigation or enquiry even if they successfully stave off the risk of insolvency. There are, in essence, four different types of procedure under the Financial Services and Markets Act 2000 ("FSMA"):

Section 165 - Powers to require information.

Section 166 - Skilled person report.

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[1] This article is reprinted with permission of the authors from the Spring 2009 Issue of Barlow, Lyde & Gilbert's Directors' and "Officers' Liability Review."

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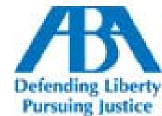

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Dallas, TX

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THE ZONE OF INSOLVENCY - PERILOUS FOR INDIAN DIRECTORS AND OFFICERS

By Shirley Spira, Esq. and Nilam Sharma, Esq.

India differs markedly from the United States in its approach to the liability of directors and officers of companies in the "zone of insolvency." By contrast with the U.S., it gives a specialized governmental agency, the National Company Law Tribunal, the power to examine the affairs of "sick" companies, and to design a plan of rehabilitation or issue a liquidation order. Like the French, German, Italian and Dutch systems, Indian law has system of personal responsibility and liability of directors for fraud on creditors or dissipation of corporate assets in the "zone of insolvency."

According to the International Association of Insolvency Regulators' profile of India, the key legislation governing Indian companies in the zone of insolvency are the Companies Act 1956 as amended by the Companies (Second Amendment) Act 2002 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI). The body with the greatest power over the affairs of an insolvent or "sick" company is the National Company Law Tribunal (NCLT), which has taken on powers of both the High Court and the Company Law Board; the Company Law Board no longer exists under Indian Law. A new appellate court, the National Company Law Appellate Tribunal, has been established to hear appeals from NCLT.

Indian Law is designed to give the government, in the form of the NCLT, a direct role in anticipating and managing insolvency. It gives the NCLT the authority to inquire into the financial health of a corporation and its expected future health. A corporation whose books show that it has losses equal to 50% of the average net worth of the company in the four preceding financial years is a "sick industrial company", as is a company that has been unable to pay creditors as debts have come due for three consecutive quarters.

When a company is "sick," the Board of Directors has the choice of reviving and rehabilitating the company, with the aim of retaining possession of the company, just as U.S. directors do in the context of a Chapter 11 "going concern." The company's auditor must provide a statement in support of the Board's position if they seek rehabilitation. The Board or corporate creditors may propose a plan of rehabilitation, and the NCLT may issue an order putting a "scheme", or plan, of rehabilitation, in place.

Like a U.S. Chapter 11 bankruptcy filing, the Indian insolvency system may permit several rounds of dueling plans of rehabilitation. Approval of an Indian "scheme" requires consent of all parties providing financial assistance within 60 days, and a failure to respond to a plan is treated as a consent. Each of the funding sources who are underwriting the rehabilitation of the company has an absolute veto. Moreover, the insolvency provisions lack the automatic stay that is so important to reorganization efforts in Chapter 11. The effect of this provision is to place the ultimate power over a company's fate in the hands of those who are funding its activities, as opposed, for example, to trade creditors or shareholders.

One of the cases rendered since SARFAESI went into effect demonstrates the adverse effect of SARFAESI's self help provisions, which permit creditors to foreclose on their investments without judicial intervention, even if it harms the going concern value of a company. On April 23, 2008, the High Court of Delhi at New Delhi rendered a pro-bank decision in *Vinedale Distilleries, Ltd. et al. v. Union of India et al.*, WP(C) No. 12112/2006. The facts of the case straddled the time period before and after the enactment of SARFAESI, and ended in the liquidation of Vinedale Distilleries, which had gone through a period of "sickness," but was according to the court, on its way to rehabilitation when its lender decided to enforce its security interests.

SARFAESI's self-help provisions inevitably create a tension between creditors and the other stakeholders of corporations, including equity investors. This imbalance of power does not bode well for directors who are caught between creditors and other stakeholders.

The Companies Act specifies that a director of an Indian company in liquidation must co-operate with the liquidator in realizing the assets of the company and distributing them among the creditors and contributors of the company. A director who fails to do so is liable to imprisonment for a term of up to five years and fine. Yet, a director who fails to act in the best interests of equity holders may be exposed to charges that he has colluded with lenders.

The directors also have extensive potential liability for any fraudulent activity that occurs in the course of the winding up of a company. If it appears that any business of the company has been carried on with intent to defraud creditors of the company or any other person, or for any fraudulent purpose, the Court, on the

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OPPRESSION REMEDY IN CANADA

By: Mary Margaret Fox, Esq., Nicholl Paskell-Mede, Toronto, Ontario

While the first of the two recent decisions of the Supreme Court of Canada (the "Supreme Court") discussed below has effectively shut the door on any suggestion that directors of insolvent corporations in Canada (or corporations approaching insolvency) owe a fiduciary duty to creditors, they by no means extinguish a creditor's ability, in appropriate circumstances, to pursue recovery against those directors through an alternative and - some would argue much broader - remedy known as the "oppression remedy".

Although first introduced in Canada in the business corporations legislation of a single province in 1960, the oppression remedy did not receive much attention until it was included in our federal business corporations' statute, the *Canada Business Corporations Act* ("*CBCA*")[1] in 1975. Today, the business corporations statutes of all but two provinces, Quebec and Prince Edward Island, provide for the oppression remedy.[2]

In a nutshell and restricting this article to creditors' remedies against directors personally as distinct from against their corporations, Section 241 of the *CBCA* provides that "If, on an application [by a "complainant"[3]] a court is satisfied that in respect of a corporation eor 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, <u>creditor</u>, director or officer, the court may make an order to rectify the matters complained of." (emphasis added)

Any number of a wide range of orders - interim or final - may be made, including an order "compensating an aggrieved person".

Although it is fair to say that at the time of its introduction into Canadian corporate statutes the oppression remedy was viewed as primarily a remedy available to shareholders and, for the most part, shareholders of privately-held corporations, in practice it has not been so restricted. As a result of the combined ingenuity of plaintiffs' lawyers, the absence until 2006 in Canada of legislation providing purchasers of securities in the secondary market with any effective recourse against corporations and/or their directors for secondary market disclosure and Canadian courts' willingness to broadly interpret the language of the oppression remedy, it has become a predictable component to most actions instituted in Canada against corporations and their directors and officers in an ever-widening circle of circumstances. Indeed, in all but a very small number of cases, it has displaced the derivative action as the most effective vehicle by which a "complainant" may seek redress against alleged corporate and/or management wrongdoing[4].

The Supreme Court obviously appreciated this when it rendered its October, 2004 decision in *Peoples Department Store Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 468 ("*Peoples*"). Briefly, after the bankruptcy in early 1995 of Wise Stores Inc. ("Wise") and its indirectly but wholly-owned subsidiary, Peoples Department Stores Inc. ("Peoples"), Peoples' trustee in bankruptcy instituted a claim against the three brothers Wise who were directors of both Wise and Peoples. One of the trustee's two arguments was that the directors had, in breach of their statutory fiduciary duty[5] under the *CBCA*, favoured the interests of Wise over Peoples to the detriment of Peoples' creditors.

Based upon findings by the trial judge that (1) there had unquestionably been a serious problem which the Wise brothers had attempted to solve by implementation of the inventory purchasing policy alleged by the trustee to have been improper; (2) there was no evidence of personal interest or improper purpose on the part of the Wise brothers; and (3) the inventory

1 The *Companies Act*, R.S.B.C. 1960, c. 67; the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, as amended.

2 According to Messrs. Brian Morgan and Harry Underwood, authors of "Directors' Liability to Creditors on a Corporation's Insolvency in Light of the Dylex and Peoples Department Stores Litigation", presented at the 33rd Annual Workshop on Commercial and Consumer Law, Faculty of Law, University of Toronto, 2003, statutory oppression remedies in the U.K. and Australia restrict the relief to shareholders; New Zealand's oppression remedies leave the question open, and in the United States, "while various corporate statutes contain some version of the oppression remedy, in no case does it extend to creditors. Canada and its provinces therefore stand virtually alone."

3 The definition of "complainant" includes "(a) 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 an officer or a former director or officer of a corporation or any of its affiliates, the Director (under the *CBCA*), or any other person who, in the discretion of a court, is a proper person to make an application under this Part;"

4 While leave of the court is required to institute a derivative action, no such leave is required in the case of a claim for oppression.

5 Section 122(1) of the *CBCA* provides: "Every director and officer of a corporation in exercising their powers and discharging their duties shall (a) act honestly and in good faith with a view to the best interests of the corporation;…" The trustee's other argument, irrelevant to this discussion, was that the Wise brothers had been privy to transactions providing for the transfer of property from Peoples to Wise at less than fair market value contrary to Section 100 of the *Bankruptcy and Insolvency Act*, Canada.

purchasing policy had been implemented out of "a desire to make both Wise and Peoples 'better' corporations", the Supreme Court held that the Wise brothers did not breach their statutory fiduciary duty. On the subject of to whom that duty was owed, the Supreme Court was clear:

> "The various shifts in interest that naturally occur as a corporation's fortunes rise and fall do not, however, affect the content of the fiduciary duty under Section 122(1)(a) of the *CBCA*. *At all times, directors and officers owe their fiduciary obligation to the corporation*. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders.
>
> The interests of shareholders, those of the creditors and those of the corporation may and will be consistent with each other if the corporation is profitable and well capitalized and has strong prospects. However, this can change if the corporation starts to struggle financially. The residual rights of the shareholders will generally become worthless if a corporation is declared bankrupt. Upon bankruptcy, the directors of the corporation transfer control to a trustee, who administers the corporation's assets for the benefit of creditors.
>
> …
>
> *The directors' fiduciary duty does not change when a corporation is in the nebulous "vicinity of insolvency"…*
>
> …In resolving these competing interests, it is incumbent upon the directors to act honestly and in good faith with a view to the best interests of the corporation. In using their skills for the benefit of the corporation when it is in troubled waters financially, the directors must be careful to attempt to act in its best interests by creating a "better" corporation, and not to favour the interests of any one group of stakeholders. *If the stakeholders cannot avail themselves of the statutory fiduciary duty*…to sue the directors for failing to take care of their interests, *they have other means at their disposal*."

Noting that the oppression remedy "grant[s] the broadest rights to creditors of any common law jurisdiction", the Supreme Court continued:

> *"Section 241 of the CBCA provides a possible mechanism for creditors to protect their interests from the prejudicial conduct of directors*. In our view, *the availability of such a broad oppression remedy undermines any perceived need to extend the fiduciary duty imposed on directors* by Section 122(1)(a) of the *CBCA to include creditors*."[6] (emphasis added)

Canadian courts have made a number of decisions of significance to creditors (individually or as collectively represented by a trustee in bankruptcy) in relation to the oppression remedy. Specifically, it is now settled that:

- although debt actions should not routinely be converted to oppression actions, in appropriate circumstances a creditor may be granted status as a "complainant" for purposes of advancing an oppression remedy;
- in appropriate circumstances, a trustee in bankruptcy[7] may be granted status as a "complainant" to bring a claim for oppression against the former directors of an insolvent corporation;
- in appropriate circumstances, a contingent creditor i.e., one whose claim against the directors had not yet crystallized at the time of the allegedly oppressive conduct, but whose legitimate interests and claim were known to the director(s) at the time of their challenged conduct, may also qualify as a "complainant";
- a finding of oppression can be made, and relief for oppression granted, even in the absence of intent or lack of probity on the part of the director whose conduct is at issue, where such conduct effects a result that is unfairly prejudicial to, or unfairly disregards, the interests of a creditor.

Notwithstanding these decisions, creditors should not take the oppression remedy for granted. In its most recent decision analyzing the scope and application of the oppression remedy, *BCE Inc. v. 1976 Debenture Holders*, 2008 SCC 69 ("*BCE*")[8], the Supreme Court emphasized the following:

> Oppression is an equitable remedy: "It seeks to ensure fairness - what is 'just and equitable'. It gives a court broad, equitable jurisdiction to enforce not just what is legal but what is fair…It follows that courts considering claims for oppression should look at business realities, not merely narrow legalities…"

Oppression is fact-specific: "What is just and equitable is judged by the reasonable expectations of the

6 *Peoples*, paragraphs 43, 44, 46, 47-51.

7 Or, it would seem, a liquidator or receiver.

8 *BCE* did not involve an insolvent corporation. Rather, certain debenture holders challenged a plan of arrangement for which BCE sought court approval and which contemplated a leveraged buy-out of BCE's shares, on the basis that it was oppressive to their interests.

stakeholders in the context and in regard to the relationships at play. Conduct that may be oppressive in one situation may not be in another."

The directors' conduct must be unfair or oppressive: "Not every failure to meet a reasonable expectation will give rise to the equitable considerations that ground actions for oppression. The court must be satisfied that the conduct falls within the concepts of 'oppression', 'unfair prejudice' or 'unfair disregard' of the claimant's interest within the meaning of Section 241 of the *CBCA*."

As well, while there have been a number of decisions finding oppression on the part of, and granting judgment personally against, directors of relatively small, usually private, insolvent corporations in circumstances where their acts have resulted in depleting their corporations' assets, thereby rendering creditors' efforts to collect upon a debt or judgment worthless - particularly in (but not restricted to) circumstances where their acts resulted in their own financial benefit or gain, there does not appear to have been any reported decision in which a Canadian court has made a finding of oppression against former directors of any publicly-listed insolvent (formally or otherwise) corporation in response to a claim by a creditor or a trustee acting on their behalf. Such claims have, however, been advanced. Two of the more significant ones in recent years were:

- *Dylex Ltd. (Trustee of) v. Anderson et al* (2003), 63 O.R. (3d) 659 (Ont. S.C.J. Comm. List) - A claim by the trustee in bankruptcy of Dylex Ltd., a Toronto-based retailer operating in Ontario, against its former directors alleging, *inter alia*, oppression arising from their approval of a leveraged buy-out by a "shell" purchaser whose financial failure shortly after the purchase resulted in Dylex's bankruptcy and significant losses to its creditors.

- *Royal Bank of Canada et al vs. Bennett et al*, (Ontario Superior Court of Justice, Comm. List, 2002) - A claim by a lending syndicate of Canadian and U.S. banks against the former directors of Bracknell Corporation, a large Toronto-based construction, network-servicing and equipment company operating in Canada and the U.S., in circumstances where, unable to obtain the lending syndicate's agreement to refinance its loans to Bracknell, the directors resigned *en masse* and turned over *de facto* control to the syndicate, leaving it to realize upon its security in the absence of any formal insolvency proceeding.

Neither of these claims reached trial.

As a result, the scope of the oppression remedy as a means of recovery by creditors against directors of publicly-traded insolvent corporations in Canada has yet to be established. From the Supreme Court's decision in *BCE*, however, two things are clear. The first is that in assessing whether oppression has occurred in any such claim, a court will examine carefully the reasonableness of a complainant's expectations in light of the corporation's published statements, documents and all of the circumstances. The second is that if the directors have, on the evidence, properly considered the relevant factors and interests before making the decision or taking the particular action, a court will be loath to second-guess them, as the business judgment rule is alive and well in Canada. It is also possible that the recent amendments to our securities legislation incorporating civil liability for secondary market disclosure will lessen the number of oppression claims. Given the state of the economy and the recent failure of a number of previously successful Canadian corporations, however, there is every reason to believe that further jurisprudence on this unique remedy will be forthcoming. ⚖

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THE "ZONE OF INSOLVENCY"...

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application of the Official Liquidator, or the liquidator or any creditor or contributory of the company, may declare that any persons, who were knowingly parties to carrying on business for a 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 the Court may direct. In addition, the law provides that every person who was knowingly a party to the fraudulent conduct shall be punishable with imprisonment for a term of to two years, or with a fine of up to five thousand rupees, or with both.

The most significant example of directors' exposure under Indian law is the Satyam case. As the *Times of India* reported on January 9, 2009, although Ramalinga Raju, the Chief Executive of Satyam, has consistently endeavored to take sole responsibility for the fraud that he has admitted committing in falsifying the company's books:

Some of the more serious penalties that Raju and others are likely to face under various laws are:

* Section 23 of the securities contract regulation Act 1956, that imposes a penalty of imprisonment up to 10 years and fine up to Rs 25 crore. The adjudicating officer of Sebi is empowered to award such punishment to directors and management executives for violating the listing agreement by making false and inaccurate disclosures in the company's quarterly and annual results. The penalty is severe because of the enormous damage that the investors are liable to suffer on account of false disclosures.

* Section 24 of the Sebi Act 1992 that imposes a penalty of imprisonment up to one year for infringement of any provisions of the law or rules and regulations, including fraudulent and unfair trade practices (FUTP).

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ASSISTING WITH ENQUIRIES...

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Section 167 - General investigations.

Section 168 - Specific investigations.

Section 165 – Powers to require information

Interestingly, although section 165 of the FSMA is often referred to as a type of investigation, it is not so regarded by the FSA itself. Instead, the FSA regards section 165 as an investigatory power, *i.e*. the power to require information to be given. What is more, if the FSA is seeking information from an authorized person, it may not always invoke the section 165 power. The reason for this is that, under Principle 11, an authorized person is required to disclose any information reasonably required by the FSA.

Section 166 - Skilled Person Report

Under section 166, the FSA may require a lawyer, accountant, industry expert or similar ("the skilled person") to produce a report. The terms of reference for this report will be set by the FSA. The report will be delivered to the FSA but must be paid for by the regulated company. its own right. For example, is a section 235 investigation "formal or official"? Is an FSA investigation under section 165 or 167 an investigation "into the affairs of the company"? From the insurers' perspective, there are good reasons for limiting the ambit of cover for investigation costs. Carriers will wish to guard themselves against the risk of picking up the tab for every type of investigation in which a company director can find himself or herself embroiled since, after all, the main purpose of the cover is to protect directors from claims; however that term may be defined. From the directors' perspective, the danger is that they may find themselves having to fund the cost of legal representation up front (or ask their company, if still solvent, to fund such costs) whilst having to engage in a separate coverage debate with their D&O carriers. Such a situation is far from ideal. In order to avoid or minimize the risk of this occurring, it is recommended that directors and their advisers scrutinize carefully (and, if necessary, discuss with the carriers concerned) the nature and scope of cover in this area before purchasing the insurance.

The Road to Insolvency and Directors' Duties in the "Twilight Zone"

In the current economic climate, the threat of company insolvency is in the forefront of many executives' thoughts. For many, however, it is uncharted territory, complete with its own jargon and procedures.

"Insolvency"_-_What is it?

The insolvency legislation (being primarily the Insolvency Act 1986, as amended by the Insolvency Act 2000 and the Enterprise Act 2002, and supplemented by the Insolvency Rules 1986) does not define the word "insolvency". A company can be considered insolvent based on either of two tests: first, the "cash flow" test, where it is unable to pay debts as they fall due; and, secondly, the "balance sheet" test, where its total liabilities (including contingent and prospective

liabilities such as guarantees) exceed its realizable assets. A company might pass the cash flow test, yet be insolvent under the balance sheet test, or vice versa. The various insolvency procedures have different features. Which one is chosen (or imposed) will largely depend on the prospects for rescuing the company.

Administration

Administration may be initiated by the company, the holder of a "qualifying floating charge" or by the court, normally on the application of a creditor. A statutory moratorium applies, preventing creditors enforcing security without the consent of the administrator. No proceedings, legal or insolvency, can be commenced. This procedure was designed to enable the company to be rescued from insolvency. However, in practice the company is likely be liquidated or dissolved following the administration.

Receivership

Receivership is commenced by a secured lender applying to the court to enforce its security either over specific property subject to a fixed charge or over all the company's assets under a floating charge. However, receivership under a floating charge is generally no longer possible if the charge was created after 15 September 2003. Instead, lenders holding such security may, generally, appoint administrators out of court.

Company Voluntary Arrangement

Under a company voluntary arrangement (or "CVA"), the debtor company and its creditors come to an agreement regarding payment of the company's debts which is implemented and supervised by an insolvency practitioner. This is a "rescue". A CVA can also be used in solvent situations.

Pre-pack

"Pre-pack" is a term used to describe a sale of business put together between the management of the company, its proposed administrators and a buyer before the company enters administration, where the sale is completed by the administrator on appointment, thereby rescuing part of the business.

Liquidation

Finally, liquidation (or "winding up") is generally commenced to close the company and distribute its assets among creditors. It may be voluntarily initiated by the company itself, either because it is insolvent (termed "creditors' voluntary liquidation" ("CVL"), or because its purpose has come to an end ("members' voluntary liquidation"). In both cases, the shareholders place the company into liquidation, but in the case of a CVL, the creditors vote on the liquidator's appointment. A creditor of a company can also petition the court for its winding up if it is insolvent. This is known as 'compulsory' liquidation.

Directors and the "Twilight Zone"

The period between the point when there is no real prospect of avoiding insolvent liquidation and the commencement of one of the insolvency procedures, is often referred to as the "twilight zone". Directors and officers must be especially aware of how the company's uncertain solvency can affect their duties. Normally, directors' duties are owed to the company, that is the shareholders as a whole. However, once a company has entered the "twilight zone", directors are under a legal duty to concentrate on protecting the interests of the creditors rather than those of the shareholders. Section 172(3) of the Companies Act 2006 states that the duty to "promote the success of the company" is subordinated to any enactment or rule of law requiring directors to consider or act in the interests of creditors of the company. By way of illustration, directors should avoid allowing the company to incur further losses or greater liabilities (such as loans), even though shareholders might wish to try and trade out of the financial difficulties. Similarly, directors should also take care to avoid disposing of company property at less than its market value or preferring one creditor unfairly over another. Directors' conduct during this period will be carefully scrutinized by the insolvency practitioner (IP) overseeing the administration or liquidation. The IP is legally obliged to investigate the directors' conduct in the run-up to the insolvency procedure and to report to the Department for Business, Enterprise and Regulatory Reform. Breaches of duty will expose directors to statutory remedies under insolvency and company legislation, such as wrongful trading and misfeasance. Furthermore, the court can set aside or vary transactions at an undervalue and preferences which were entered into up to two years before the commencement of the liquidation or administration. Such proceedings may result in directors facing personal liability and even disqualification. A director's personal lack of awareness of the company's pending insolvency is no defense: the test for liability under wrongful trading, for example, is what is referred to as a "subjective/objective" test. This means the director will be judged both according to the standards of what a reasonably competent director ought to have known, and also with regard to any special knowledge or skills the director actually possesses (for example, accountancy skills). This can raise the courts' expectations accordingly.

Practical Tips

Despite these concerns, neither the courts nor insolvency practitioners aim to punish directors who act reasonably in protecting creditors. The following are

practical considerations for directors to minimize the risk of claims. The financial position of the company should be monitored by preparation of regular financial statements, projections and accounts. Take appropriate advice from professionals. The company accountants should be asked to verify current solvency and cash flow to establish if insolvency can be avoided. Lawyers may be consulted to determine whether any proposed transactions are inappropriate. Advice from an insolvency practitioner should be sought to assess potential strategies for recovery.

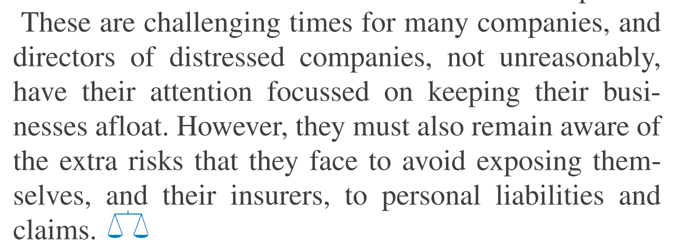
Board meetings and other more informal meetings attended by all directors should be held at regular intervals. Detailed minutes should be kept and briefing papers should be circulated in advance to promote discussion. Absent directors should ensure they are kept informed.

Individual directors with concerns about the solvency of the company should raise them with other board members and have any concerns minuted. If a director's concerns are ignored, the director may even wish to consider obtaining independent legal advice. As a final step, he or she may wish to consider resignation. Resignation alone is not, however, a bar to liability for wrongful trading.

Directors should consider the company's financial situation before incurring further liabilities or agreeing to large compensation or pension packages for departing management.

Be wary, if you are a nominee director or a director of several group companies, of conflicts of interest. Duties to a parent company or appointing company do not override the duties to a subsidiary (and its creditors).

Major creditors and investors should be kept informed, subject to advice from the company's advisers. Special considerations apply for listed companies. For example, the LSE Disclosure and Transparency Rules impose obligations on the release of information. Appropriate announcements must be made to avoid the creation of a false market in shares of listed companies.


These are challenging times for many companies, and directors of distressed companies, not unreasonably, have their attention focussed on keeping their businesses afloat. However, they must also remain aware of the extra risks that they face to avoid exposing themselves, and their insurers, to personal liabilities and claims.

Barlow, Lyde & Gilbert LLP is a leading international law firm. Francis Kean, Esq., Partner, Roderic Mclauchlan, Esq., Partner, and Ross Chipperfield, Esq., Associate The authors, as members of the firm, specialize in directors' and officers' insurance. They advise a wide range of Lloyd's syndicates, London market companies and captive insurance companies in connection with policy construction and coverage disputes.

LIABILITY OF DIRECTORS...

Continued from page 4

be the liquidator though there are provisions that permit unsecured creditors to bring actions directly against directors for trading while insolvent, See Section 588M(3), of the Corporations Act. The standard of proof is predicated on the balance of probabilities.

For a director to be liable under Section 588G(1) there must be "reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be." Section 588G(2) provides that a person contravenes that section by failing to prevent a company from trading while insolvent if:

(a) The person is aware at that time that there are such grounds for so suspecting; or

(b) A reasonable person in a like position in a company in the company's circumstances would be so aware Section 588H contains four separate defenses to liability for trading while insolvent. In summary they are:

(1) At the time the debt was incurred, the person had reasonable grounds to expect, and did expect, that the company was solvent (section 588H(2));

(2) The person had reasonable grounds to believe and did believe that s/he could rely on information from a responsible competent person as to solvency (Section 588H(3));

(3) The director did not participate in the management of thecompany at the relevant time (Section 588H(4));

(4) The person 'took all reasonable steps' to prevent the company from incurring the debt (Section 588H(5)).

Where a director wishes to rely on Section 588H above, the burden of proof shifts to the director to establish one of the four listed affirmative defenses, though the standard remains throughout proof as the balance of probabilities.

It is customary in seeking to establish insolvency to

use expert accounting or actuarial evidence: the requirements for the admissibility of relevant expert opinion evidence are discussed by the Full Court of the Federal Court in *Quick v Stoland,* (1998) 87 FCR 371.

Through voluntary administration and a deed of company arrangement, most directors can potentially create a win / win situation whereby they avoid

insolvent trading claims and creditors get a better return then they would in liquidation. However, directors can no longer rely on the limited liability concept underlying Australia's Corporations Act of 2001. That protection evaporates if the company trades while insolvent.

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Peter Harkin is a partner in the Commercial Dispute Resolution Group of Colin Biggers & Paisley, Sydney, Australia, and leads CBP's Insolvency team. He has extensive experience in all areas of insolvency law, and acts for a number of Liquidators and Trustees as well as financial institutions and creditors. He also assists companies and businesses in financial turnaround exercises.

Perry Granof is Managing Director of Granof International, LLC.

INSOLVENCY AND D&O...

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rise to possible civil penalties and civil claims by liquidators against *de jure* directors as well as *de facto* directors and others who took part in the company's management, including "shadow" directors. The liquidator is entitled to seek recovery on behalf of the creditors for the losses sustained while the Company traded when insolvent.

II. England (Wrongful Trading)

Under Section 214 of the **Insolvency Act of 1986**, and other key statutory provisions, a liquidator may request that the court order directors to contribute towards the shortfall of the company's assets if the directors knew, or ought to have concluded, that there were "no reasonable prospect(s)" of a company avoiding insolvent liquidation, yet continued to do business. Under Section 214, dishonest conduct is not required. If the directors are found liable, damages are paid to the liquidator for distribution among the company's creditors. There are two defenses which directors may assert. First, the directors did not know and could not have been expected to realize that there was no reasonable prospect of avoiding insolvency. Second, if there was no reasonable prospect of avoiding insolvent liquidation, the directors must have taken every effort to minimize the potential loss to the creditors.

III. Germany (Obstruction of Bankruptcy)

Generally, only a company, and not its managing directors, can be liable for wrongful acts. However, there has been at least one case in which the managing directors of a publicly listed corporation were found liable for granting loans without performing sufficient solvency and collateral checks. More commonly, under Section 15a of the **Germany Insolvency Code**, a managing director can be held personally liable in tort if he is proven to have delayed the filing a corporate bankruptcy petition. The insolvent company or its creditors can claim damages for payments that were made by the managing directors when the company was in fact insolvent, preceding the filing of bankruptcy.

IV. France (Liability to pay for the Insufficiency of assets)

Under L.651-2 of the **Commercial Code** by law No. 2005-845 of 26th July, 2005, where the corporation's assets prove insufficient to cover its outstanding liabilities, any *de jure* or *de facto* manager may be held personally liable to pay the insufficiency of the corporation's assets, based upon a finding that **management fault**, contributed to the insolvency. A director may be held liable for the full amount of the insufficiency of assets, even though he was in fact only partially at fault in causing the corporate bankruptcy. The case of ***Nasa Electronique,*** decided by the French Supreme Court on January 3, 1995 held a permanent representative of a legal entity that owned only 5% of the voting shares of a corporation jointly and severally liable with other culpable parties to pay for the entire insufficiency, regardless of the fact that his fault only caused a modest portion of the damages.

V. Netherlands: (Liability for the Deficit in the Bankruptcy)

Under S. 2:138 of the **Dutch Civil Code For Public Companies,** a trustee has the exclusive right to invoke personal liability of corporate directors of bankrupt corporations. Personal liability is established where directors engaged in **obvious mismanagement,** which can be interpreted as a grave mistake that exceeds an entrepreneurial risk. **Ceteco N.V.** is a seminal Dutch case evaluating liability under Dutch bankruptcy statutes. Ceteco was a producer and distributor of audiovisual equipment and white goods that focused on the Latin-American market. It filed for bankruptcy, and the trustee brought action against its former directors. At trial, the court ruled that the trustee had sufficiently

proved that a major cause of the bankruptcy was improper management. It found that management continued to accelerate its growth model, despite the fact that they knew this involved the risk of overstretching. The case is currently on appeal. The trial decision has been strongly criticized as being tainted by hindsight, and that it failed to recognize the board's right to exercise its own business judgment.

VI. Canada: (Oppression Remedy)

Under section 99(1) of the **Ontario Corporations Act**, directors of insolvent corporations are obligated to pay "all debts", not exceeding six months' owed to employees for services provided. It includes guaranteed bonuses, unused sick pay and vacation pay. Canadian law also has an **"oppression remedy"** which is a civil remedy based upon equitable principles. In the case of ***Peoples v. Wise***, the Canadian Supreme Court decided that Oppression could be used as a remedy against Directors and Officers in the context of insolvency. The "oppression remedy" provides that where the business or affairs of the directors "have been or are threatened to be 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 of the corporation, the court may make an order to rectify the matters complained of. "The court may issue a variety of equitable and legal orders of relief, and may order the corporation to pay the claimant's costs. The court need not find fault to provide an oppression remedy; it is sufficient that ones interests have been prejudiced.

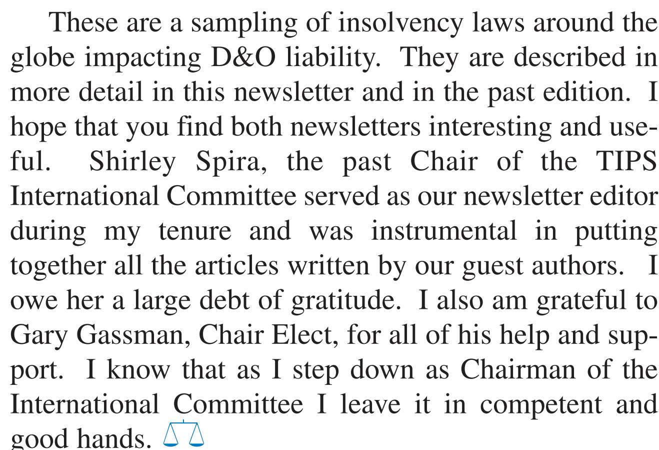
VII. Italy: (Liability for actions when the company was in good standing, and liability for failing to preserve the company's remaining value).

Upon a declaration of bankruptcy, the company's Directors and Officers are automatically terminated from office. Liability stems from the violations of the Directors' and Officers' duties for actions taken while the company was still in good standing. It is very common for the company's Directors and Officers to try to "save" the company by continuing its operations, but, in case of the company's ultimate bankruptcy, such actions constitute a *per se* violation of their duties to preserve the company's remaining value by ceasing operations.

VI. India (Duty of Cooperation of Directors of Insolvent Companies)

The Indian Companies Act specifies that a director of an Indian company in liquidation must co-operate with the liquidator in realizing the assets of the company and distributing them among the creditors and contributors of the company. A director who fails to do so is liable to imprisonment of up to five years, and fine. The directors also have extensive potential liability for any fraudulent activity that occurs in the course of the winding up of a company. If it appears that any business of the company has been carried on with intent to defraud creditors of the company or any other person, or for any fraudulent purpose, the Court may declare that any persons who were knowingly parties to carrying on business for a fraudulent purpose were 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. In addition, the law provides that every person who was knowingly a party to the fraud is punishable with imprisonment for a term of up to two years, or with a fine of up to five thousand rupees, or both.

These are a sampling of insolvency laws around the globe impacting D&O liability. They are described in more detail in this newsletter and in the past edition. I hope that you find both newsletters interesting and useful. Shirley Spira, the past Chair of the TIPS International Committee served as our newsletter editor during my tenure and was instrumental in putting together all the articles written by our guest authors. I owe her a large debt of gratitude. I also am grateful to Gary Gassman, Chair Elect, for all of his help and support. I know that as I step down as Chairman of the International Committee I leave it in competent and good hands.



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THE "ZONE OF INSOLVENCY"...

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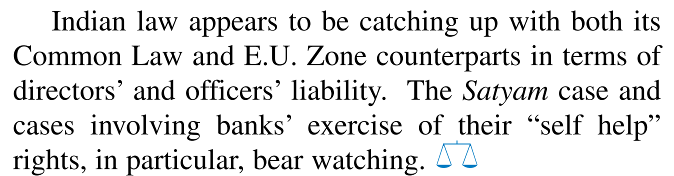
* Section 477-A of the Indian Penal Code, that imposes a penalty of imprisonment up to seven years. The police may on their own or on the recommendation of the serious fraud investigation office (SFIO) invoke this IPC provision meant to punish those found to have falsified accounts "willfully and with intent to defraud."

* Section 211 of the Companies Act that imposes a penalty of imprisonment up to six months. The company law board is empowered to punish those who are found to have "willfully" failed to comply with the require-ments of law relating to the annual financial statement.

Significantly, the job of the prosecuting agencies has been made easier by the damaging admissions made by Raju in his resignation letter to the board. Having taken responsibility for cooking the Satyam books to the tune of Rs 7,136 crore, it is just as well that Raju said, "I am now prepared to subject myself to the laws of the land and face the consequences thereof."

For all his exertions in his resignation letter to save the skin of other directors, they have reason to worry because the Companies Act does not only hold the board to account for any such failure of due diligence, it also makes no distinction in the liability of executive and non-executive or independent directors. The onus is on them to prove the action they had taken to discharge their fiduciary responsibility.



Indian law appears to be catching up with both its Common Law and E.U. Zone counterparts in terms of directors' and officers' liability. The *Satyam* case and cases involving banks' exercise of their "self help" rights, in particular, bear watching.

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2010 TIPS CALENDAR

February

3-9 **ABA Midyear Meeting**
Contact: Felisha A. Stewart – 312/988-5672
The Swan Hotel
Orlando, FL

April

8-9 **2010 Emerging Issues in Motor Vehicle Product Liability Litigation**
Contact: Donald Quarles – 312/988-5708
Arizona Biltmore Resort & Spa
Phoenix, AZ

9-10 **19th Annual Toxic Torts Spring CLE Meeting**
Contact: Debra D. Dotson – 312/988-5597
Arizona Biltmore Resort & Spa
Phoenix, AZ

17-21 **TIPS/ABOTA National Trial Academy**
Contact: Donald Quarles – 312/988-5708
Grand Sierra Resort & Spa
Reno, NV