Inês Viegas Lopes Fiduciary Duties of Directors and the Problem of Uncertainty of the "Zone of Insolvency": Comparative Perspective.

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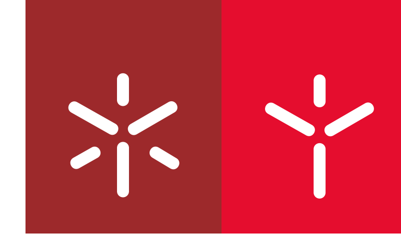

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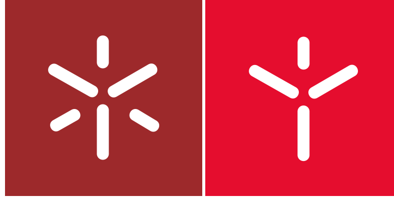

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Inês Viegas Lopes

Fiduciary Duties of Directors and the Problem of Uncertainty of the “Zone of Insolvency”: Comparative Perspective.

Master Dissertation
LLM in European and Transglobal Business Law

Dissertation conducted under the guidance of
Pedro Dias Venâncio PhD

July, 2020

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I would like to dedicate this work to my inspirations:
my grandfather and my mother.

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It is with great satisfaction that I take this challenging stage of my life to an end and it is also with my eyes projected on the future and new challenges that I thank all those who contributed, directly or indirectly, to the success of this thesis.

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Obrigada a todos!

STATEMENT OF INTEGRITY

I hereby declare having conducted this academic work with integrity. I confirm that I have not used plagiarism or any form of undue use of information or falsification of results along the process leading to its elaboration.

I further declare that I have fully acknowledged the Code of Ethical Conduct of the University of Minho.

ABSTRACT

The fiduciary duties of corporate directors are one of the most important principles in the management of modern corporations and have the main objective of controlling the people who manage the company as well as giving an answer to the agency theory. Traditionally the fiduciary duties are an Anglo-Saxon concept that were transplanted to the civil-law world. Directors must comply with those duties, in the different financial stages where the company may find itself, under the penalty of triggering their personal liability. The vicinity of insolvency is a problematic financial period in which a company may find itself. In most jurisdictions, the vicinity of insolvency is regarded as an undefined period between solvency and insolvency. This lack of precise definition, be it legal or economic, and the inherent difficulty (and even impossibility) to establish clear and precise guidelines for those who manage the firm's assets create insecurity for the all business enterprise. Some jurisdictions, such as the UK, apply a shifting duty to creditors during the vicinity of insolvency. That is to say that when the company is presumed to be in the vicinity of insolvency, the creditors' interests become paramount. After comparing with two other jurisdictions – the US corporate law Portuguese jurisdiction – that do not apply the shifting during the vicinity of insolvency, it is possible to conclude that creditors are already strongly protected by the law and, for this reason, the shifting can only add more uncertainty to the twilight zone. The objective of this thesis is to prove that, although the shifting duty theory may grant more protection for creditors in an earlier stage before insolvency and also can, in some cases, be easier for directors to balance the conflict of interests, the shifting duty theory during the "zone" will be detrimental for the business activity. That can happen due to the pressure added on directors, who fear to trigger their personal liability and thus make decisions which can compromise the company's ability to create wealth and a possible turnaround.

Keywords: vicinity of insolvency; zone of insolvency; fiduciary duties; duty shifting; agency problems; "zone"; twilight zone; personal liability; civil-law; Anglo-Saxon concept.

RESUMO

Os deveres fiduciários dos administradores são um dos princípios mais importantes na gestão das empresas, tendo como principal objetivo controlar aqueles que fazem parte dessa gestão e dar resposta aos problemas da teoria da agência. Os deveres fiduciários são, tradicionalmente, vistos como uma criação Anglo-saxónica que foram posteriormente transplantados para o contexto legal dos países com um sistema legal Romano. Os administradores corporativos devem cumprir essas obrigações, nos diferentes estágios financeiros em que a empresa se possa encontra; caso não o façam podem desencadear a sua responsabilidade civil. A zona de insolvência é um período problemático da vida de uma empresa. Na maioria das jurisdições, a insolvência iminente é considerada um período incerto entre solvência e insolvência. Esta lacuna (jurídica e económica), aliada da impossibilidade inerente de estabelecer diretrizes claras e concretas de como se espera que o administrador atue, cria insegurança para toda a empresa e para a atividade económica da mesma. Algumas jurisdições, como o UK, adotaram a transferência de prioridade dos deveres fiduciários da empresa e respetivos acionistas para os credores, durante situações de insolvência iminente. Nesse sentido, quando se presume que a empresa está próxima da insolvência, a satisfação dos interesses dos credores torna-se a prioridade. Comparando com as outras duas jurisdições – US e Portugal – que não aplicam esta teoria no limiar da insolvência é possível concluir que os credores já se encontram devidamente protegidos pelos meios legais e contratuais existentes, não sendo necessário a aplicação de uma mudança de prioridade dos deveres fiduciários dos administradores durante a zona de insolvência, uma vez que a mesma poderá criar ainda mais incerteza. O objetivo desta tese é provar que, embora a teoria da priorização dos interesses dos credores durante o estágio anterior à insolvência possa, em alguns casos, facilitar a gestão dos conflitos de interesses pelos administradores, esta priorização poderá ser muito mais prejudicial para toda a atividade empresarial. Ao aplicar a teoria da priorização dos interesses dos credores pressionará os administradores a tomar decisões menos arriscadas, o que pode comprometer a criação de riqueza da empresa e uma possível recuperação.

Palavras-chave: pré-insolvência; zona de insolvência; insolvência iminente; deveres fiduciários; deveres dos administradores; teoria da agência; responsabilidade dos administradores; “zona”; limiar de insolvência; sistema legal Romano; conceito Anglo-saxónico.

METHODOLOGY

The elaboration of this master thesis presupposes the critical analysis of an exhaustive bibliographic review with a series of works and Jurisprudence of significant importance to Corporate Law, specifically in the field of Governance and Compliance with fiduciary duties and Insolvency Law.

It is important to comprehend first that one of the most relevant and active courts in the world regarding fiduciary duties is the Supreme Court of Delaware. Delaware's decisions are cited by countless legal experts not only in the US and in the UK, but also by scholars in the civil law countries. Thanks to the relevance that those decisions have in the corporate law all around the world, the comparative analysis of this thesis will have as a starting point the position of the Delaware Supreme Court.

The comparative approach of this study proposes the establishment of a parallel between Delaware's position and other jurisdictions, in this case the UK and more specifically the English law, as well as Portugal. Regarding the UK, we will be focusing on the Companies Act of 2006 and the Insolvency Act of 1986. Regarding Portugal, we will be focusing the *"Código das Sociedades Comerciais (CSC)"*[1] and also *"Código da Insolvência e da Recuperação de Empresas (CIRE)"*[2], which were largely influenced by the German doctrine and also by the EU law, thus aiming to better understand the differences between common and civil law jurisdictions regarding the topic.

The comparative approach to the problem intends to scrutinize what is the most effective way to look at the fiduciary duties of directors of distress companies. In other words, what is the most effective approach to guarantee profits and avoid liquidation. Therefore, after analysing the different legal approaches to the controversial question of fiduciary shifting duties to creditors during the vicinity of insolvency, it is possible to conclude whether there should be a fiduciary duty to creditor when a company is facing financial problems and what the most effective approach would be to deal with the agency problems and create value for the firm.

[1] Portuguese Commercial Companies Code.

[2] The Portuguese Insolvency and Corporate Recovery Code.

CITATION STYLE[3]

The citation style of this thesis is made according to general rules:

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[3] Disclaimer: all the citations regarding the books and articles of Portuguese authors were translated to English by this author's dissertation. The laws cited in this thesis are subjected to change.

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ABBREVIATIONS

AC – Portuguese Court Decision (*Acórdão)*

BJR – Business Judgment Rule

CA – Companies Act

CDDA – Company Directors Disqualification Act 1986

CIRE – The Portuguese Insolvency and Corporate Recovery Code

CSC – Portuguese Commercial Companies Code

CVA – Company Voluntary Arrangements

DL – Law Decree

DIP – Debtor in Possession

EU – European Union

IA – Insolvency Act

MAP – Early Warning Mechanism

LLC – Limited Liability Company

PER – Special Revitalization Process

Proc. – Process number

RERE – Extrajudicial Regime for the Companies Recovery

UFTA – Uniform Fraudulent Transfer Act

UK – United Kingdom

US – United States

USBC – United States Bankruptcy Code

UVTA – Uniform Voidable Transactions Act

INTRODUCTION

In modern corporations, fiduciary duties are a fundamental criterion when running a business and an essential tool to guarantee profits for the company. Directors' fiduciary duties are one of the most important principles to control the management of the company – particularly when that company is facing financial problems. For this reason, it is easy to understand why directors are subjected to such intense scrutiny. Fiduciary duties are creations of Equity that was, in turn, created in the equity courts of England and transplanted to the US years later. The origins and definition of these concepts are debatable. Indeed, there are different theories regarding the nature of fiduciary duties that we going to explore in the first part of this dissertation. Despite some opinions to the contrary[4], most of the Doctrine and scholars considered the concept of fiduciary duties as a common law concept that was transplanted to the civil law world, thanks to the movement of Corporate Governance.

One of the main explanations of the necessity of having fiduciary duties imposed on directors has to do with the classic agency costs problem or the principal-agent problems[5]. Since shareholders give directors the power to control the corporate assets, directors have the obligation to pursuit corporate efficiency; shareholders are then in a vulnerable position and thus the fiduciary duties exist to control and mitigate the possibility of directors' abuse of power.

It is largely agreed and sustained by the majority of the Doctrine that directors in solvent companies owe fiduciary duties to the corporation and its shareholders, but not to the creditors beyond the relevant contractual terms, which means that creditors have no direct claim against directors for breach of fiduciary duties. There are two main fiduciary duties that a director must always comply with: the duty of care and the duty of loyalty. In Delaware, the duty of care is a standard of behavior; this means that the director must act in the company's best interest. In other words, directors have the responsibility to be informed while making decisions and be aware of the business of the corporation to avoid any behavior that could bring about negative consequences. To meet this duty, directors should consider several

[4] Some authors defend the existence of fiduciary duties in the civil law world for many years, though with different nature and definition. See e.g., Gelter, Martin & Helleringer, Geneviève. "Fiduciary Principles in the European Civil Law Systems", *in The Oxford Handbook of Fiduciary Law*, edited by Criddle, Evan J., Miller, Paul B., & Sitkoff, Robert H. Oxford University Press, 2019, at p. 583. Retrieved from: https://books.google.pt/books?id=WiSQDwAAQBAJ&pg=PA583&lpg=PA583&dq=Gelter,+Martin+%26+Helleringer,+Genevi%C3%A8ve.+Fiduciary+Principles+in+the+European+Civil+Law+Systems,&source=bl&ots=dMKm17gPK1&sig=ACfU3U2_DbyyVYIBMIjLBMhLdnB9IbzJOg&hl=ptPT&sa=X&ved=2ahUKEwinnaW62rLmAhVE8eAKHZn3AssQ6AEwA3oECAkQAQ#v=onepage&q=Gelter%2C%20Martin%20%26%20Helleringer%2C%20Genevi%C3%A8ve.%20Fiduciary%20Principles%20in%20the%20European%20Civil%20Law%20Systems%2C&f=false [Accessed on 13.12.2019].

[5] With this point of view see in general e.g., Sitkoff, Robert H. "An Economic Theory Of Fiduciary Law", in *Philosophical Foundations of Fiduciary Law*, edited by Andrew Gold & Paul Miller eds. Cambridge: Oxford University Press, 2014; see also Kraakman, Reinier et al. *The Anatomy of corporate Law. A Comparative and Functional Approach*. Third edition. Oxford University Press, 2017.

factors: (1) time commitment and regular attendance, which presupposes that directors will attend regularly and participate in the board meetings; (2) the necessity to be informed and prepared, they must seek all the information needed to properly fulfill their duty; (3) the right to rely on others, which means rely on good faith on reports and other information from corporate officers, legal counsel, etc.; (4) inquiry regarding potential issues that could affect the corporation and the business; and (5) obligation to mediate during possible conflict of interests that may appear inside the corporation, to ensure the effective decision-making process of the board. On the other hand, we have the duty of loyalty that requires directors to act also in the company's best interests. Additionally, the duty of loyalty presupposes that the director will not act according to his or her own interests or in the interests of another person or organization. This duty also entails the avoidance of conflict of interests; for this reason, directors must consider several factors. Besides the requirement of acting with good faith and the requirement of avoiding conflict of interests, they need to review the impartiality of the transaction involving conflicts of interests and provide impartial advice during such conflicts. It is important to note that the approach of Delaware is very different from the way the UK sees fiduciary duties and much more similar to the actual fiduciary duties of Portuguese corporate directors, as we are going to explore in the first Chapter of this dissertation.

When a company becomes insolvent, this regular paradigm changes. In fact, in these cases, the fiduciary duties of directors increase to also include the interests of creditors – in the Delaware approach – or those interests are seen as paramount – which is the case in the Portuguese and English approach. An important aspect regarding insolvency and fiduciary duties has to do with the question of when a corporation enters that stage. To know in fact if the company is insolvent or not, the directors can apply two different tests. The first one is the Cashflow Test, which takes into consideration if a company can pay its liabilities and when they are due. If the company is unable to meet the daily costs, then we can say that it is near insolvency or insolvent. The second test is the Balance Sheet Test, which looks at all assets of the company, including stock, credits, property (movable and immovable) and then places these assets against the company's debts. The objective is to understand if the company has more assets or debts. If the debts are superior to the assets the company is insolvent.

Beyond solvency and insolvency, there are two more financial stages that a corporation can face: the vicinity of insolvency and bankruptcy – the latter being commonly used as a synonym of "insolvent", but has a different meaning, as we going to see later. The vicinity of insolvency is particularly problematic because is not yet a crisis, but does not presuppose a stable and profit financial situation. Although the fiduciary duties that directors owe to shareholders, creditors and to the corporation are clear when the

company is solvent and even when it becomes insolvent, when we talk about the "vicinity of insolvency" the boundaries of those duties start to blur. One of the major problems of the vicinity of insolvency has to do with the shifting duty theory. This shifting duty theory defends the shift of director's fiduciary duties from shareholders to creditors, to protect the latter from possible abuse of shareholders. This shifting theory is applied by the UK. However, the same does not occur in the US or in Portugal. Since the *Gheewalla* case the US, and namely the Delaware corporate law, has rejected the shifting duty theory. When it comes to Portugal, until this moment, there has not been applied any shifting in priority of the fiduciary duties of directors. However, some authors defend that the new Directive (EU) 2019/1023 may change this paradigm.

The vicinity of insolvency is a particularly dangerous period for directors, because conflicts of interests between shareholders and creditors start to happen more frequently and, for that reason, directors must be able to balance these conflicts efficiently in order to comply with their fiduciary duties. However, since there is no legal definition regarding the brink of insolvency nor coherent legal guidelines to directors, the balance of conflicts tends to be more sensitive and difficult. This leads us to the subject of the director's possible liabilities. In the US, the liabilities during the vicinity of insolvency are mainly civil and not criminal. Regarding the risk of liability, the US occupies the "Low Risk" group, according to the international survey conducted by PHILIP R. WOOD in the report of INSOL INTERNATIONAL GROUP THIRTY-SIX[6]. Maybe one of the possible explanations for this low risk of liability has to do with the strong influence of the Business Judgment Rule (BJR) in the US courts.

The Business Judgment Rule (BJR) understands that directors manage the business and the affairs of a corporation in an informed way; the BJR reflects a fundamental economic freedom of directors in decision-making and an encouragement of informed risk taking[7]. Consequently, if directors act in good faith and in an informed way, the BJR will protect them from the results of those business decisions. On the other hand, in the UK and Portugal, directors may see their civil and criminal liabilities triggered for decisions take in the vicinity of insolvency. Indeed, the risk of liability is much more dramatic in these two countries; although both apply mechanisms similar to the BJR, these jurisdictions are much more creditor friendly than the US.

This dissertation is divided in three fundamental parts. The first part clarifies the nature of fiduciary duties; the fiduciary duties of the board of directors; their importance to the corporate law; the

[6] Wood, Philip R. "Overview" *in Directors in the Twilight Zone V*, edited by INSOL International Group Thirty-six, 2017, p. ix. Retrieved from: https://www.insol.org/_files/Publications/TwilightV/Twilight%20V%209%20May%20BM%20linked%202017.pdf.

[7] See e.g., Branson, Douglas M. "The Rule That Isn't a Rule. The Business Judgement Rule." *Valparaiso University Law Review* No 36, 2002, pp. 631-654.

differences in nature and in the application of fiduciary duties in civil and common law countries. This part also presupposes the analysis of the fiduciary duties in the different financial stages of a corporation – solvency, vicinity of insolvency, insolvency and bankruptcy. In the second part, CHAPTER II, we discuss the problems surrounding the zone of insolvency; the problems that the zone aggravates; and the different approaches (of the US, the UK and Portugal) to the shifting duty theory. The third and last part of this dissertation, CHAPTER III, intends to analyse the question of possible liabilities for directors for decisions made during the vicinity of insolvency in the US, the UK and Portugal.

CHAPTER I – CORPORATE FIDUCIARY DUTIES

1. The Nature of Fiduciary Duties:

The fiduciary duties are a historical and very rich concept and one of the most important standards in the modern world. Historically speaking, the fiduciary duties have ancient roots[8]; it is possible to find allusions to the fiduciary principles, for instance, in provisions of the code of Hammurabi (1700 b.C.) and its celebration in the codification of the Chinese law during the Qing Dynasty (1644-1911). Beyond that, it is also possible to see the incorporation of fiduciary duties in Roman law[9], in regulations regarding social relationships and also business practices.

The fiduciary duties are complex, and the meaning is surrounded by controversy. To understand the concept and its controversy it is necessary, first, to understand the relationships in which fiduciary duties may appear. A fiduciary duty is a specific duty which arises from specific relationships, commonly called of "fiduciary relationships". A fiduciary relationship can be defined as the relationship in which a person has a duty to act in the best interests of another[10]. Beyond that, these relationships presuppose an interaction between a fiduciary – the one in which the law imposes the duty – and the beneficiary, who is more vulnerable in case of abuse of those duties. It is important to understand that fiduciary relationships, like the concept of fiduciary duties, are also problematic concepts. In fact, one of the biggest problems has to do with the lack of precise definition of their boundaries; of what constitutes a breach of those relationships; and of what the consequences of this breach can be[11].

For professor AUSTIN SCOTT[12], *a fiduciary* can be understood as "a person who undertakes to act in the interest of another person"[13]. A fiduciary relationship includes, for example, duties of an agent to a principal, an attorney to his/her client, an executer to a legatee, the duties of corporate directors to the corporation and its shareholders, etc. Furthermore, for this author the element of trust is the fundamental

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[8] See e.g., Frankel, Tamar. *Fiduciary Law.* 1st Edition. Oxford University Press, 2010; Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers." *Journal of Markets & Morality* vol 8, no. 1, 2005, pp. 27-51.

[9] See Frankel, Tamar. *Fiduciary Law*, ibid.; Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers", ibid.; Rotman, Leonard I. "Fiduciary Doctrine: A concept in Need of Understanding." *Alberta Law Review,* vol. XXXIV, no. 4, 1996, p. 822-851.

[10] See e.g., Velasco, Julian. "Fiduciary Duties and Fiduciary Outs". *GEO. MASON L. REVIEW* vol. 21, no. 1, 2013, pp. 157-216; Miller, Paul B. "Justifying Fiduciary Duties". *MCGILL LAW JOURNAL* vol. 58, no. 4, 2013, pp. 971-1023. Retrieved from: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2083855; Miller, Paul B. "A Theory of Fiduciary Liability." *MCGILL LAW JOURNAL* vol. 56, no. 2, 2011, pp. 240-247.

[11] See Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers", *supra* note 8.

[12] Scott, Austin W. "The Fiduciary Principle". *California Law Review* vol. 37, no. 4, 1949, pp. 540-555.

[13] Ibid., *op.cit.,* p. 540.

criterion to be met in a fiduciary relationship. Consequently, the fiduciary relationship and the underlying element of trust creates a moral obligation of loyalty for the fiduciary. This moral obligation of loyalty, according to the author, forces the fiduciary to act in the best interest of the beneficiary.

DEBORAH A. DEMOTT, on the other hand, criticized Austin Scott's definition by saying that his formulation is not always linear[14]. The fiduciary relantionships are much more complex than Austin Scott demonstrated. For DEBORAH A. DEMOTT, Austin Scott's definition presents an unjustified focus on the voluntary hypothesis of the duty for the fiduciary, which does not make sense in “cases of constructive trustees”[15] or in other cases in which the courts imposed fiduciary duties to one of the parties of the fiduciary relationship. Beyond that, the formulation of Austin Scott about fiduciary obligations give rise to a conjecture that all fiduciaries owe the same duties regardless the situation. This appears to be, for the majority of the Doctrine, a misguided assumption[16].

Although the doctrine has developed over time, the lack of consensus regarding the nature of fiduciary law still exists. For many legal experts, the complexity of fiduciary law results in the lack of a precise definition about its principles and obligations[17]. For some legal experts, fiduciary duties are creations of trust relationships or equity; however, others believe that fiduciary duties have roots in property law or contract law[18]. It is necessary to understand, however, that even with all the controversy about the nature of fiduciary duties, the most recognized approach nowadays is the one which suggests that fiduciary duties are creations of trust law[19] – which, in turn, lead to a creation of Equity.

For LEONARD I. ROTMAN[20], the evolution of the fiduciary law is palpable. In fact, for this author

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[14] DeMott, Deborah A. “Beyond the Metaphor: An Analysis of Fiduciary Obligation.” *Duke Law Journal,* vol. 37, 1988, at p. 923 (“The considerable variety of relationships in which parties are bound by fiduciary obligation further complicates the analysis. Determining whether fiduciary obligation applies in a particular context and what requirements in here in the imposition of fiduciary obligation demands recognition of this situation-specificity.”).

[15] Ibid., *op. cit.,* p. 910.

[16] See DeMott, Deborah A. “Beyond the Metaphor: An Analysis of Fiduciary Obligation.”, at p. 923 (“Fiduciary obligation has a number of characteristics that classify it among the law's most exotic species”); Sealy, LS. “Fiduciary Relationship”. *Cambridge Law journal,* vol. 20, no. 1, 1962, pp. 69-81(in his opinion, the term *fiduciary* does not describe one single spectrum of relationships to which are fixed rules and obligations); for more information see also Finn, Paul. *Fiduciary Obligations.* Sydney: The Federation Press, 1977; Smith, Gordon D. “The Critical Resource theory of Fiduciary Duty”. *VANDERBILT LAW REVIEW*, vol. 55, no. 5, 2002, at p. 1427 (“This principle may not account for fiduciary relationships that are formed inadvertently, such as general partnerships. Even if the "undertaking principle" accurately described all fiduciaries, it contains no limiting principle that would exclude, for example, a random act of kindness”). Retrieved from: https://pdfs.semanticscholar.org/efbd/aa434ee71f813410402ad389269a0668fcf6.pdf?_ga=2.60223341.1768419407.1580169146-1033518257.1561476563;Frankel, Tamar. *Fiduciary Law*, at pp. 2 (quoting that “one reason for the paucity of general definition of fiduciary relationships may be the many situations and contexts in which these relationships appear”). See in general also Kelly, Daniel B. “Fiduciary Principles in Fact-based Fiduciary Relationships”, *in The Oxford Handbook of Fiduciary Law,* edited by Criddle, Evan J., Miller, Paul B., & Sitkoff, Robert H. Oxford University Press, 2019. Retrieved from: https://books.google.pt/books?hl=en&lr=&id=WiSQDwAAQBAJ&oi=fnd&pg=PP1&ots=dMKm-blORV&sig=BGcwn9jkDdJBuu88-7nq9r_YoCI&redir_esc=y#v=onepage&q&f=false [Accessed on 11.12.2019];

[17] See Velasco, Julian. “Fiduciary Duties and Fiduciary Outs”, *supra* note 10.

[18] Ibid., p. 160 (“For example, scholars do not agree on the source of fiduciary law- whether it is based on property, contracts, morality, or some other foundation. In fact, many scholars are sceptical about whether fiduciary law can be adequately defined”).

[19] DeMott, Deborah A. “Beyond the Metaphor: An Analysis of Fiduciary Obligation”, at p. 923 (“Fiduciary obligation has a number of characteristics that classify it among the law's most exotic species. Its origin in Equity and its continuing tie to Equity's legacy make it unusually context-bound as a legal obligation”);

[20] Rotman, Leonard I. “Fiduciary Law’s Holy Grail: Reconciling Theory and Practice in Fiduciary Jurisprudence”. *BOSTON UNIVERSITY LAW REVIEW*, vol. 91, no. 921, 2011, pp. 921-971. Retrieved from: https://pdfs.semanticscholar.org/f96f/3279b081049cc3debd87e50f6ada1bfa84c2.pdf.

"when the fiduciary law was initially developed in English law, was not distinguished terminologically from the concept of trust"[21]. This connection started to expand to also embrace non-trustees "who occupied positions of trust and confidence or who were entrusted by others for particular purposes but did not satisfy the criteria associated with express trusts"[22]. Consequently, in the author's opinion, the fiduciary duties are strict duties and should be applicable in those situations in which the law of contract is poor or ineffective.

The term *fiduciary duty* has been present in the English corporate law for more than 250 years[23] and was subsequently transferred into American law. In the leading case of *Keech v. Sandford,* in 1726, the English Court of Equity established that the rule present in the case was not restricted only to trustees; in other words, the rule applies to every person in a fiduciary position. This case is particularly relevant because it establishes the foundations of what we now call "duty of loyalty", one of the most important legal obligations in modern corporate law.

In the field of American law , one of the most significant cases which has been cited by numerous scholars is the *Meinhard v. Salmon*. This case reflects the basic principles of a fiduciary relationship: a duty of loyalty that goes beyond the exact terms of a contract[24]. Beyond that, *Meinhard v. Salmon* proves the existence of a relationship of dependence between economics and the fiduciary law[25]. The objective of fiduciary law is to ensure that the agent or the fiduciary – knowing that his or her misconduct may give rise to compensation for damages and disgorgement remedies – will be persuaded to act in the best interest of the beneficiary. This means that, without the protection of fiduciary duties, investors will fear losing all their assets, when there is an opportunity on the table to invest in risky projects, which could compromise "the success of our system of managerial capitalism"[26].

2. The civil law tradition vs the common law tradition:

The fiduciary duties are originally creations of the Anglo-Saxon jurisdiction, and as previously said, fiduciary duties are the creation of the courts of Equity in England. It is important to be aware of the fact

[21] Ibid., *op. cit.*, pp. 925.
[22] Ibid.
[23] See in general Cooter, Robert & Freedman, Bradley J. "The fiduciary relationship: its economic character and legal consequences." *New York University Law Review,* vol. 66, no. 1045, 1991, pp. 1045-1075; in the same line see e.g. Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers.", *supra* note 8; and Rotman, Leonard I. "Fiduciary Doctrine: A concept in Need of Understanding.", at p. 822.
[24] See *Meinhard v. Salmon,* 164 N.E. 545 (N.Y. 1928) (fiduciaries held to the duty of "undivided loyalty").
[25] Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers", at p.32.
[26] Ibid. *op.cit.,* p.32.

that in the common law countries there is a historical difference between law and equity, which does not happen in the tradition of civil law. This view of law and equity as separate fields influenced a lot the way in which fiduciary duties were explored and developed in both legal systems. Indeed, even with the fusion of the courts of equity and law – after the Judicature Acts of 1873 and 1875[27] – the functional rules of law and equity remained divergent. Consequently, the fiduciary duties developed, in the common law countries, as a separated field from contract law, something that did not happen in the civil law countries, where fiduciary duties tended to be a part of other domains.

Even so, it is possible to find fiduciary duties and fiduciary relationships in the jurisdiction of civil law. In fact, if we look closely at the contract law of the civil law jurisdiction, for example Portugal[28], it is possible to observe a fiduciary obligation of one to the other party of the contract. In fact, the duty of good faith and "fairdealing" is one of the most important legal principles in the contract law of the civil law countries[29]. This obligation of good faith applied into contract law does not exist in the common law tradition. Therefore, in the world of civil law, fiduciary duties are not seen as a separate category from contract law, unlike the historical tradition of common law.

For MARTIN GELTER & GENEVIÈVE HELLERINGER, fiduciary relationships and fiduciary duties have been present in the world of civil law for many years. However, the terms had not been named and remained undeveloped and implicit in the law[30]. This led to the inexistence of special remedies for fiduciary breaches in the civil law countries, unlike the common law jurisdictions. In fact, for TAMAR FRANKEL "(...) common law remedies for breach of fiduciary duties are far more extensive and serious than those breach of contract, and included that are awared for breach of property rights"[31].

Furthermore, another relevant aspect of the fiduciary duties has to do with the legal transplant of the term. The term "fiduciary duties" is exceptionally difficult to translate to languages other than English.

[27] Pearce, Robert; Stevens, John & Barr, Warren. *The Law of Trusts and Equitable Obligations*. Fifth edition, Oxford University Press, 2010, (explored the notion of trust as a creation of Equity); Frankel, Tamar. "Towards Universal Fiduciary Principles". *Queen's Law Journal,* vol. *39*, no. 2, 2014, pp. 391-392 (tried to unify the fiduciary law by defending a position in which the fiduciary law results from the property law model and from principles of equity). About the same relation of equity in general e.g., Sealy, L.S. "Fiduciary Relationships*", supra* note 12 (also explored the fiduciary duties as creation of equity).

[28] See e.g., Cordeiro, António Menezes. "Os deveres fundamentais dos administradores das sociedades (artigo 64 nº 1, do CSC)" in *A Reforma do Código das Sociedades Comerciais, Jornada em homenagem ao professor Raúl Ventura*. Coimbra: Almedina, 2007. Available at: https://portal.oa.pt/comunicacao/publicacoes/revista/ano-2006/ano-66-vol-ii-set-2006/doutrina/antonio-menezes-cordeiro-os-deveres-fundamentais-dos-administradores-das-sociedades/ [Accessed on 20.03.2020]; Campos, Diogo Leite de. "Boa Fé e Segurança Jurídica em Direito Tributário". Revista ano 2008, ano 68, vol. I. Available at: https://portal.oa.pt/publicacoes/revista/ano-2008/ano-68-vol-i/doutrina/diogo-leite-de-campos-boa-fe-e-seguranca-juridica-em-direito-tributario/ [Accessed on 14.03.2020].

[29] Frankel, Tamar. "Towards Universal Fiduciary Principles", at p. 401 ("(...) the civil law focuses on the contractual terms of the relationship").

[30] Gelter, Martin & Helleringer, Geneviève. "Fiduciary Principles in the European Civil Law Systems", *in The Oxford Handbook of Fiduciary Law*, edited by Criddle, Evan J., Miller, Paul B., & Sitkoff, Robert H. Oxford University Press, 2019, at p. 583. Retrieved from: https://books.google.pt/books?id=WiSQDwAAQBAJ&pg=PA583&lpg=PA583&dq=Gelter,+Martin+%26+Helleringer,+Genevi%C3%A8ve.+Fiduciary+Principles+in+the+European+Civil+Law+Systems,&source=bl&ots=dMKm17gPK1&sig=ACfU3U2_DbyyVYIBMIjLBMhLdnB9IbzJOg&hl=ptPT&sa=X&ved=2ahUKEwinnaW62rLmAhVE8eAKHZn3AssQ6AEwA3oECAkQAQ#v=onepage&q=Gelter%2C%20Martin%20%26%20Helleringer%2C%20Genevi%C3%A8ve.%20Fiduciary%20Principles%20in%20the%20European%20Civil%20Law%20Systems%2C&f=false [Accessed on 13.12.2019].

[31] Frankel, Tamar. "Towards Universal Fiduciary Principles", *op.cit.,* p. 403.

Consequently, it is imperative to be aware of the substantial distinction in the legal definition of fiduciary duties between common law jurisdictions and civil law jurisdictions to better understand the history and nature of the fiduciary duties. In fact, as KATHERINA PISTOR & CHENGGANG XU defended in their article "cases brought in different jurisdictions will differ and require different responses from judges, and give their past and constraints of their own legal system, judges in transplant countries are likely to resolve them differently"[32].

3. Why do the directors' fiduciary duties exist?

In modern corporations, fiduciary duties are an essential standard for the daily management of a business and an indispensable tool to guarantee profits to the company. The directors' fiduciary duties are one of the most important principles to understand the management of a company, as the fiduciary duties are linked by the courts to each financial situation that a company may face.

In both common and civil law countries directors are bound by the general duties of care and loyalty and by specific duties, which derive from the general ones. It should be highlighted, however, that regardless of the size, type or period of existence of the company[33], directors must always act in compliance with their fiduciary duties of care and loyalty. Indeed, these general duties of care and loyalty represent essentially general and abstract clauses which, on a case-by-case basis, identify the correct conduct of directors in the performance of their duties. Nevertheless, we must bear in mind that the fiduciary duties are legal requirements and not merely moral ones. This means that directors fully understand that if they do not respect and do not act in accordance with their duties, they will face the legal consequences of those actions[34].

The main goal of the directors' fiduciary duties involves the classic agency costs problem or the principal-agent problems[35]. In the corporate context, shareholders give directors the power to control the corporate assets; directors then have the obligation to pursue corporate productivity. Consequently, shareholders become vulnerable to the abuse of directors, who may not resist the temptation to use that

[32] Pistor, Katharina & Xu, Chenggang. "Fiduciary duty in transitional civil law jurisdictions; lessons from the incomplete law theory" *Corporate Law: Corporate Governance Law Journal*, 2002, at p. 2. Retrieved from: http://hdl.handle.net/10722/138704.

[33] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency." *ABI Law Review*, vol. 19, no. 36, 2011, pp. 363.

[34] See in general e.g., Velasco, Julian. "The role of Aspiration in Corporate Fiduciary Duties". *William & Mary Law Review,* vol. 54, no. 519, 2012. Retrieved from: https://scholarship.law.wm.edu/wmlr/vol54/iss2/5.

[35] With this point of view see in general e.g., Sitkoff, Robert H. "An Economic Theory Of Fiduciary Law", in *Philosophical Foundations of Fiduciary Law*, edited by Andrew Gold & Paul Miller eds. Cambridge: Oxford University Press, 2014; see also Kraakman, Reinier et al. *The Anatomy of corporate Law. A Comparative and Functional Approach.* Third edition. Oxford University Press, 2017.

power to pursue their own private interests[36]. As a result, the fiduciary duties exist to control and mitigate the possibility of directors abusing their power.

The American jurisprudence, particularly the law of Delaware, is one of the main sources of corporate law not only in the United States, but all over the world. In the US, most corporations are incorporated in Delaware and for that reason, the law had to develop to better address and resolve the conflicts which are inevitable in the corporate context. This necessity of evolution led to the creation of a highly regarded chancery court organization with judges who have special knowledge and experience regarding corporate litigations[37]. For this reason, and knowing that fiduciary duties are the essential tool for the survival of a corporation, an endless number of cases regarding this topic were inevitable; cases in which the presence and necessity of the directors' duties are constantly reaffirmed, not only by the Delaware courts but also by many other courts in the US.

Furthermore, as CAMPBELL AND FROST[38] argued regarding the US's courts, there is a legal trend to link the extension of the directors' fiduciary duties with the financial situation of the company. Therefore, these authors divide the fiduciary duties of directors into the four possible financial situations in which a company may find itself: (1) solvency; (2) vicinity of insolvency; (3) insolvency in fact; (4) bankruptcy. This link, as we are going to explore later, is rather vague in Portugal.

In the common law countries, like the UK and the US, the directors' fiduciary duties are seen in a much more extensive way than the simple obligation of performing the explicit terms of the contract. Both jurisdictions share the same historical creation of the fiduciary duties. However, it is important to understand that, although the UK and the US share the same history regarding the nature of fiduciary duties, they do not see those duties in the same way, as we are going to explore in the following chapters.

Regarding the world of civil law, particularly in Portugal, the directors' fiduciary duties were transplanted to company law. In fact, until recently, the Portuguese jurisdiction did not recognize the fiduciary duties of corporate directors explicitly in the law. The movement of the new model of Corporate Governance is one of the main reasons for the implementation of the directors' fiduciary duties, namely

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[36] Velasco, Julian. "Fiduciary Principles in Corporate Law", in *The Oxford Handbook of Fiduciary Law*, edited by Criddle, Evan J., Miller, Paul B., & Sitkoff, Robert H. Oxford University Press, 2019, at pp. 62-63. Retrieved from: https://books.google.pt/books?hl=en&lr=&id=WiSQDwAAQBAJ&oi=fnd&pg=PP1&ots=dMKm-blORV&sig=BGcwn9jkDdJBuu88-7nq9r_YoCI&redir_esc=y#v=onepage&q&f=false [Accessed on 20.12.2019].

[37] Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers", at p. 37.

[38] See e.g., Campbell, Rutheford B. and Frost, Christopher W. "Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)". *The Journal of Corporation Law,* vol. 32, 2007, pp. 492- 525. Retrieved from: https://uknowledge.uky.edu/cgi/viewcontent.cgi?article=1331&context=law_facpub; in the same line of thinking see also Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 363.

the fiduciary duty of loyalty and duty of care, into the Portuguese Commercial Companies Code (CSC)[39]. In recent years, after the economic crisis of 2008, the necessity to have a mechanism to control the management of the company was recognized not only in Portugal, but also in other members of the EU. As a result, and thanks to the globalization of the economy, it was necessary to bring harmony not only to the company law of the EU members but also between both legal systems[40].

4. General fiduciary duties of directors under the common law tradition:

4.1. Duty of Loyalty:

The Duty of Loyalty is a fundamental and ancient duty for the daily management of a business. This duty is the reaffirmation of "the basic moral principle that a person who undertakes to act for another must refrain from placing his own interest ahead of the other's interest."[41] In the aforementioned *Meinhard v. Salmon* case, Judge Cardozo defined the duty of loyalty as "something stricter than the morals of the market place (...) is then a standard of behaviour"[42]. In the corporate context, the duty of loyalty requires the directors to act in the best interests of the company. In fact, the Supreme Court of United States enlightened in *Pepper v. Litton* that corporate directors are fiduciaries and, for that reason, have a duty of loyalty to the corporation and its shareholders[43].This means that directors will not act according to their own interests or in the interests of another person or organization[44].

The duty of loyalty is, in fact, the most important legal standard in the common law tradition. Inherent to the duty of loyalty is another very important notion: the concept of "interest". For the Delaware courts a director is considered to be interested in three situations: (1) if the director is on both sides of the transaction; (2) if the director wants to receive a personal financial "compensation"; or (3) if there is some other type of benefit from a business, which is not distributed equally by the corporation's stockholders[45]. The main idea here is that directors will be interested if they can benefit personally from a decision, which do not obligatory implies a financial benefit. Beyond that, in the *Floyd v. Hefner* case,

[39] Cordeiro, António Menezes. "Os deveres fundamentais dos administradores das sociedades (artigo 64 n° 1, do CSC)", *supra* note 28.
[40] Ibid.
[41] Ibid.
[42] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 365 (citing Judge Cardozo in Meinhard v. Salmon 164 N.E. 545 (N.Y. 1928) at 546).
[43] See Pepper v. Litton, 308 U.S. 295 (1939).
[44] See Guth v. Loft*, Inc.*, 5 A.2d 503 (Del. 1939) ("The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.") Retrieved from: https://h2o.law.harvard.edu/collages/4308#p46 [Accessed on 22.10. 2019]; see also Schoon v. Smith, 953 A.2d 196, 206 (Del. 2008) (stating the same).
[45] See e.g., Reed, John L. "Avoiding Personal Liability: A Guide for Directors and Officers". *DLA PIPPER'S DELLAWARE,* April 13 of 2015, p. 4. Retrieved from: https://www.dlapiper.com/en/us/insights/publications/2015/04/avoiding-personal-liability.

the court considered directors "interested" when they had profited from "a transaction by dealing with the corporation, transact business with a second associated, or transact corporate business in their capacity with family member"[46]. Therefore, directors that are "interested" violate their fiduciary duty of loyalty, and for that reason can see their personal liabilities triggered.

The duty of loyalty also presupposes that the director will act in good faith; in other words, directors must truly believe that their decisions will benefit the corporation. Directors may fail to act in good faith when they: 1) do not act in the corporation's best interests; 2) fail to act while knowing they have a duty to act; or 3) act with the intention of violating an applicable law[47]. Besides the requirement of acting in good faith and the requirement of avoiding conflict of interests, they must also be impartially knowledgeable when there is a conflict of interests[48]. This requirement of good faith was, for many years, seen as a separate duty by the Delaware courts. However, this has started to change and nowadays the duty of good faith and the duty of loyalty are identical concepts[49]-[50].

Another interesting aspect of the duty of loyalty is how it is regarded by the Delaware law. According to *Section 102(b)(7)* of the Delaware General Corporation Law, the corporation cannot limit the director's liability when there is a breach of the duty of loyalty[51]. Indeed, the law is very strict regarding breaches of the fiduciary duty of loyalty. This means that there is no escape from liability for a breach of

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[46] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", p. 365 (citing Floyd v. Hefner, 556 F. Supp. 2d 617, 649 (S.D. Tex. 2008)); for more information see also Holland, Randy J. "Delaware Directors' Fiduciary Duties: The focus on Loyalty." *University of Pennsylvania Journal of Business Law,* vol. 11, no. 3, 2008, pp. 675-701. Retrieved from: https://scholarship.law.upenn.edu/jbl/vol11/iss3/4/.

[47] Corporate Laws Committee. "Corporate Director's Guidebook". Sixth Edition. *The Business Lawyer,* vol. 66, no. 4, 2011, p. 994. Retrieved from: http://www.jstor.org/stable/23239635.

[48] Ibid.

[49] There is no unified opinion regarding the duty of good faith. However, nowadays, in Delaware, numerous courts and legal experts consider the duty of good faith and the duty of loyalty identical in their meaning and objective. See, e.g. Stone v. Ritter, 911 A.2d 362, 370-71 (Del. 2006) ("stating that the duty to act in good faith is subsumed with the duty of loyalty"); Velasco, Julian. "Fiduciary Principles in Corporate Law", at p. 71; Reed, John L. "Avoiding Personal Liability: A Guide for Directors and Officers", at p. 5. Contrarily to this position see e.g., Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers", at p. 37.

[50] Inherent to the duties of care and the duty of loyalty there is another relevant obligation that we cannot fail to mention. The majority of the doctrine does not talk about the existence of a duty of disclosure but rather an obligation to disclosure. Directors of the US have the obligation to disclose all the relevant material information when a shareholder's action is needed. Indeed, directors who have relevant information to the corporate decisions are also obliged to inform the other directors and management about that information. Directors who give false information to shareholders – resulting in corporate injury or damage to stockholders – are breaching their fiduciary duties of loyalty and care and may be held liable for those actions. Additionally, directors are prohibited share confidential information with others under penalty of being held liable for "misappropriation" (for more information about this theory see Bainbridge, Stephen M. "Insider trading Regulation: The Path Dependent Choice Between Property Rights and Security Fraud". *SMU L. REV,* vol. 52, 1999, pp. 1589-1651. Retrieved from: https://scholar.smu.edu/cgi/viewcontent.cgi?article=1744&context=smulr. Some authors, however, talk about the obligation of disclosure as "duty of disclosure", in this sense, see e.g., Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers", at p. 40; see also Black, Bernard S. "The Principal Fiduciary Duties of Boards of Directors". Presentation at Third Asian Roundtable on Corporate Governance Singapore, at 4 April 2001 (saying that "there are at least two additional core duties that directors have today: a duty of disclosure, and a duty that has no precise name, that I will call the duty of extra care when your company is a takeover target"). Retrieved from: http://www.oecd.org/daf/ca/corporategovernanceprinciples/1872746.pdf; Waisman, Christopher Mallon Shai Y. *The Law and Practice of Restructuring in the UK and US.* Oxford University Press, 2011, at pp. 133-134. Available at: https://books.google.pt/books?id=BePK15o8E3MC&pg=PA136&lpg=PA136&dq=directors+liabilities+in+the+zone+US&source=bl&ots=kkiWuitrWp&sig=ACfU3U38cF83ldIYQEFMEWr5pI2EoUemYA&hl=ptPT&sa=X&ved=2ahUKEwiD3P74gM3oAhUCxhoKHSWACmEQ6AEwDHoECAwQNA#v=onepage&q=directors%20liabilities%20in%20the%20zone%20US&f=false.

[51] Section 102(b)(7): "A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (...)". Available at: https://delcode.delaware.gov/title8/c001/sc01/index.shtml#102 [Accessed on 22.10.2019].

the duty of loyalty, neither by contract nor by the decision of the corporation's shareholders. For Justice[52] RANDY J. HOLLAND of the Supreme Court of Delaware (during 1986-2017), the focus of Delaware's fiduciary duty law is on the duty of loyalty[53]. This may explain why the legal consequences for breaching the fiduciary of loyalty are much more severe than those regarding breaches of the duty of care. In fact, a disloyal fiduciary is liable for the compensation of the beneficiary's losses and for all the profits "realized through their wrongdoing"[54].

The UK courts also understand the duty of loyalty as the key element in the corporate law field. In fact, under *Section 172*, Chapter 2 of Part 10 of the Companies Act (CA) 2006[55] any action contrary to good faith will be "treated as a breach of trust which carries the full range of remedies, not merely compensation for incompetence"[56]. Directors are agents of the company and for that reason stand in a fiduciary position. This ultimately means that their fiduciary duties of loyalty are "virtually identical with those imposed in trustees"[57]. This means that the breach of loyalty is a breach of confidence and trust. Decisions based on lack of good faith imply not only mere negligence but also a blameworthy state of mind on the part of the director.

It is interesting to compare two jurisdictions that share the same legal system because we can identify, not only similarities but also differences between them. A particularly curious difference between the US and the UK regarding the duty of loyalty is their expression in the law. In fact, *Section 172* (1) of the Companies Act 2006 define the duty of loyalty in a more objective way[58]. The modern version of the basic duty of loyalty, according to section 172(1), is the *duty to promote the success of the company*. This duty, together with the non-fiduciary duty to exercise care, skill and diligence, outlines the way directors must run the company.

However, this does not mean that the objective of the duty of loyalty in its pure form has changed. In fact, the new formulation of the duty of loyalty continues to be the main "duty to which directors are subject"[59].This formulation of the duty of loyalty by the Companies Act 2006, "applies to every exercise of judgment which directors undertake"[60]. Beyond that, directors still have the obligation to act in good

[52] Synonym of judge, more usual in the American Doctrine.
[53] See in general e.g., Holland, Randy J. "Delaware Directors' Fiduciary Duties: The focus on Loyalty", *supra* note 46.
[54] Miller, Paul B. "Justifying Fiduciary Remedies". *The University of Toronto Law Journal* vol. 63, no. 4, 2013, p. 570. Retrieved from: www.jstor.org/stable/24311902.
[55] Available at: http://www.legislation.gov.uk/ukpga/2006/46/part/10 [Accessed on 22.10.2019]
[56] Lowry, John. "The Duty of Loyalty of Company Directors: Bridging the Accountability Gap Through Efficient Disclosure". *The Cambridge Law Journal,* vol. 68, no. 3, 2009, at p. 622.
[57] Davies, Paul L. "Principal of Modern company Law". Fifth edition. Sweet & Maxwell, 2012, at p. 496.
[58] Ibid., at p. 506.
[59] Ibid.
[60] Ibid.

faith, with the objective to promote the success of the business enterprise and its shareholders.

4.2. Duty of Care:

The duty of care, also known as the duty of prudence in trust law[61], is often cited by fiduciary legal experts as a core principle of associations of trust and agency. Indeed, the courts usually define the duty of care as a standard of behaviour; this means that directors must act in the best interest of the company and this, naturally, implies the necessity for directors to be always informed and aware of the corporation's business affairs so as to avoid any behaviour that could cause harm to the business enterprise[62]. This standard is also commonly referred to as the "prudent man" rule[63].

According to the Corporate Laws Committee[64], to meet this duty, directors should consider several factors: (1) time commitment and regular attendance, which presuppose that directors will attend regularly and participate in the board meetings; (2) the necessity to be informed and prepared, they must search for all the information needed to properly fulfil their duty; (3) the right to rely on others, which basically means relying on the good faith of the reports and other information from corporate officers, legal counsel, etc.; (4) inquiry regarding potential issues that could affect the corporation and the business; and (5) obligation to mediate possible conflicts of interests that may appear within the corporation, to ensure the effective decision-making process of the board[65]. In the Anglo-American jurisdictions[66], breaches of the duty of care generally accrete negligence or nonfeasance – in situations where directors fail to monitor an unreasonable decision. This duty also includes protecting the corporation and its shareholders from threats created from third parties or other shareholders.

Regarding the UK, similarly to the duty of loyalty, until the Companies Act (CA) 2006, the duty of care was more abstract and general. With its codification, under *section 174* of the prementioned act,

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[61] Sitkoff, Robert H. "Fiduciary Principles in Trust Law", in", in *The Oxford Handbook of Fiduciary Law*, edited by Criddle, Evan J., Miller, Paul B., & Sitkoff, Robert H. Oxford University Press, 2019, at p. 46. Retrieved from: https://books.google.pt/books?hl=en&lr=&id=WiSQDwAAQBAJ&oi=fnd&pg=PP1&ots=dMKm-blORV&sig=BGcwn9jkDdJBuu88-7nq9r_YoCI&redir_esc=y#v=onepage&q&f=false [Accessed on 29.12.2019]; see also Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers", p. 39.

[62] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 364 (citing Lange v. Schropp, 496 F.3d 892, 900 (8th Cir. 2007)); Aronson v. Lewis, 473 A.2d 805, 812 (Del.1984); see also Corporate Laws Committee. "Corporate Director's Guidebook", at p. 994.

[63] Johnston Jr., Joseph F. "Natural Law and the Fiduciary Duties of Business Managers", at p. 39; Velasco, Julian. "Fiduciary Principles in Corporate Law", *op.cit.,* p. 67 (citing Graham v. Allis-Chalmers Mfg. Co., 188 A.2d. 125, 130 (Del. 1963)).

[64] Corporate Laws Committee. "Corporate Director's Guidebook", at p. 994.

[65] Ibid.

[66] See *Section 174*, Chapter 2 of Part 10 of the Companies Act 2006. Available at: http://www.legislation.gov.uk/ukpga/2006/46/part/10 [Accessed on 23.10.2019]; and regarding the US see e.g. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Retrieved from: https://law.justia.com/cases/delaware/supreme-court/1984/473-a-2d-805-4.html [Accessed on 23.10.2019]

the duty of care developed into a more objective form: the *duty of reasonable care, skill and diligence*[67]. The duty of reasonable care, skill and diligence is, in fact, an incorporation nearly verbatim of the section 214(4) of the Insolvency Act (IA) 1986, regarding the standard of care in (the wrongful trading provision)[68]. Beyond that, one of the main goals of the general fiduciary duty of care codification is the delimitation of the "level by which the director will be judged"[69], which in turn will be evaluated through the analysis of the expected conduct of a reasonably diligent person[70]. In other words, the courts will look to directors' actions and decisions in both a subjective and objective way, which includes the analysis of the directors' special skills.

4.2.1. The Business Judgment rule (BJR):

The courts of the US early recognized the limitations of the judiciary power regarding the business decisions of directors. In fact, in the famous *Dodge v. Ford Motor* case, the court of Michigan stated that "courts are not business experts"[71]. In this sense, courts are more likely to be against risk taking, which is fundamental in the business context to promote shareholder benefits in the long term[72]. For this reason, it was necessary to create a mechanism to protect the business wealth and risk-taking. This mechanism involves the business judgment rule.

The major argument defending the need for this rule has to do with the necessity of risk-taking. For this reason, it is commonly agreed upon that Directors should have a certain level of freedom "to act without fear of liability"[73]. However, this level of freedom does not exclude the obligation to act according to their duties, and to take informed business decisions. Indeed, to benefit from the protection of the business judgment rule, directors must carry out disinterested and independent analyses. Beyond that, directors must consider all the relevant business information available.

Directors who act according to their function do not breach the fiduciary duty of care even if the

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[67] *Section 174* of the Companies Act 2006: Duty to exercise reasonable care, skill and diligence ("this means the care, skill and diligence that would be exercised by a reasonably diligent person with: (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and; (b) he general knowledge, skill and experience that the director has"). Available on: http://www.legislation.gov.uk/ukpga/2006/46/section/174 [Accessed on 07.01.2020].

[68] See in general Lowry, John. "The Irreducible Core of the Duty of Care, Skill and Diligence of Company Directors: "Australian Securities and Investments Commission v Healey". *The Modern Law Review* vol. 75, no. 2, 2012, pp. 249-61. Retrieved from: www.jstor.org/stable/41415406. See also Cairns, Steven Ronald. "Changing the Culture of Financial Regulation: a Corporate Governance Approach." PhD thesis summited at the University of Liverpool (September, 2014), at p.71. Retrieved from: https://livrepository.liverpool.ac.uk/2008505/1/CairnsSte_Sep2014_2008505.pdf.

[69] Morley, Sarah Emily. "Takeover Litigation: the US does it more than the UK, but why and does it matter?", Durham thesis, Durham University, 2017, at p. 69. Retrieved from: http://etheses.dur.ac.uk/12228/.

[70] See Foster J in Dorchester Finance Co Ltd v. Stebbing [1989] BCLC 498.

[71] See Velasco, Julian. "Fiduciary Principles in Corporate Law", p. 5 (citing Dodge v. Ford Motor Co., 170 N.W., 668, 684 (Mich. 1919). For more informations, see in general Bainbridge, Stephen M. "The Business Judgment Rule as Abstention Doctrine". *Vanderbilt Law Review,* vol. 57, no. 1, 2004, pp. 83-129.

[72] Velasco, Julian. "Fiduciary Principles in Corporate Law", at p. 68.

[73] Ibid., p. 69.

result of their decisions was not expected. In other words, the court will not consider directors liable for the results of their decisions, even if those decisions can be considered by others as bad business choices. Therefore, the business judgment rule is built on the notion that directors, acting in compliance with their fiduciary duties, make their decisions while keeping in mind the best interest of the corporation. Accordingly, courts will not second-guess decisions made based on principles of good-faith and appropriate care[74].

It is important to understand, however, that the business judgment rule does not protect every decision made by directors[75]. For instance, in situations regarding the sale of the company[76] or the adoption of defensive procedures in response to hostile takeovers[77], the business judgment rule will not protect directors from second-guess decisions by the courts. For that reason, directors always have to act in compliance with their fiduciary duties[78]. The business judgment rule protects only decisions to take action or not, and does not protect directors for failing to act when breaches of the duty of loyalty are at stake.

An important aspect of the business judgment rule is its nature. Despite the controversy surrounding its nature, we can say that the business judgment rule is an assumption based on trust and confidence in directors. As a result, this assumption manifests itself in "the divergence of standards of conduct and standard of review"[79], which gives directors the exclusion of liability from the decisions' results. This divergence is fundamental in corporate law and have the ultimate goal to safeguard the corporation's potential creation of wealth.

In the UK, the business judgment rule has not been formally recognized; at least not codified in the UK corporate law[80]. However, this rule has been adopted by courts in many cases and is not restricted to litigations regarding breaches of the duty of care. The business judgment rule in the UK is especially difficult to identify[81] because the term "business judgment rule" is rarely used by courts. In fact, in the

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[74] See Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (stated that "(...) an acknowledgment of the managerial prerogatives of Delaware directors (....) It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company"). Retrieved from: https://law.justia.com/cases/delaware/supreme-court/1984/473-a-2d-805-4.html [Accessed on 23.10.2019]

[75] Smith v. Van Gorkom , 488 A.2d 858 (Del. 1985).

[76] Sale transactions as to do with the sell the company and in these situations, the board must follow so-called *Revlon mode*, in which directors are obliged to get the best price reasonably availed for the shareholders.

[77] Directors must satisfy the *Unocal standard* – created by the case law Unocal Corp v. Mesa Petroleum Co. (493 A.2d 946 (Del. 1985)) – which places the burden on the board to prove that the defensive actions adopted were reasonable to answer the threat that the corporation was facing.

[78] In situations where the Business Judgment Rule does not apply, the director must prove the fairness of the challenged transaction (citing Weinberger v. UOP, Inc., 457 A.2d, 711 (Del. 1982)).

[79] Velasco, Julian. "Fiduciary Principles in Corporate Law", *op. cit.,* p. 67.

[80] Keay, Andrew & Loughrey, Joan. "The concept of business judgment". *Legal Studies*, vol. 39, issue 1, 2019, p. 37. Retrieved from: http://eprints.whiterose.ac.uk/129655/3/Concept%20of%20BJ%20%20LS%20paper%20submitted%20post%20reviewing.pdf.

[81] Ibid., at p.39; see also Cairns, Steven Ronald. "Changing the Culture of Financial Regulation: a Corporate Governance Approach" at p.148.

UK, the preferential terminology used is "commercial judgment or even commercial decision"[82].

Professors ANDREW KEAY and JOAN LOUGHREY conducted an investigation with the objective to identify case-law about the business judgment rule. The result of the research includes "breach of duty of care, wrongful trading, disqualification, acting for an improper purpose, and derivative claims"[83]. In fact, they discovered a total of 82 cases, in which "terms that indicated deferral to directors' judgment" can be found[84]. However, in none of those cases had the courts defined precisely the terminology used. Consequently, although the UK does not used the same terminology and concept of BJR as the US, the courts used a similar mechanism to analyse whether directors breached their fiduciary duties or not.

5. The general directors' fiduciary duties under the Portuguese jurisdiction:

In the civil law tradition, it may be hard to find the director's fiduciary duties of loyalty or care in their pure form or meaning. As explained previously, fiduciary duties are common law concepts that were transplanted to civil law jurisdictions. This becomes clear when we look to the "Código das Sociedades Comerciais (CSC)" of the Portuguese jurisdiction, more precisely to the reform of CSC introduced by the article 2 of the *DL Nº 76-A/2006, of March 29*[85]. In fact, it is commonly believed that article 64(1) of CSC is not the direct result of any national elaboration – neither jurisprudential nor doctrinal[86] – and thanks to the ancient history of these terms, the goal of the national legal experts is to find a new balance and coherence for these duties to prosper in the Portuguese legal field of CSC. Furthermore, some authors also consider that these fiduciary duties are the outcome of the introduction of Corporate Governance Principles in the EU jurisdictions[87], and thanks to legal transplanting and the EU's law harmonization, these principles were, subsequently, incorporated in the Portuguese CSC.

The reform of the CSC introduced a new element that had thrived in the common law countries for many years. In the new reform of 2006 it is easily demonstrated that the duty of diligence – where directors must be judicious *(criterioso)* and orderly *(ordenado)* – in which the article 64(1) was initially created, gave rise to a distinction between two duties: the duty of care *(deveres de cuidado)* and the duty

[82] Keay, Andrew & Loughrey, Joan. "The concept of business judgment", at p. 39.
[83] Ibid., at p.40.
[84] Ibid., at p. 40.
[85] See the full text of the Portuguese law decree in: https://dre.pt/web/guest/pesquisa/-/search/620286/details/normal?q=Decreto-Lei+n.º%2076-A%2F2006%2C%20de+29+de+março [Accessed on 24.10.2019].
[86] Cordeiro, António Menezes. "Os deveres fundamentais dos administradores das sociedades (artigo 64 nº 1, do CSC)", *supra* note 28.
[87] Ibid.; see also Xavier, Rita Lobo; Ferreira, Emília Rita. "O sistema de Family Governance como parte integrante do bom governo da empresa familiar" *in Roadmap para Empresas Familiares: Mapeamento, Profissionalização e Inovação*, edited by Marques, Ana Paula. Braga: Centro Interdisciplinar de Ciências Sociais (CICS.NOVA) – Polo da Universidade do Minho (CICS-UMinho), October 2018, p. 145 and followings.

of loyalty *(deveres de lealdade)*[88]. However, this does not mean that the duty of diligence ceases to apply. In fact, according to some authors, directors continue to have the obligation to act in accordance with the duty of diligence[89].

Another relevant aspect to be aware of when considering the reform of CSC has to do with the question: to whom do directors own the general fiduciary duties of care and loyalty? It is commonly accepted that the interests of the company are the interests of shareholders. However, the reform of 2006, and the new redaction of article 64 brought an extension regarding to whom directors' fiduciary duties are own[90]. In fact, directors have an obligation to the entire business enterprise; in other words, they have to consider not only the shareholders' short-term interests, but also the long-term interests as well as the interests of the stakeholders.

In general terms, the Portuguese doctrine established two main obligations for directors: the administration and the representation of the company[91], according to articles 405 and 431 of CSC. Regarding the first obligation, directors are entitled to manage the business activities of the company. The second obligation, according to ANA PERESTRELO DE OLIVEIRA, drifts from the first one[92]. In fact, directors have almost exclusive powers to represent the company. Therefore, the actions of directors in the pursuing of these obligations binds the company to those actions[93]. The Article 64 expresses the way in which these two obligations are fulfilled and what the other responsibilities which may result from them are[94]. In fact, the general duties of care and loyalty represent general and abstract clauses, and the specific duties that arise from them should be interpreted in each case separately.

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[88] See in general e.g., Abreu, Jorge Manuel Coutinho de. "Deveres de Cuidado e de Lealdade dos Administradores e Interesse Social" *in Reformas do Código das Sociedades*. Coimbra: Almedina, 2007, pp. 16-47.

[89] See in general Costa, Ricardo. "Deveres Gerais dos Administradores e Gestor Criterioso e Ordenado", *in I Congresso DSR*. Coimbra: Almedina, 2011; Rodrigues, Ricardo Alexandre Cardoso; Soares, João Luz. "Business Judgment Rule: enquadramento, apresentação, análise e reflexões" *in REVISTA DE DIREITO DAS SOCIEDADES, ANO IX, Número 3,* 2017, p. 689. Available at: http://www.revistadedireitodassociedades.pt/artigos/business-judgment-rule-enquadramento-apresentacao-analise-e-reflexoes.

[90] Cunha, Paulo Olavo. *Direito das Sociedades Comerciais.* 7° Edição. Coimbra: Almedina, 2019, pp. 34 and following; Paulo, Câmara. "O governo das sociedades e os deveres fiduciários", *in Jornadas Sociedades abertas, valores mobiliários e intermediação financeira* (coord. de Maria Fátima Ribeiro). Coimbra: Almedina, 2007.

[91] For more information see e.g. Cordeiro, António Menezes. *Código das Sociedades Comerciais anotado.* 2° Edição. Lisboa: Almedina, 2012, pp. 252 and follow; Frada, Manuel A. Carneiro da. "A business judgment rule no Quadro dos deveres gerais dos administradores". *Revista da Ordem dos Advogados*, vol. I, no. 67, January 2007. Available at: https://portal.oa.pt/comunicacao/publicacoes/revista/ano-2007/ano-67-vol-i-jan-2007/doutrina/manuel-a-carneiro-da-frada-a-business-judgement-rule-no-quadro-dos-deveres-gerais-dos-administradores/ [Accessed on 24.10.2019]; Costa, Ricardo. *Os Administradores de Facto das Sociedades Comerciais.* Coimbra: Almedina, 2014; Costa, Ricardo. "Deveres Gerais dos Administradores e Gestor Criterioso e Ordenado", *supra* note 89; see also Ferreira, Bruno. "Os deveres de cuidado de administradores e gerentes", *in Cadernos do Mercado de Valores Mobiliários,* 2008. Retrieved from: https://works.bepress.com/brunoferreira/11/.

[92] Oliveira, Ana Perestrelo de. *Manual de Governo das Sociedades*. Coimbra: Almedina, 2018, at p. 227.

[93] See in general terms Antunes, José Engrácia. *Direito das sociedades: parte geral.* 5° ed., Ed. Autor, Porto, 2015; Antunes, José Engrácia. *Os Grupos de Sociedades*, 2ª ed., Almedina Coimbra, 2002. See also Oliveira, Ana Perestrelo de. *Manual de Governo das Sociedades,* at p. 226.

[94] See Cunha, Paulo Olavo. *Direito das Sociedades Comerciais, supra* note 90.

5.1. The duty of loyalty:

Like the common law formulation, the duty of loyalty represents the essential guide to the inevitable corporate conflict of interests[95]. In fact, the duty of loyalty expressed in article 64(1)(b) presupposes a true commitment to the company's best interests, and a continuously pursuit, in good faith, of wealth for the corporation.

The duty of loyalty, expressed in article 64(1)(b) of CSC emerged firstly as a preventative measure and secondly as an indicator of to whom the duty of loyalty lies[96]. We may, therefore, argue that the duty of loyalty represents two distinct strands: a positive and a negative one[97]. On the one hand, the duty of loyalty can be understood as the obligation of directors to act in the pursuit of the corporation's best interests, taking into account the shareholders' long-term interests and considering the interests of other parties also relevant to the corporation's sustainability – such as workers, clients and creditors.

On the other hand, directors are not allowed to act according to their own interests[98]. In fact, directors will be considered disloyal if, for example, they mistreat the business enterprise to satisfy their private interests; if they use or trade confidential information of the business enterprise; or if they do not act impartially or in good faith. Directors that breach their fiduciary duty of loyalty will see their civil liability triggered[99].

5.2. The duty of care:

The duty of care, expressed in article 64(1)(a) of CSC, can be understood as the obligation of managers and directors to diligently fulfil their functions in the best interest of the company with the care expected of a person of mutual care in similar circumstances[100]. However, the text of the article failed to define unambiguously what the conduct of the directors should be to fulfil their duty of administration[101]. For CARNEIRO DA FRADA, the text of the article 64(1)(a) only explains that the director's obligation to administer the corporation should be fulfilled with care. This does not mean, however, that the objective

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[95] Câmara, Paulo and Dias; Figueiredo, Gabriela. "O Governo Das Sociedades Anónimas", in *O Governo das Organizações: A vocação universal do corporate governance,* by Câmara Paulo [*et al*]. Coimbra: Almedina. 2011.
[96] Xavier, Rita Lobo; Ferreira, Emília Rita. "O sistema de Family Governance como parte integrante do bom governo da empresa familiar", p. 147.
[97] See e.g. Oliveira, Ana Perestrelo de. *Manual de Governo das Sociedades*, at p. 238.
[98] Ibid.
[99] Abreu, Jorge Manuel Coutinho de. "Deveres de cuidado e lealdade dos administradores e interesse social"*, supra* note 88.
[100] Ibid.; Oliveira, Ana Perestrelo de. *Manual de Governo das Sociedades*. *supra* note 85; see also Costa, Ricardo. "Responsabilidade dos administradores e business judgement rule", text corresponding to the Conference given on 14 December 2006 and published in *AA. VV., Reformas do Código das Sociedades, Colóquios do IDET*, n° 3. Coimbra: Almedina, 2007. Retrieved from: https://www.ricardo-costa.com/data/FILEP_20_2017129165628.pdf.
[101] Frada, Manuel A. Carneiro da. "A Business Judgment Rule no Quadro dos Deveres Gerais dos Administradores", *supra* note 91; for more information see Abreu, Jorge Manuel Coutinho de. "Deveres de Cuidado e de Lealdade dos Administradores e Interesse Social", *supra* note 88.

of the article is compromised. In fact, for the author "the imperfection of language used in the article does not prejudice the application of appropriate dogmatic constructions in the management relation"[102].

MENEZES CORDEIRO also shares the same opinion. The article 64(1)(a) states that directors must: (1) be available; (2) have technical competences; and (3) have informed knowledge concerning the corporation. However, these three main elements, according to the author, will necessarily give rise to other duties, that the text of the article does not clearly define. Consequently, the text must be interpreted considering the specific circumstances of each case. The article should, for this reason, have an extensive interpretation[103]. Beyond that, the duty of care is understood by MENEZES CORDEIRO as a rule of conduct, or rather: part of a rule of conduct, which must be determined independently from any responsibility or guilt. The breach of duty of care will trigger the illicitness of the act *(ilicitude)*[104].

As we explored previously, the fiduciary duty of care is an Anglo-Saxon creation. It seems, for this reason, valid to infer that the duty of care in its pure form does not have expression in the Portuguese tradition. Indeed, some authors argue that the duty of care should be interpreted taking into consideration the standard to act with diligence (*deveres de diligência*)[105] required to corporate directors. Additionally, the duty of care should not be confused with the duty of loyalty. In fact, both duties have the ultimate objective of promoting the social interest or, in other words, the interest of the corporation and its shareholders. However, unlike the duty of loyalty, the duty of care does not give answers to the eventual and inevitable conflicts of interests[106].

5.2.1. The Business judgment rule under the Portuguese law:

The business judgment rule, as explained in the previous chapter, is a standard with an Anglo-Saxon origin, and especially relevant in the US courts. However, like the transplant of fiduciary duties, the business judgment rule entered in the legal sphere of the Portuguese commercial law through corporate governance principles incorporated in the German law[107].

However, it must be pointed out that, according to some authors[108], the legislator did not have the clear intention of transposing into the legal system the common law formulation of the business

[102] Frada, Manuel A. Carneiro. "A Business Judgment Rule no Quadro dos Deveres Gerais dos Administradores", *supra* note 91.
[103] Cordeiro, António Menezes. "Os deveres fundamentais dos administradores das sociedades", *supra* note 24.
[104] Ibid.
[105] See Câmara, Paulo. "O governo das sociedades e os deveres fiduciários dos administradores", *supra* note 83.
[106] See e.g. Oliveira, Ana Perestrelo de. *Manual de Governo das Sociedades*, at p. 234.
[107] In Portugal the legal transplant of fiduciary duties and the business judgment rule is, in fact, a hybrid construction between the Anglo-Saxon conception of the term and the way German law applicated it.
[108] Abreu, Jorge Manuel Coutinho de. "Responsabilidade Civil dos Administradores de Sociedades", *in Instituto de Direito das Empresas e do Trabalho*, n.º 5. 2ª Edição. Coimbra: Almedina, 2010.

judgment rule in its pure form and objective. The article 72(2) is, in fact, an adaption of the Anglo-Saxon rule – in which the legislator intended to prevent courts from an appreciation of the merits of business management decisions. The business judgment rule can be understood in three different ways. The first defends that its infringement constitutes a *sine qua non* requirement for exclusion of responsibility. The second one states that the business judgment rule is, on the contrary, formally conceived as an assumption of unlawfulness[109]. And the third one, appears to be a combination of the two.

The majority of the Doctrine, however, interprets the BJR as a requirement for exclusion of culpability. For example, CARNEIRO DA FRADA argues that the BJR comprehends the relationship between a good administration and the result which is inherent to it. Therefore, although the action and decision of directors may give rise to personal liability, the business judgment rule says that directors "should be relieved from any assessment of the merits in his or her administration (bearing in mind its outcome) if he or she can prove the requirements laid down by that rule"[110]. On the other hand, RICARDO COSTA defends a hybrid version of both positions. For the author, the mere existence of damage resulting from a decision cannot in any way be enough to determine the existence of directors' unlawful practice, otherwise we may put the companies' directors under threat of massive weight. As RICARDO COSTA argued, "it would be detrimental to the whole business enterprise if the directors' decisions could be successively questioned by shareholders in court"[111]. Beyond that, the possibility of successively inquiring of directors' business decisions "could eventually transfer the decision-making authority from the board to the shareholders"[112].

To be protected by the business judgment rule, directors must fulfil some conditions[113]. The fundamental requirement of the business judgment rule translates into an informed and conscious director's decision, which does not include decisions strictly linked to his or her contract. In this sense, the article 72(2) is a cause of exclusion from liability if proved the compliance with the fiduciary duty of care and all the inherent obligations[114]. Beyond that, directors must not have any personal interest in that decision[115]. This means that, if it verifies that directors had a personal gain in the decision, their action

[109] The Delaware jurisprudence interprets the business judgment rule as a "presumption of unlawfulness". The CMVM, on the contrary, interprets it in the inverse way, based on the "presumption of guilt".

[110] Frada, Manuel A. Carneiro da. *A Business Judgment Rule no Quadro dos Deveres Gerais dos Administradores*, *supra* note 91. In the same line see e.g., Magalhães, Vânia Patrícia Filipe. "A conduta dos administradores das sociedades anónimas: deveres gerais e interesse social" *in Revista de Direito das Sociedades*, ano I, no 2, Almedina: Coimbra, 2009, pp. 394-395; Nunes, Pedro Caetano. *Dever de Gestão dos Administradores de Sociedades Anónimas*. Coleção Teses. Almedina: Coimbra, 2012, p. 515.

[111] Costa, Ricardo. "Responsabilidade dos administradores e business judgement rule", at p. 2.

[112] Ibid.

[113] Ferreira, Bruno. "Os deveres de cuidado de administradores e gerentes", at p. 40.

[114] Costa, Ricardo. "Responsabilidade dos administradores e business judgement rule", supra note 103.

[115] Ferreira, Bruno. "Os deveres de cuidado de administradores e gerentes", at p. 40.

will be considered a breach of the duty of loyalty[116].

Regarding the applicability of the BJR, some authors argue that it should be applicable to both fiduciary duties of care and loyalty[117]; others, by its turn, defend the application of the BJR only to the duty of care[118]. This last approach is similar to what happened with the US conception of the BJR, where the business judgment rule does not grant protection to directors in cases of breach of the duty of loyalty.

However, it must be said that the failure to comply with all these requirements does not, itself, settle automatic liability on directors. Indeed, what will happen is that the immunity granted by the business judgment rule is broken and the responsibility for the damaging results of the operations and the decisions of the directors will be seen as a result of the merit imposed by the standard to directors to be "judicious *(criterioso)* and orderly *(ordenado)"*[119]*.* In this sense, and knowing that business decisions can be risky, directors should not be responsible for the result of those decisions when they are acting in the best interest of the company.

6. Directors' fiduciary duties in different financial stages:

6.1. Solvency:

To understand the way that fiduciary duties enter the financial stage of solvency, it is necessary first to understand the concept of solvency. Economically speaking, a corporation is solvent when the value of its assets is superior to the number of its debt obligations. Both shareholders and creditors are concerned with the solvency of the company but for different reasons. Shareholders, on the one hand, want to make sure that the company is in a good financial situation and will continue to grow, generate profits, and produce dividends. Creditors, on the other hand, are concerned with the company's ability to repaid them the credits conceded.

In the corporate law of the UK, when a corporation is solvent its directors and officers owe their duties of loyalty and care to the corporation as a whole. In this sense, they must be able to balance the interests of all subjects which may be affected by their decisions. In other words, the ultimate objective during solvency times is the corporation's wealth maximation, however, the interests of those groups that

[116] See e.g. Xavier, Rita Lobo; Ferreira, Emília Rita, at p. 149.

[117] See e.g., Leitão, Adelaide Meneze. "Responsabilidade dos administradores para com a sociedade e os credores sociais por violação de normas de protecção" in *Revista de Direito das Sociedades*, Ano I, no. 3, 2009, at p. 670; Frada, Manuel A. Carneiro da. "A business judgment rule no Quadro dos deveres gerais dos administradores", supra note 91.

[118] Abreu, Jorge Manuel Coutinho de. "Responsabilidade civil dos administradores de sociedades", at p. 38 and p. 47.

[119] Costa, Ricardo. "Responsabilidade dos administradores e business judgement rule", supra note 103.

do not benefit directly from it – like creditors, employees, etc. – must be also taken into consideration by directors.

In the Portuguese jurisdiction, as MADALENA PERESTRELO DE OLIVEIRA has explained when the corporation is solvent directors owe an indirect duty to creditors[120]. In fact, directors, according to the principle of legality, have the obligation to comply with the duties as representative of the corporation. For the author, directors do not directly owe any duty to creditors, since "there is no binding relationship"[121]. In this sense, although directors must act respecting the duties of their position in the company, they should also respect the position and interests of the creditors, "this must not be confused with a clear duty of loyalty to creditors"[122]

When we talk about the US approach, as CAMPBELL & FROST explain, directors do not owe fiduciary duties to creditors[123]. Directors fiduciary duties to creditors are merely "contractual in nature"[124]. Consequently, the goal of directors must be the wealth creation and to create profit for the shareholders – which will indirectly benefit creditors too. Creditors cannot, therefore, enforce claims of breach of fiduciary duties upon directors during solvency times[125]. In fact, when the company is solvent directors are "playing" with the company's assets; if directors act in a disloyal way, shareholders may be prejudicated by those actions. For this reason, only shareholders can enforce derivative claims on the behalf of the corporation when it is solvent[126].

6.2. Insolvency:

6.2.1. The US insolvency law:

According to the US legal definition, insolvency is a type of financial distress, which presupposes

[120] In this sense, and according to article 82(3)(b) of CIRE do not have the legitimacy to bring claims against fiduciary duties of directors. With different opinion see e.g., Frada, Manuel A. Carneiro da. "A responsabilidade dos administradores na insolvência", *in Revista da Ordem dos Advogados* Ano 66, vol. II, September 2006. Available at: https://portal.oa.pt/comunicacao/publicacoes/revista/ano-2006/ano-66-vol-ii-set-2006/doutrina/manuel-a-carneiro-da-frada-a-responsabilidade-dos-administradores-na-insolvencia/ [Accessed on 14.11.2019].

[121] See Oliveira, Madalena Perestrelo. *Limites da Autonomia dos Credores na recuperação da Empresa Insolvente*. Coimbra: Almedina, 2013, *op. cit.,* at p. 61.

[122] Ibid., *op.cit.,* at p. 63.

[123] See e.g., Campbell, Rutheford B. & Frost, Christopher W. "Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)", at pp. 495 and following ("A corollary of this fiduciary duty to act in the best interests of shareholders is that corporate managers owe no fiduciary duty to the corporation's creditors 20 or any other non-shareholder constituency, such as employees"); Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 370 ("When the corporation is solvent, directors and officers do not owe fiduciary duties to constituencies other than the corporation and its shareholders").

[124] Campbell, Rutheford B. and Frost, Christopher W. "Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)", at pp. 496.

[125] Zanardo, Alessandra. "Fiduciary Duties of Directors of Insolvent Corporations: A Comparative Perspective". *J. Bus. & Tech. L.,* vol. 93, Issue 3, article 10, 2018, at p. 872. Retrieved from: https://scholarship.kentlaw.iit.edu/cgi/viewcontent.cgi?article=4224&context=cklawreview; Wood, Justin. "Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan" *Penn State International Law Review,* vol. 26, no. 1, article 5, 2007, pp. 139-168. Retrieved from: http://elibrary.law.psu.edu/psilr/vol26/iss1/5.

[126] However, it must be said that these derivative claims are more frequent in the common law, especially in the US, than in the civil law countries.

a corporation that is no longer able to pay the debts or other obligations as they fall due. In economic terms, a corporation is insolvent when all its liabilities exceed all its assets[127].

In insolvent companies, creditors become "risk carriers", which means that their interests are now affected by directors' business decisions in a way they were not affected before the corporation went insolvent. Consequently, the director's fiduciary duties of loyalty and care then extend to creditors[128]. However, it is important to understand that legal experts are divided on the issue of fiduciary duties to creditors during the insolvency period.

There are two approaches to the problem. The first one says that when a corporation becomes insolvent, directors no longer represent the interest of shareholders, they should instead represent the creditors' best interest[129]. This approach was established through the "trust fund doctrine"[130], which states that directors of insolvent companies must safeguard the corporation's assets before they can distribute those assets to shareholders, and for that reason, the payment of the corporation's debts to its creditors must be the director's priority. The second approach – and the one defended by the Delaware courts[131] – says that shareholders' interests continuous to matter and directors should consider them, however, creditors' interest have primacy. This means that shareholders will only be paid after creditors receive their credits back; however, their interest must be also considered in the decision-making process.

The extension of directors' fiduciary duties to creditors in insolvent corporations led to a consequence extension of creditors' rights which until the company became insolvent were exclusive of shareholders. Indeed, creditors of insolvent companies have the right, like shareholders, to bring a derivative action in the corporation's name against directors for breaches of fiduciary duties on the behalf of the corporation[132].

An insolvent company and the extension of fiduciary duties of directors during the insolvency results pose greater risks to directors and for that reason they will need to know at which moment the fiduciary duties will extend to creditors. This leads us to the question of: when does a corporation become insolvent? There are different ways to determine when the insolvency began. However, the preferred approach to the question passes through the application of solvency tests: the "cash flow" test and the

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[127] 11 U.S Code § 101(32). Available at: https://uscode.house.gov/view.xhtml?path=/prelim@title11/chapter1&edition=prelim [Accessed on: 10.11.2019]

[128] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 378.

[129] Ibid. at p. 379, citing the decision expressed in Arnold v. Knapp, 84 S.E 895, 899 (W. Va. 1915) ("when a corporation become insolvent (...) directors (...) become trustees for the creditors").

[130] For more information about the "trust fund doctrine" see e.g. Lipson, Jonathan C. "The Expressive Function of Directors' Duties to Creditors". *Sandford Journal of Law, Business & Finance*, vol. 12, no. 2, Spring 2007, pp. 229 and follow.

[131] Since Gheewalla case law, in 2007.

[132] Zanardo, Alessandra. "Fiduciary Duties of Directors of Insolvent Corporations: A Comparative Perspective", *supra* note 125.

"balance sheet" test[133].

The cash flow test takes into consideration if a company can pay its liabilities and when they are due. If the company is unable to meet the day-to-day costs, then we can say that it is near insolvency or insolvent[134]. The balance sheet test, on the other hand, looks at all assets of the company, including stock, credits, property (movable and immovable) and then these assets are placed against any debts of the company. The objective is to understand if the company has more assets or debts. Under this test, a company is insolvent if its assets are below its liabilities "with no reasonable prospect that the business can successfully be continued"[135]. This test is commonly used to decide whether the company will continue to stay afloat or to file for bankruptcy[136].

It is important to understand, however, that a business can be cash-flow insolvent, but balance sheet solvent; in other words, a company can be asset-rich but cash-poor. The contrary is also possible, in other words, a business can be balance sheet insolvent but cash flow solvent. However, this does not mean that the company has to cease operations. In fact, many companies that have debts continue to function in this financial state; some even recover from insolvency.

Some authors argue, however, that the possibility of different tests can create unnecessary uncertainty for litigants because "parties know that the evaluation of the company's financial position is partially dependent on the specific test or tests a court chooses to employ" [137], which makes it impossible to predict what methodology the court will use to determine if the company is insolvent and whether the director breached a fiduciary duty to creditors. For this reason, neither of these solvency tests should be seen or applied independently; they should be complementary to one another.

6.2.2. The UK insolvency law:

According with the UK definition, a debtor is insolvent when unable to pay its obligations[138]. The insolvency law regarding corporations is essentially concerned with the technical situation and not with the factual one. In an economic and financial context, a company may be considered insolvent in two

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[133] Stearn, Robert. J & Kandestin, Cory D. "Delaware's Solvency Test: What is it and does it make sense? A Comparison of Solvency tests under the Bankruptcy Code and Delaware Law." *Delaware Journal of Corporate Law,* vol. 36, 2011, pp. 165-187.

[134] See e.g. Sheinfeld, Myron M. & Pippitt, Judy Harris. "Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case." *The Business Lawyer,* vol. 60, no. 1, 2004, pp. 79-107. Retrieved from: www.jstor.org/stable/40688262.

[135] Pearce, John A. & Lipin. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", op. *cit.*, at p. 380.

[136] Sheinfeld, Myron M. & Pippitt, Judy Harris. "Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case", op. *cit.,* p.90.

[137] Pearce, John A. & Lipin. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", *op. cit.,* at p. 381.

[138] With this view see Goode, Roy M. *Principles of Corporate Insolvency Law.* 3rd ed. London: Sweet & Maxwell, 2005; Keay, Andrew & Walton, Peter. *Insolvency Law: Corporate and Personal.* 2nd ed. Bristol: Jordan Publishing Limited, 2003; Fletcher, Ian F. *The Law of Insolvency.* Fifth edition. Sweet & Maxwell, 2017.

situations, regulated by the Insolvency Act (IA) of 1986, section 123(1)(e) and section 123(2)[139]. In this sense, a company is presumed to be insolvent if it is unable to pay its debts as they fall due – also known cash flow insolvency – or in situations where "the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities"[140] – known balance sheet insolvency.

In the UK, the traditional approach to the problem of the insolvency is the balance sheet test[141]. Upon this test, as previously explained, the debtor's liabilities exceed the assets, and for this reason it "is impossible for all the liabilities to be discharge in full"[142]. In commercial terms, however, the cash flow presents more advantages. In fact, the cash flow insolvency requires not only the control of the debts that are actually due, but also the examination of the debts about to be due[143]. Therefore, unpaid bills may be seen as an indicator of insolvency, which does not mean that the insolvency is inevitable[144].

However, according to some authors, the cash flow test poses some difficulties in determining the precise moment when a company became insolvent[145]. For this reason, and bearing in mind that a company may be considered cash flow insolvent and not balance sheet insolvent and *vice versa*, similar to what happens in the US, the two tests should not be seen as independent or alternatives, but rather as complementary tests[146].

The UK insolvency law stipulates four principal types of insolvency proceedings applicable to the companies: the administration, the receivership, liquidation, and the Company Voluntary Arrangements (CVA). However, similar to the US, in the UK, directors do not have any obligation to file for insolvency. In fact, the UK's companies are able to continue to operate, without infringing any law, and in some cases the companies might actually recover and become solvent again[147]. This does not mean that directors are prohibited from filing for the insolvency proceedings; this simply means that they are free to choose whether to file for it or not[148].

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[139] Available at: http://www.legislation.gov.uk/ukpga/1986/45/section/123/2014-01-01 [Accessed on 16.01.2020].
[140] Section 123(2) – Definition of inability to pay debts.
[141] Fletcher, Ian F. *The Law of Insolvency*, *op. cit.,* p. 1145.
[142] Ibid.
[143] See Bailey, Edward & Groves, Hugo. *Corporate Insolvency Law and Practice.* Fifth edition. LexisNexis – RELX (UK), 2017, at p.1146 (citing *Re Calder; Slater v Wetton* [2011] EWHC 3192 (Ch), [2012] BPIR 63 at [16]).
[144] See e.g., *Re Taylor Sinclair (Capital) Ltd* [2001] 2 BLCL 176 at [23];
[145] Keay, Andrew & Walton, Peter. *Insolvency Law: Corporate and Personal,* at p. 16; see also Bailey, Edward & Groves, Hugo. *Corporate Insolvency Law and Practice*, at p. 1146.
[146] Bailey, Edward & Groves, Hugo. *Corporate Insolvency Law and Practice,* p. 1146 ("the two test, cash-flow and balance-sheet, are complementary, not alternatives"); *Re Casa Estates (UK) Ltd, Carman v. Bucci* [2014] EWCA Civ 383, [2014] 2 BCLC 49 at [27] ("the cash flow test and the balance sheet test stand side by side"); Spindler, Gerald. "Trading in the Vicinity of Insolvency". *European Business Organization Law Review*, vol. 7, 2006, at p. 347.
[147] Keay, Andrew. "The shifting duties of directors' in the vicinity of insolvency". *International Insolvency Review*, vol. 24, issue 2, 2015 pp. 140-164. Retrieved from: http://eprints.whiterose.ac.uk/84965/5/Vicinity_of_insolvencyIIR_sub_revised.pdf; see also Davies, Paul. "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency". *European Business Organization Law Review*, vol. 7, 2006, at p. 315.
[148] Ibid., at p.3.

Nevertheless, it is important to be aware of the fact that insolvency is particularly dangerous for directors. In fact, during insolvency – and during the vicinity of insolvency, as we are going to see – directors are exposed to potential civil and criminal liabilities. If a director is considered to have delayed considerably the filing for formal insolvency proceedings, resulting in creditors' losses, directors may be found guilty of wrongful trading and fraudulent trading, triggering their civil and even criminal liability. On the other hand, directors may also be liable for the premature initiation of insolvency proceedings, if this causes losses to creditors. In this sense, directors must be able to prove that their actions were taken in the best interests of the company and with good faith – only then can they be protected by the presumption of business judgment.

The UK has one of "the most famous creditor friendly regime in the world"[149]. In fact, the insolvency proceedings have the ultimate function of protecting the rights of the creditors and guarantee the payment of the credits made by the company. Therefore, directors of insolvent companies owe their fiduciary duties to the creditors. Similar to what happens in some states of the US – and in Portugal as we are going to explore next – the creditors become "risk barriers", and for this reason, they stand in a vulnerable position, as their interests prevail over others.

6.2.3. The Portuguese insolvency law:

Insolvency translates into a situation where a debtor – a person, a company or other legal entity – is unable to meet its obligations, generally due to lack of liquidity at a specified period, or in certain cases where the total liabilities exceed the total assets. Under the article 3(1) of The Portuguese Insolvency and Corporate Recovery Code (CIRE)[150], insolvency is defined as the inability to pay the overdue debts. This criterion of "inability" expressed in the article 3(1) is relevant because the insolvency situation has to do only with the inability to pay overdue obligations[151]. In fact, the definition of the article 3(1) does not include situations where the debtors "refuse the existence of an obligation"[152].

A clear indicator that the corporation no longer has the money to fulfil its debts is the non-payment of those obligations when they are due. According to many legal experts, the legislator does not link insolvency to the failure to meet all the overdue obligations. In fact, the inability to pay a single and particular debt – which assumes a significant burden on the debtor's liabilities or in the environment

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[149] Bailey, Edward & Groves, Hugo. *Corporate Insolvency Law and Practice,* at p. 1730.
[150] Available at: https://dre.pt/legislacao-consolidada/-/lc/34529075/view [Accessed on 13.01.2020].
[151] See e.g. Martins, Alexandre Soveral. *Um Curso de Direito da Insolvência*. 2ª ed. Ver. e atualizada. Coimbra: Almedina, 2016.
[152] Martins, Alexandre Soveral. *Um Curso de Direito da Insolvência*, ibid., p. 47.

underlying the default – can determine that the debtor is unable to continue to meet (on time) its obligations[153].

Regarding the definition of insolvent companies, beyond the notion expressed in article 3(1) we should also analyse the insolvency situation regulated by article 3(2) of CIRE. According to the article 3(2), the companies "for whose debts no natural person answers personally and unlimitedly, directly or indirectly, are also considered insolvent when their liabilities are manifestly higher than their assets, valued in accordance with applicable accounting standards"[154]. In fact, insolvency determined on this basis presupposes that the volume and weight of the company's liabilities, when comparing with its assets, are much more significant. For this reason, the debtor cannot or will soon be unable to fulfil its obligations[155].

Like the US and UK, the Portuguese law, namely CIRE also stipulates two tests to determine if the debtor is in an insolvency situation or not: the cash flow test and the balance sheet test. In economic terms, these tests are equivalent in both jurisdictions regarding their definition, and for this reason, it seems to us redundant to explain them again. However, we cannot leave the observation aside that, in Portugal, the preferential test used to determine if a company or a natural person is insolvent is the cash flow test, unlike the US and the UK approach. This preference has to do with the definition of insolvency under the article 3(1), previously examined[156].

It is also important to be aware that under the Portuguese jurisdiction of CIRE, and contrary to the US and the UK, the board of directors of limited liability companies have the formal obligation to file for insolvency (*o dever de apresentação de insovência*) within 30 days of the date on which they had – or should have known – that the company was insolvent[157]. In fact, the Portuguese law, and more precisely the articles 18 and 19 of CIRE, clearly states that the board of directors, responsible for the administration

[153] Martins, Alexandre Soveral. *Um Curso de Direito da Insolvência,* ibid., at p. 47; Costeira, José Maria. *A insolvência das pessoas coletivas. Efeitos no insolvente e na pessoa dos administradores.* JULGAR n. ° 18, 2012, p. 162. Retrieved from: http://julgar.pt/wp-content/uploads/2012/09/161-173-A-insolv%C3%AAncia-de-pessoas-colectivas.pdf.

[154] Article 3(2) of CIRE, available at: https://dre.pt/web/guest/legislacaoconsolidada/lc/118376176/202001141515/73661586/diploma/indice [Accessed on 14.01.2020].

[155] Costeira, José Maria. *A insolvência das pessoas coletivas. Efeitos no insolvente e na pessoa dos administradores, p. 162*; see also the *AC do Tribunal da Relação de Lisboa proc. 2509/09.1TBPDL-2, relator Farinha Alves, of 20.05.2010. Available at: http://www.dgsi.pt/jtrl.nsf/33182fc732316039802565fa00497eec/a413b150db6237988025778f0052936d?OpenDocument*. [Accessed on 14.01.2020].

[156] Martins, Alexandre Soveral. *Um Curso de Direito da Insolvência, supra* note 151; Leitão, Luís Manuel Teles Menezes. *Direito da Insolvência*. 9ª Edição. Coimbra: Almedina, 2019.

[157] For more information about the duty to file for insolvency see e.g. Leitão, Luís Manuel Teles Menezes. "Pressupostos da declaração de insolvência", *in* Catarina Serra (org.), *I Congresso de Direito da Insolvência, Coimbra:* Almedina, 2013, pp. 175-186; Costa, Maria Olímpia. *Dever de apresentação à insolvência.* Coimbra: Almedina, 2016; Martins, Alexandre Soveral. "Apontamentos sobre os trâmites do processo de insolvência antes da sentença de insolvência ou de indeferimento do pedido de declaração do pedido de insolvência", *in AA.VV., Para Jorge Leite – Escritos Jurídicos,* vol. II. Coimbra: Coimbra Editora, 2014.

of the company[158], have the duty to apply for insolvency[159]. If the obligation to file for insolvency is not fulfilled within the period stipulated, the law establishes a presumption of serious liability on directors[160]-[161].

The insolvency proceedings have the objective to grant the credits payment to the insolvent's creditors[162]. In fact, like most jurisdiction, in Portugal, directors of insolvent companies owe their duties to the company's creditors. In the insolvency proceedings, according to CIRE, creditors can decide between two different outcomes: the liquidation of the insolvent company or the company restructuring. If the intention is the restructuring of the company, the debtor must submit an insolvency plan, which is subjected to the approval of creditors. However, it must be highlighted that if the insolvency proceeding is opened and there is no submission of an insolvency plan, creditors can decide if the company will be closed – this necessarily involves the liquidation of the company's assets.

One of the consequences of the initiation of the insolvency proceedings to the insolvent is the deprivation of the administrative powers (*privação dos poderes sobre os bens da massa insolvente),* in this case, the powers of the company's directors. According to article 81(1), after the declaration of insolvency the insolvent and its directors cease immediately to exercise their powers of administration and representation of the company. Generally, after the insolvency is declared, the directors' powers are transferred to the insolvency administrator[163] appointed by court. However, as CATARINA SERRA argued, this is not, nowadays, an absolute effect of the obligation to file for insolvency[164], because, as the author referred, there are "some set of goods that have to obligatory remain in the debtor possession"[165].

Nevertheless, for some authors, the article 82 of CIRE seems to contradict the norm expressed in the article 81[166]. In fact, according to the article 82 of CIRE, the debtor's social bodies remain in their positions although with limited powers. The debtor's actions are now supervised by the creditors' general meeting, for the creditor's committee, for the insolvency administrator[167] and for the court. It must be

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[158] Regarding the definition of administration of the company see article 6 of CIRE.

[159] See Serra, Catarina. *O regime português da insolvência.* Coimbra: Almedina, 2012, pp. 40-41 (for the author the deadline of 30 days to file for insolvency is shorter that would be the desirable and can lead to a "risk-chilling effect"; directors fearing to trigger their personal liability resign from the effort to find solutions).

[160] Frada, Manuel A. Carneiro da. "A responsabilidade dos administradores na insolvência", *supra* note 120.

[161] We will analyse the questions of civil and criminal liability of directors in the final chapter of this dissertation.

[162] See Serra, Catarina. *Lições de Direito da Insolvência*. Coimbra: Almedina, 2018.

[163] See e.g.: Leitão, Luís Manuel Teles Menezes. *Direito da Insolvência*, at p.169.

[164] Serra, Catarina. *Lições de Direito da Insolvência*, at p. 144.

[165] Ibid., *op.cit.,* p.144-145.

[166] Leitão, Luís Manuel Teles Menezes. *Direito da Insolvência*, at p.169; for more information see e.g. Fernandes, Luís Carvalho; Labareda, João. *Código da Insolvência e da Recuperação de Empresas: Anotado. Sistema de Recuperação de Empresas por Via Extrajudicial (SIVERE) Anotado. Legislação Complementar.* 3ª Edição. QUID JURIS, 2015, at p. 418.

[167] The insolvency administrator is appointed by the judge and has the ultimate function of supervising the insolvent mass and to proceed to its administration. For more information see e.g., Leitão, Luís Manuel Teles Menezes. *Direito da Insolvência*, at p.119; Serra, Catarina. *Lições de Direito da Insolvência*, *supra* note 162; Epifânio, Maria do Rosário. *Manual de Direito da Insolvência.* 7ª Edição. Coimbra: Almedina, 2019;

pointed out that the court does not have a significant participation in the process to decide the future of the debtor. The most important organ in the decision process is, in fact, the creditors[168]. As a result, directors are obliged to collaborate with all these entities, even if with limited powers, and continue to have their general fiduciary duties to the corporation.

In the opinion of Professor CATARINA SERRA, however, the norm expressed in the article 82 is reasonable[169]. The text of article 82(2) gives to directors the possibility to renounce to their function in the company[170]. In this sense, directors are not obliged to stay in their positions they are free to choose whether to remain in their position – keeping in mind that will not receive a remuneration for that. Additionally, the author also argues that the deprivation of the administrative powers is not a "necessary effect of the insolvency declaration"[171], because, nowadays, the CIRE permit exceptions to this general rule, namely with the debtor in possession regime. The debtor in possession (DIP) entrust the debtor with the company's administration. In this special situation, inspired in the Chapter 11 of the Bankruptcy Code of the US, directors continue to receive their remuneration and continue to perform their full range of functions, always in compliance with their fiduciary duties[172].

6.3. Bankruptcy:

There are two interpretations regarding the origins of the word "bankruptcy". The first one supports that the word "bankruptcy" has its origins in "the medieval Italian custom of breaking the benches of a banker or merchant who absconded and left creditors unpaid"[173]. Another formulation regarding the origins of the word "bankruptcy" is related to "the French words *banque,* meaning bench, and *route*, meaning a trace; thus, a ruined trader would remove his trading bench without leaving a trace"[174].

In both common law and civil law countries, "bankrupt" is usually used as a synonym of "insolvent". However, when we are talking about legal terminology this use is in fact incorrect[175]. In the common law countries, bankruptcy and insolvency are, in fact, historically different from one another:

[168] Serra, Catarina. *Lições de Direito da Insolvência*, op. cit., p. 79.

[169] Serra, Catarina. *Lições de Direito da Insolvência*, op. cit., p. 179 (saying that the norm expressed in the article 82 has a limited utility by ensuring the representation of the debtor when his intervention is necessary to the insolvency process); in contrary opinion see Costeira, José Maria. *A insolvência das pessoas coletivas. Efeitos no insolvente e na pessoa dos administradores,* at p. 167.

[170] Serra, Catarina. *Lições de Direito da Insolvência*, at p. 179.

[171] Ibid., *op. cit.,* p. 145.

[172] Costeira, José Maria. *A insolvência das pessoas coletivas. Efeitos no insolvente e na pessoa dos administradores, supra* note 153.

[173] Baird, Douglas G. *Elements of Bankruptcy.* Sixth Edition. Foundation Press, 2014, *op.cit.,* at p. 4.

[174] Tabb, Charles Jordan. *Law of Bankruptcy.* Fourth Edition. United States of America: Handbook Series, 2016, *op.cit.,* at p. 2.

[175] Fletcher, Ian F. *The Law of Insolvency*, at p. 5.

bankruptcy is seen as a legal condition or status, while insolvency is a factual condition. An individual may be insolvent and escape bankruptcy, while "a solvent person may nevertheless undergo adjudication as a bankrupt"[176]. In fact, the English law admits the possibility to consider a person bankrupt or a company to be wound-up, when there is on the table a refusal of that person or company to pay their debts[177]. As we analysed previously, the insolvency situation is not related to the refusal to pay the debts, but rather with the lack of assets to do so.

An important aspect to be aware of regarding the notion of bankruptcy in the English formulation of the term is that the subjects that can be considered bankrupt. In fact, according to EDWARD BAILEY AND HUGO GROVES, for the English law only individuals can be considered bankrupt[178]; the companies are considered to be winding-up and not bankrupt[179]. Contrary to this, the US formulation of bankruptcy refers not only to individuals, but also to companies.

In the US the term bankruptcy evolved significantly since its first codification. In fact, in the beginning the bankruptcy law had the ultimate role of protecting and relieving creditors of merchant trader. On the contrary, the insolvency law's main role was to grant the debtor relief. This has undergone significant changes and today the US bankruptcy law does not make this distinction between insolvency and bankruptcy. In fact, the actual Bankruptcy Code embraces "both notions of a remedies for creditor and of debtor relief"[180]. This does not mean that insolvency and bankruptcy are the same thing, as we saw previously, at least in the US[181].

Today, the goal of the bankruptcy law of the US, regarding corporations, is to grant a "fresh start" for a trustworthy but "unfortunate debtor"[182], expressed in the famous Chapter 11 of the Bankruptcy Code. The principle of this chapter is so useful in the business context that many countries in the world have adopted laws inspired by it, including the UK and Portugal. For instance, inspired by Chapter 11 of the Bankruptcy Code, the Portuguese law has also created mechanisms that permit the rescue of distressed companies, namely the Special Revitalization Process (PER) and the Extrajudicial Regime for the Companies Recovery (RERE).

Although there is no direct reference of fiduciary duties in the US Bankruptcy Code, they "play a

[176] Ibid., at p.6.
[177] Ibid.
[178] Bailey, Edward & Groves, Hugo. *Corporate Insolvency Law and Practice,* at p. 1729.
[179] Ibid.
[180] Tabb, Charles Jordan. *Law of Bankruptcy, op.cit.,* at p. 3.
[181] The same does not happen in the Portuguese jurisdiction, where bankruptcy is equivalent to insolvency.
[182] Tabb, Charles Jordan. *Law of Bankruptcy,* at p.4 (citing Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934)).

central role in the administration of the insolvent debtor's assets"[183]. After the filing for Chapter 11, directors continue to owe fiduciary duties to the corporation, to the creditors and to the shareholders[184]. Another relevant aspect of bankruptcy in the US jurisdiction is the position of creditors. In fact, during the bankruptcy process, creditors "become active participants in all the corporate affairs, negotiations, and reorganization processes"[185]. Chapter 11 admits the Debtor in Possession (DIP), where directors continue to manage the business, even if with the supervision of creditors. However, in very rare cases where the company did not apply for the Chapter 11, the court nominee a trustee[186] – which, although not considered a pure fiduciary, has fiduciary obligations and responsibilities, under section 704 of the Bankruptcy Code[187].

The duty of loyalty of directors, during Chapter 11 proceedings, remains the same as the one they must follow in solvent times. However, the duty of care during bankruptcy is seen as a "multifold"[188] duty. In fact, the duty of care imposes on directors during DIP is the same that the duty of care imposed to the trustee[189] appointed by the court in the others bankruptcy proceedings. The duty of care, therefore, obliges directors to exercise care and diligence that an average prudent person would exercise in comparable situations.

Regarding corporations, we can conclude that the US Bankruptcy law is, in fact, very similar not only to the UK Insolvency law but also to the Portuguese Insolvency law. There are, obviously, technical differences in the application of the term in these jurisdictions, but the analyses of these differences in the proceedings is not the objective of this study. The point here is to understand that, although the "insolvency proceedings" – in the UK and Portugal – and "bankruptcy proceedings" – in the US – can be interpreted as different concepts, they ultimately have similar effect. For this reason, and for the propose of this study, they will be used as synonyms.

[183] Pottow, John A. E. "Fiduciary Duties in Bankruptcy and Insolvency". *Law & Economics Working Papers 135*, 2017, at p. 1. Retrieved from: https://repository.law.umich.edu/law_econ_current/135.
[184] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 386.
[185] Ibid.
[186] For more information regarding the nomination and responsibilities of the trustee se e.g. Pottow, John A. E. "Fiduciary Duties in Bankruptcy and Insolvency", supra note 183.
[187] 11 U.S.C. § 704. Duties of Trustees. Available at: https://www.law.cornell.edu/uscode/text/11/704.
[188] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 386.
[189] Ibid., referring Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 461 (6th Cir. 1982) ("the duties of a debtor in possession are similar to those trustees in bankruptcy"); In re Four Score Broad., Inc., 77 B.R. 404, 407 (Bankr. W.D.N.Y. 1987) (stating the same).

CHAPTER II – THE "ZONE" OF INSOLVENCY

1. Defining the "zone" of insolvency:

The "zone" of insolvency is a particularly problematic financial stage. Most countries do not have a precise definition, neither legal nor economic, for the vicinity[190] of insolvency. For this reason, the so-called "zone" of insolvency is usually referred to as an undefined period between solvency and insolvency[191], where it is almost certain that the company will be insolvent very soon[192]. In fact, according to the UNCITRAL, the zone of insolvency intends to describe "a period in which there is a deterioration of the company's financial stability to the extent that insolvency has become imminent, mature, or unavoidable"[193]. However, as some authors have argued, the definition of the "zone" is particularly difficult or impossible[194].

This lack of precise definition places significant problems for the company's directors that do not know the boundaries of their duties and to whom those fiduciary duties are owed. As we already discussed in the topic regarding insolvency, when the company becomes insolvent the creditors become "risk barriers". Therefore, according to the US approach, their interests must be taken into consideration, while in other jurisdictions, such as the UK and Portugal, more creditor defensive, they become the objective of the insolvency relief.

In the vicinity of insolvency, however, directors find themselves in a very unfortunate situation. Since there is no legal definition for the brink of insolvency nor coherent legal guidelines to directors, the balance of conflicts tends to be must more sensitive and difficult. As a result, the lack of consensus regarding the definition of the boundaries of the director's fiduciary duties and whether these duties will exchange or not to increase creditors makes the brink of insolvency a very dangerous and uncertain time, where the director's liability is at risk. We cannot leave the observation aside that the theory of the shifting duties, as we are going to see, is especially relevant in the US and the UK. Within the doctrine there are those who support the shift and others that argued that this shift may cause the increase in "costs on

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[190] It is a synonym of "zone"; equivalent to "brink" or "near".

[191] See e.g., Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 371.

[192] Dionne, Anna Manasco. "Living on the Edge: Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency". *Stanford Law Journal of Law, Business & Finance*, vol. 13, no. 1, Fall 2007, p. 188.

[193] UNCITRAL Legislative Guide on Insolvency Law. "Directors' Obligations in the period approaching insolvency". *Working Group V*, 43rd session, New York, 15-19 April 2013, at p. 14.

[194] See e.g., Hargovan, Anil & Todd, Timothy M. "Financial Twilight Re-Appraisal: Ending the Judicially Created Quagmire of Fiduciary Duties to Creditors". *University of Pittsburgh Law Review*, vol.78, Winter 2016, at p. 155.

directors and firms"[195]. These costs depend on numerous factors and will differ regarding the jurisdiction in question[196].

2. Problems which the "zone" intensifies:

2.1. Agency Cost problems:

When a corporation enters the zone of insolvency, the conflicts of interest between shareholders and creditors tend to intensify[197]. It must be argued that both creditors and shareholders can influence the board decision-making process through distinctive instruments. The first group, the shareholders, can influence the business decision-making process because they are the ones who appoint and remove directors from the board. The second group, the creditors, influence the process through their ability to start insolvency proceedings, which can influence also the board's decision-making process[198]. Beyond that, we must not forget that one of these groups is more vulnerable to the opportunism of the other. In fact, the shareholders' opportunism vis-à-vis creditors tends to be much more significant when the company enters in the zone of insolvency[199].

Shareholders and creditors have different risk appetites regarding business decisions. As residual claimants of the company, shareholders profit from business decisions that intend to maximize the value of the company's assets. Creditors, on the other hand, have generally fixed dues of the corporate assets, and for this reason, do not profit from investments beyond the value of these dues[200]. In the case of financial distress, shareholders will not suffer the full burden from failed company's investment decisions because they are protected by limited liability. However, it is not that simple for creditors. In fact, creditors of financial distress corporations will bear the full burden of that distress because the assets that the company invested disastrously will no longer be at one´s disposal to pay their credits. For this reason, creditors will definitely prefer low-risk investments and shareholders will almost certainly be more tempted

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[195] Hargovan, Anil & Todd, Timothy M. "Financial Twilight Re-Appraisal: Ending the Judicially Created Quagmire of Fiduciary Duties to Creditors", *op.cit.,* at p. 159.
[196] Ibid.
[197] Bainbridge, Stephen M. "Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency". *J. BUS. & TECH. L.,* vol. 1, article 7, issue 2, 2007, at p. 357.
[198] Ibid., at p. 140.
[199] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 6; Davies, Paul. "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency", at p. 306; Kraakman, Reinier et al. *The Anatomy of Corporate Law. A Comparative and Functional Approach*, at pp. 111- 116; Ribeiro, Maria de Fátima. "A responsabilidade de gerentes e administradores pela actuação na proximidade da insolvência de sociedade comercial", in *O Direito,* Ano 142°, vol. I. Coimbra: Almedina, 2010, pp. 81-128.
[200] Wood, Justin. "Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan". *Penn State International Law Review*, vol. 26, no. 1, art. 5, 2007, pp. 139-168.

to make riskier investments where the expectations for higher profits are superior[201].

Furthermore, another issue regarding the agency cost problems, which is also inherent with some pressure against directors, has to do with the directors' willingness to maintain themselves in their positions in the company. In fact, as HORST EIDENMULLER argued, directors may be tempted to make decisions that will grant their permanence in the company for the longest period possible[202]; they will, therefore, only have something to lose – disqualification or other remedies – if the company enters an insolvency proceeding[203].

Another relevant aspect is related to the question of who will know first if the company is operating in the zone of insolvency. It seems obvious that the first ones to know when the company is in the zone of insolvency are the shareholders, and for this reason, they can be tempted to pressure directors to make riskier decisions, which might not benefit the creditors[204]. In fact, when the company is approaching insolvency shareholders are more permeable to underinvestments. We must keep in mind that shareholders can influence the investment decisions of companies operating in the zone of insolvency. As a result, it is almost certain that they will not favor investments that will not grant their return in equity or that will benefit the creditors and not them[205].

Beyond the aforementioned points, shareholders and creditors also differ in their liquidation preferences. Creditors are more vulnerable to lose their claims when the corporation is approaching the insolvency stage or is operating on the brink of insolvency. For this reason, it seems expectable that they will be more favorable to the repayment of their credits through liquidation over the insecurity and "risk involved in keeping the company operational"[206]. Shareholders, on the other hand, will be more favorable to the corporation continuing operations for the longest period possible, expecting the possible turnaround of the company.

Another issue magnified by the vicinity of insolvency has to do with the uncertainty in regards to its definition. In fact, as we saw previously the zone of insolvency lacks in a proper definition and for this reason, it is very difficult for directors to know if the company is operating under the "zone" or not. But

[201] Lin, Laura. "Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors". *VAND. L. REV.,* vol. 46, no. 1485, 1993, at pp. 1489-90; see also Davies, Paul. "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency", *supra* note 147.

[202] Eidenmüller, Horst. "Trading in Times of Crisis: Formal Insolvency Proceedings, Workouts and the Incentives for Shareholders/Managers*." European Business Organization Law Review*, vol. 7, no. 1, 2006, at p. 243.

[203] Davies, Paul. "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency", at p. 308.

[204] Ribeiro, Maria de Fátima. "A responsabilidade de gerentes e administradores pela actuação na proximidade da insolvência de sociedade comercial", at pp. 123-124.

[205] Ibid., at p. 1496.

[206] Ibid., op. cit., at p. 142.

why is this relevant for the case? Because directors owe duties to the corporation and its shareholders during solvency times, and these duties shift to creditors when the company is, in fact, insolvent, when it comes to the US. In case of the UK, this shift also occurs in the "zone". However, in the zone of insolvency, there is no unified position regarding the question of the shifting duties. As a result, directors will not know if their fiduciary duties remain to be owned by the shareholders or if they shift to the creditors.

Due to all these problems, we can argue that the vicinity of insolvency creates difficulties for the entire company and especially for directors, who must be able to successfully manage all this conflict of interest. It must be pointed out, however, that this management will differ from jurisdiction to jurisdiction. In fact, there is no universal approach to the agency's problems, and for this reason, the approach can differ greatly from one jurisdiction to another – as we are going to examine later in this dissertation.

Some authors argue that the shifting duties from shareholders to creditors can increase the agency cost problems in those companies which are operating in the vicinity of insolvency[207]. Indeed, the inevitable litigation inherent to the shifting duty to creditors and the increase in the possibility of directors' personal liabilities can affect the good name of the company in the market. Furthermore, as STEPHEN M. BAINBRIDGE argued the shifting duty to creditor strips the directors of their ability to judge whether their behavior is in accordance with the law and their fiduciary duties or not. Since directors have to also take into consideration the interests of creditors, they need to answer to "two masters", which increases the costs of corporate governance[208].

3. Director's fiduciary duties of companies operating in the "zone":

3.1. The US perspective:

The guidelines to this ambiguous zone may differ in the different federal states[209]. The zone of insolvency does not have a generally accepted definition, which creates different approaches to the problem of: when does a corporation enter the zone of insolvency? The bankruptcy court in the case *In re Healthco International, Inc.*[210], argued that a corporation is operating in the zone of insolvency when it has "unreasonable small capital"[211] which makes the insolvency almost certain. However, this gives rise

[207] With different opinion see in general: Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", supra note 190.
[208] Bainbridge, Stephen M. "Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency", at p. 23.
[209] See e.g., Baker, Jan D., et al. "Corporate Governance of Troubled Companies and the Role of Restructuring Counsel." *The Business Lawyer*, vol. 63, no. 3, 2008, pp. 855-879. Retrieved from: www.jstor.org/stable/40688514.
[210] 208 B.R. 288 (Bankr. D. Mass. 1997).
[211] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 372 (quoting *In re* Healthco International, Inc. 208 B.R. 288 (Bankr. D. Mass. 1997))

to another issue: the analysis of the "small capital" of the company requires a precise audit on the financial projections of the company, which is very difficult. Beyond that, the inexistence of a precise test to determine if the company is or not in the vicinity of insolvency amplifies the problem with this definition presented by the court.

The vicinity of insolvency is usually referred to as a very uncertain financial stage known for being "imprecise and hard-to-define"[212]. This lack of definition of its legal boundaries creates serious problems not only to directors but also to investors and creditors of a company[213]. In fact, the common approach of the American courts is the application of the familiar solvency tests – the already spoked cash flow and balance sheet tests – to analyze if that director's decision was taken during the zone of insolvency or not[214]. However, if the insolvency itself is already hard to define precisely, the definition of the zone of insolvency is much more complex. In fact, defining precisely when was the company entered in the vicinity of insolvency is tremendously difficult, not to saying practically impossible, which creates practical problems for directors regarding their fiduciary duties.

It can be easily understood why this complex financial stage poses such difficulties for corporate directors. Similar to what happened with the definition of the zone of insolvency, the fiduciary duties of directors of distress companies is also a problematic issue that does not yet have a proper solution. Today, the general rule of Delaware is that directors of companies operating in the vicinity of insolvency owe their fiduciary duties to the all corporation and the corporation´s shareholders[215], for this reason, directors of companies in the zone of insolvency do not have to take into consideration the interests of creditors. In fact, only the insolvency itself will generate the obligation for directors to consider creditors' interests. However, this has not always been so peaceful. Indeed, until 2007 the zone of insolvency and the fiduciary duties of directors during that period were a hot topic for the US corporate law, surrounded by controversy and uncertainty.

3.1.1. The uncertainty created by *Credit Lyonnais*:

One of the most controversial and cited cases regarding the fiduciary duties of director of

[212] Production Res. Group v. NCT Group, 863 A.2d. 772, 786-90, no. 56 (Del. Ch. 2004).
[213] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 373.
[214] See e.g., Wood, Justin. "Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan", supra note 176; Sjovall, John M. "What Duty Do Company Directors Owe to Banks and Other Creditors?". *BANKING LAW JOURNAL*, vol. 4, no. 13, 2004, at p. 121; Cieri, Richard M. & Riela, Michael J. "Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone of Insolvency: Important Considerations, Practical Solutions". *DePAUL BUS. & COMM. L.J.*, vol.2, 2004, at p. 40.
[215] Pearce, John A. & Lipin, Ilya A. "The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency", at p. 373.

distressed companies operating in the "zone" is *Credit Lyonnais*[216]*.* This notorious case did not clearly state that during the vicinity of insolvency, the fiduciary duties of directors shift to creditors. Even so, some courts and legal experts have since interpreted the decision in this way[217]. Beyond that, *Credit Lyonnais* failed to address a very important issue: could creditors enforce claims against directors for fiduciary duty breaches? The answer to this is not consensual. The omissions and the lack of a precise language led to different readings of *Credit Lyonnais*[218]. By then, the most accepted interpretation argued that creditors had the right to enforce fiduciary duty claims against the directors' decisions when the company is near insolvency[219]. On the other hand, we have other legal experts that had interpreted the language of *Credit Lyonnais* as giving to directors a "protector shield" against "shareholder challenges decisions that take other stakeholders' interests into consideration"[220].

The consequence of these different interpretations led to a massive number of breach of fiduciary duty claims enforced by creditors against directors of near insolvent companies. Consequently, and with the fear of possible fiduciary duty breaches, directors of distressed companies changed their business strategies to less risky business decisions[221], which was not the objective. In the famous footnote of *Credit Lyonnais*, the Chancellor Allen (1985-1997) argued that directors of a distressed companiescould take one of three courses of action regarding their business decisions: (1) a very risky decision, that will almost certainly benefit the shareholders but might be detrimental do creditors; (2) a moderately risky decision, which will generate smaller profits for shareholder, but will enable the payment of creditors in full; and (3) the least risky decision, in which the creditors will be paid in full but shareholders will not have profit from the process[222]. According to Chancellor Allen, the best approach to the problem would be the second one, namely a moderately risky decision, in which directors would be able to manage better the conflict of interests between shareholders and creditors. The position of this Chancellor can, thus, be summarized

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[216] Bank Netherland v. Pathe Communications Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

[217] Dionne, Anna Manasco. "Living on the Edge: Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency", *supra* note 192.

[218] See e.g., Wood, Justin. "Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan", at p. 148 and follow; Callison, J. William. "Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice?". *Journal of Business &Technology Law*, vol. 1, no. 2, 2007, at p. 435 and follow.

[219] The majority of the doctrine had interpreted the Credit Lyonnais as creating a duty to creditor see e.g., Hartman, Rima Fawal. "Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?". *Washington and Lee Law Review,* vol. 50, no. 4, Fall 1993. Retrieved from: https://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=1794&context=wlulr; Lipson, Jonathan C. "The Expressive Function of Directors' Duties to Creditors", supra note 130; Lipson, Jonathan C. "Directors' Duties to Creditors: Power Imbalance and the Financially Distress Corporation". *UCLA L. REV.,* vol. 50, 2003, at p. 1211; Becker, Bo, and Per Stromberg. "Fiduciary Duties and Equity- Debtholder Conflicts." *Review of Financial Studies*, vol. 25, no. 6, June 2012, pp. 1931–1969. Retrieved from: https://dash.harvard.edu/bitstream/handle/1/9491449/Becker+Stromberg_Fiduciary_Duties201201.pdf;sequence=1; Hughes, R.L, and M. McGee. "Fiduciary duties of directors of insolvent corporations", in *Annual current developments in bankruptcy and reorganization.* A. M. Quittenden, ed. New York: Practicing Law Institute, 1995.

[220] Wood, Justin. "Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan", at p. 148 (citing Barondes, Royce de R. "Fiduciary Duties of Officers and Directors of Distress Corporations". *GEO. MASON L. REV.*, vol. 7, 1998).

[221] Ibid.

[222] See Callison, J. William. "Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice?", at p. 435.

as follows: during the vicinity of insolvency, directors represent the interests of the business enterprise as a whole and not only the shareholders' interests.

Therefore, although *Credit Lyonnais* is open to interpretation, the opinion of CALLISON seems to be the one that best matches the opinion of Chancellor Allen[223]. We can thus argue that *Credit Lyonnais* gives, in fact, the corporate directors of distressed companies the power to “strike a balance in an attempt to reach a fair and efficient result, without fear of a fiduciary breach to shareholders” and “without fear of fiduciary breach to (...) creditors”[224], and does not create shifts of fiduciary duties to creditors, as some have defended[225].

Delaware courts, given the potential problems and the controversy of the *Credit Lyonnais,* showed some reluctance in applying the doctrinal theory created by the case[226]. Only a year after the decision, the Court of Chancellery of Delaware, in *Greyer v. Ingersoll Publications Co.*[227]*,* opposed to the notion of the fiduciary duty shift to creditors when the company was in the vicinity of insolvency. It was decided that only upon insolvency would fiduciary duties shift to creditors[228]. Another relevant case in which the reference is indispensable is the *Production Resources*[229]. In this case, the Vice-Chancellor Strine (during 1998- 2011) rejected the notion posed by *Credit Lyonnais* by saying that: "even if directors had duties to creditors in the zone of insolvency, creditors did not necessarily have the standing to assert breach of fiduciary duties claims"[230].

Vice-Chancellor Strine concluded that creditors could only assert derivative claims against corporate directors on behalf of the corporation, rather than direct claims. Nevertheless, from its perspective the "spirit of *Credit Lyonnais"*[231] has in its basic theory the BJR. Beyond that, the court also defended that *Credit Lyonnais* provides a shield that protects directors from “shareholders’ potential benefit”[232] as long as the company does not breach its legal obligations to creditors. This means that

[223] In the same line of thinking see also Dionne, Anna Manasco. “Living on the Edge: Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency”, *supra* note 192.
[224] See Callison, J. William. “Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice?”, at p. 436.
[225] In this case, the court had interpreted *Credit Lyonnais* in a much more extensive way, considering that the case creates a shift in priority of fiduciary duties: Weaver v. Kellogg, 216 B.R. 563, 582-84 (Bankr. S.D. Tex. 1997) (stating that directors of companies operating in the zone of insolvency owe a duty to creditors); stating the same: see e.g., In re Kingston Square Associates, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997); In re Buckhead America Corp., 178 B.R. 956, 968-69 (Bankr. D. Del. 1994).
[226] Pearce, John A. & Lipin, Ilya A. “The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency”, at p. 374 (stating that more courts followed the reluctance of Delaware, namely California and Louisiana courts).
[227] 621 A.2d. 784, 787 (Del.Ch. 1992).
[228] Callison, J. William. “Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice?”, at p. 436 (citing Geyer v. Ingersoll Publ’ns Co., 621 A.2d. 784, 787 (Del.Ch. 1992)).
[229] Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.ed 772, 775 (Del. Ch. 2004).
[230] Lipson, Jonathan C. “The Expressive Function of Directors’ Duties to Creditors”, *op. cit.,* at p. 17.
[231] Ibid.
[232] Callison, J. William. “Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice?”, *op. cit.*, at p. 437.

Credit Lyonnais does not create a new type of creditors' rights in the vicinity of insolvency, as some argued. Thanks to this, some authors argue that *Production Resources* was fundamental to explain some question that *Credit Lyonnais* left untouched, and helps to clarify if *Credit Lyonnais* created or not a shift in fiduciary duties to creditors[233].

However, it must be said that the conclusion of Vice-Chancellor Strine does not create any theoretical foundation. In fact, according to CALLISON, the approach of "if" analysis "is not helpful in determining how Delaware Chancery Court is likely to approach cases that do not come with *Production Resources'* factual settings, including the zone-of-insolvency situations"[234]. Additionally, for the author, the *Production Resources* does not provide any "guidance on the nature of the duty to creditors and the firm"[235]. Beyond that, for JONATHAN LIPSON, the opinion of the Vice-Chancellor Strine can be vague and opaque because does not define precisely which claims could be derivative, and because it fails to explain "how creditors could possibly jump the unusual procedural hurdles that typically bar derivative actions"[236].

Two years later, however, in the *Trenwick* case[237], Vice-Chancellor Strine reiterated that the Delaware law does not prioritize the creditors' rights when the company is navigating through the "zone". Beyond that, he also reasserted that directors' discretion during the zone of insolvency is entitled to the BJR. In fact, the prioritization of directors' fiduciary duties to creditors during the brink of insolvency would be unnecessary and dangerous for two main reasons: (1) because creditors are extensively protected by contract law, by fraudulent conduct and the Trust Fund Doctrine in insolvency cases[238]; and (2) because the existence of a specific duty to creditors would damage the protections of the business judgment rule – so important to the US corporate law, as we previously saw. Thus, for ANNA MANASCO DIONNE, the *Trenwick* "took the focus on the corporate enterprise to its logical conclusion, affirming directors' entitlement to the business judgment insulation and curbing their exposure for the sake of preserving that protection"[239].

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[233] See e.g., Dionne, Anna Manasco. "Living on the Edge: Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency", *supra* note 176.

[234] Callison, J. William. "Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice?", *op.cit.,* at p. 440.

[235] Ibid.

[236] Lipson, Jonathan C. "The Expressive Function of Directors' Duties to Creditors", *op. cit.,* at p. 17.

[237] Trenwick Am. Litig. Trust v. Ernest & Young LLP, 906 A.2d 168 (Del. 2006).

[238] In *Production Resources* Vice Chancellor Strine argued that when a corporation is insolvent, creditors should be treated as if they were shareholders. See e.g., Lipson, Jonathan C. "The Expressive Function of Directors' Duties to Creditors", at p. 18.

[239] Dionne, Anna Manasco. "Living on the Edge: Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency", s*upra* note 192.

3.1.2. The importance of the *Gheewalla* decision and its implications:

One of the most important cases, regarding fiduciary duties, that changed the perception of those duties in the corporate law of the US was the *Gheewalla* case[240]. This famous case has influenced not only the Delaware law but also the corporate law of the other federal states of the US[241]. In fact, *Gheewalla* is the turning point in how Delaware sees the fiduciary duties of directors in the zone of insolvency and the important clarification of how the creditors' rights during the "zone" should be seen.

To begin with, the *Gheewalla* stated that there is no recognition that the zone of insolvency has implications to fiduciary duties claims; only the insolvency will implicate consequences on those claims. In fact, the court said that the zone of insolvency is extremely difficult to define, even more so than the insolvency itself. As a result, when a corporation is operating in the vicinity of insolvency, directors must continue to perform their fiduciary duties to the corporations and for the shareholders' benefit[242]. This leads us to the next question examined by the court: the ability of creditors to bring direct claims when the company is insolvent and when it is in the zone of insolvency.

The Delaware court, in *Gheewalla*, asserted that "direct claims (...) is a claim on which the stockholder can prevail without showing an injury or breach of duty to the corporation, and one in which no relief flows to the corporation"[243]. From the court's perspective, directors' negligence damages the creditors "only indirectly, by diminishing the value of the assets from which they may satisfy their claims"[244]. For this reason, creditors will not have the same motive to enforce fiduciary duties as the shareholders if permitted to assert direct claims. Consequently, in *Gheewalla*, the court reinforces the idea expressed in earlier cases that during the vicinity of insolvency, creditors do not have the right to assert direct claims for the breach of fiduciary duties. Additionally, the court also concluded that creditors can only assert derivative claims for fiduciary duties' breaches when the company is insolvent and not when the company is operating in the vicinity of insolvency or seriously distressed. The Court justified this position defending that since creditors are not considered "risk barriers" during the vicinity of insolvency, their ability to sue directly will only benefit themselves and not the company's interests as a whole, which is not the objective.

Nowadays, the *Gheewalla* theory continues to influence the Delaware decisions regarding

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[240] N. Am. Catholic Educ. Programming Found., Inc. v. Rob Gheewalla, 930 2. Ad, 92, 98 n.20 (Del. 2007).

[241] See e.g., Berg & Berg Enters., LLC v. Boyle, 178 Cal. App. 4th 1020, 1041 (Cal. Ct. App. 2009); Sol. Tr. V. v. 2100 Grand LLC (In re AWTR Liquidation Inc.), 548 B.R. 300, 324-26 (Bankr. C.D. Cal. 2016); Sanford v. Waugh & Co., 328 S.W.3d 836,846 (Tenn. 2010).

[242] Zanardo, Alessandra. "Fiduciary Duties of Directors of Insolvent Corporations: A Comparative Perspective", *supra* note 125.

[243] Lipson, Jonathan C. "The Expressive Function of Directors' Duties to Creditors", op. cit., p. 22 (quoting *Gheewalla* case at *12)

[244] Ibid., at p. 879.

fiduciary duties during the vicinity of insolvency. In fact, in *Quadrant Structured Products*[245], the court reaffirmed the decision of *Gheewalla* by saying that only upon insolvency could creditors enforce derivative claims against fiduciary duties' breaches[246]. Additionally, the court reasserted that during the vicinity of insolvency directors' fiduciary duties do not shift to creditors; and that directors must continue to act in the best interests of the company and its shareholders.

Nowadays there is a more unified court position regarding the shifting duties to creditors. In fact, the large majority of the US states had revised the *Gheewalla* decision and adopted in more recent decisions. As a result, we can argue that the *Gheewalla* case law contributed to the uniformization and clarification of the US federal corporate laws regarding the issue of the shifting duties to creditors during the vicinity of insolvency. Furthermore, the notion set out by *Gheewalla* is remarkably important for the dismissal of the controversy created by the *Credit Lyonnais* theory. However, we cannot leave the observation aside that the opinions regarding the zone of insolvency and the inherent question of the shifting duties to creditors in the "zone" will always diverge. For this reason, it is very difficult to eliminate the controversy that its lack of definition creates. In fact, the *Gheewalla* does not answer every problem of the "zone", which contributes to the uncertainty and unpredictability for corporate directors of companies that are operating in the vicinity of insolvency.

3.2. The UK perspective:

The zone of insolvency does not have a precise definition and is not legally defined in the law. This, like in the US, leaves room for uncertainty and controversy. Beyond that, according to the case-law, the vicinity of insolvency enters the scope of "financial distress", that also does not have a legal definition. This link between the two terms is problematic and generates an increment of the ambiguity of the "zone". However, before analysing the problem surrounding the zone of insolvency, it is important to note that unlike the United States, in the United Kingdom, there is a well-recognised shift of directors' fiduciary duties to creditors. In fact, the recognition of this duty is quite peaceful within the doctrine and the courts, and it therefore makes sense to explain its origin first and later explain the problems of the vicinity of insolvency.

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[245] Quadrant Structured Products Company, Ltd. v. Vertin, CA 6990-VCL (Del. Ch. 2015). Available at: https://www.courtlistener.com/opinion/2798267/quadrant-structured-products-company-ltd-v-vertin/ [Accessed on 11.02.2020].

[246] Keay, Andrew. "Directors Negotiating and Contracting in the Wake of their Companies' Financial Distress". *Journal of Strategic Contracting and Negotiation,* vol. 1, no. 3, 2015, at p. 6. Retrieved from: http://eprints.whiterose.ac.uk/90423/3/DIRECTORS%20NEGOTIATING%20AND%20CONTRACTING%20IN%20THE%20WAKE%20OF%20THEIR%20COMPANIES%20sub%20JSCN%20revised%202%20%281%29.pdf.

The duty shifting doctrine has its origins in the Australian High Court decision during the famous *Walker v. Wimborne* case[247] and after that was brought to the UK jurisdiction. In fact, in the UK, the first steps taken towards the recognition of the shifting duty to creditors appeared in 1980, in *Lonrho Ltd. V. Shell Petroleum Co. Ltd.*[248]. In this case, Lord Diplock argued that the best interest of the company extended to also include creditors. However, most of the doctrine[249] agrees that it was only with the *Liquidator of West Mercia Safetwear Ltd v Dodd*[250] that the English courts officially recognized the shifting duty to creditors when the company is financially distressed.

The Australian and the United Kingdom courts, as well as some economists and legal experts, link the necessity of a duty to creditors to the theory of the agency cost – that we have previously analysed – where the financial distress tends to increase. In fact, in his article RONALD J. DANIELS disclosed practical evidence that supports the notion that during financial distress shareholders will be tempted to pressure directors to make riskier decisions[251]; since they are protected by the limited liability principle, they will not lose from an unsuccessful investment made by the company[252]. As a result, the doctrine commonly agrees the duty as a mechanism to protect creditors' claims. For ANDREW KEAY, when the insolvency approaches, creditors must be protected from the exposure ''to risks that they do not agree to accept''[253]. For the author, the duty is also necessary to fill the gaps that the wrongful trading does not solve – as we are going to explain later in the next chapter[254]. Additionally, for the author, the shifting duty applied before the company became insolvent might also lead to the company turnaround to solvency.

A year later, in Companies Act 2006, the UK codified the shifting duty to creditors when the company is in the vicinity of insolvency. In fact, section 172(3) assumes the recognition of a duty to creditors; and this duty should be interpreted in the light of section 172(1)[255]. However, it should be pointed out that the shifting duties do not give creditors the ability to take legal proceedings against the directors who breached their fiduciary duties when the company was financially distressed. In fact, the

[247] McKenzie-Skene, Donna W. "Directors' Duty to Creditors of Financially Distressed Company: A Perspective from Across the Pond". *Journal of Business & Technology Law*, vol. 1, issue 2, art. 13, 2007, at p. 500 (citing Walker v. Wimborne (1979) 137 C.L.R. 1 (Austl.)).
[248] *Lonrho Ltd. V. Shell Petroleum Co. Ltd.* [1980] 1 W.L.R. 627 (H.L.(E.)) (Eng.)).
[249] See e.g., Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 9; McKenzie-Skene, Donna W. "Directors' Duty to Creditors of Financially Distressed Company: A Perspective from Across the Pond", at p. 501.
[250] (1988) 4 BCC 30.
[251] In contrary opinion: see e.g., Barondes, Royce de R. "Fiduciary Duties of Officers and Directors of Distressed Corporations". *Geo. Mason L. Rev.*, vol. 7, no. 45, 1998, at p. 101. Retrieved from: https://pdfs.semanticscholar.org/90af/b90e15d00da283cecb2ebe8331bdc94ad002.pdf.
[252] For a better understanding see e.g., Daniels, Ronald J. "Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance". *Canadian Business Law Journal*, vol. 24, 1994, at pp. 247 and following. Retrieved from: https://repository.upenn.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1016&context=law_series.
[253] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", *supra* at p. 7 (citing Wishart, David. "Models and Theories of Directors' Duties to Creditors". *New Zealand Universities Law Review*, vol. 14, no. 323, 1991, at p. 354).
[254] Ibid., p. 9.
[255] Ibid., at p. 10.

directors' fiduciary duties in the vicinity of insolvency are owed to the company, in this sense, only the company can sue directors for fiduciary duty's breach. Because of that, only shareholders – or even the appointed administrator or liquidator – are able to enforce derivative claims on the company's behalf and against directors[256].

As previously discussed, the vicinity of insolvency is usually linked to the term "financial distress" and this creates problems and uncertainty in the law. In fact, the financial distress is not legally defined, which means that similar to what happened with the US definition of the "zone", directors operating in the vicinity of insolvency do not know when the shifting duty to creditors will occur. In the UK case, this is even more problematic. As a matter of fact, the majority of the jurisdiction nowadays links the shifting duties to the insolvency defined by the solvency tests. However, the United Kingdom also connects the shifting duty with even more imprecise financial stage than insolvency – already difficult to define[257]. Some authors, therefore, defend that to protect themselves from personal liability, directors of distressed companies should act as if that shift had already occurred[258].

The United Kingdom has one of the most creditor-friendly regimes in the world and, for this reason, it seems obvious the assumption that the main focus of the insolvency law is to protect the creditors' credits. For that reason, the law and the case decisions are constructed with the goal of continuous maintenance of this protection. In fact, the shifting duty to the creditor will almost certainly occur in five situations. The first one involves the insolvency situation[259], while the second involves situations when the company is "nearing, approaching, on the borderline of, or on the verge of insolvency"[260]. The third situation has to do with companies that are considered to be doubtfully solvent[261]. In the fourth category, there are those situations when the company is subjected to a risk of insolvency or when directors acknowledged that creditors will be prejudiced by its actions in the short term. Lastly, there are cases where the courts did not make references either to insolvency or to solvency[262]. In this last situation the courts only mentioned a threatening financial stage that can put at the creditors' interests at risk[263].

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[256] Ibid., at p.7.
[257] Keay, Andrew. "Directors Negotiating and Contracting in the Wake of their Companies' Financial Distress", at p. 7.
[258] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 7.
[259] For more information about this: see e.g., Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 13; Keay, Andrew. "Directors Negotiating and Contracting in the Wake of their Companies' Financial Distress", at pp. 6-7.
[260] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 13, see the footnotes from 68 until 71 (the author refers to some cases where the court had used the words expressed above).
[261] Ibid., referring e.g., Nicholson v Permakraft (NZ) Ltd (1985) 3 A.C.L.C. 453 at 459; Brady v Brady (1988) 3 B.C.C. 535 at 552; Colin Gwyer v London Wharf (Limehouse) Ltd [2002] EWHC 2748 (Ch); [2003] B.C.C. 885 at [74].
[262] Keay, Andrew. "Directors Negotiating and Contracting in the Wake of their Companies' Financial Distress", at p. 7.
[263] Regarding these terms see e.g., Re MDA Investment Management Ltd [2003] EWHC 227 (Ch); Re Idessa (UK) Ltd (sub nom Burke v Morrison) [2011] EWHC 804 (Ch).

As we can observe, the case law lacks a precise definition regarding the exact moment where the shifting duties should occur. This lack of precise definition creates very uncertain boundaries for directors[264], who have to continuously be able to manage the conflict of interests between creditors and shareholders[265]. In fact, the problem of the zone of insolvency is much more intense in the UK than in the US, for all the reasons that we have previously analysed. Directors in the UK are subjected to higher risks of personal liability than the US directors, who are more protected since the *Gheewalla* case law. Beyond that, this lack of precise definition leads us to another relevant question: what are the interests of creditors, and how should directors act to protect those interests?

There is no consensus as to the answer to this question, with the doctrine being quite divided regarding this issue. On the one hand, we have those who defend that the creditors' interest must be seen as "paramount"[266], as is the case during the insolvency. In other words, some courts defend that creditors' interest should be prioritized over any other interest that the director may have to consider. The principal and most cited case that recognized this theory is *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd*[267]. In this case, the court did not differentiate "insolvency" from "vicinity of insolvency", for this reason, directors of companies operating in the vicinity of insolvency should give priority to the interests of creditors, as it happens in the insolvency itself[268].

On the other hand, we have those who support the view that in the vicinity of insolvency, directors should consider creditors' interests, but they are not obliged to give them priority above the interests of other members of the corporation, namely the shareholders[269]. This second position is very similar to the Delaware approach that we have already considered. In fact, when the company is operating in the vicinity of insolvency, directors' fiduciary duties extend to also include the interests of creditors; position expressed in the case *In Re MDA Investment Management Ltd*[270].

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[264] UNCITRAL Legislative Guide on Insolvency Law. "Directors' Obligations in the period approaching insolvency", at p. 14 ("Determining exactly when the obligations arise is a critical issue for directors seeking to make decisions in a timely manner consistent with those obligations. Moreover, without a clear reference point, it would be difficult for directors to predict with confidence the point in time in the period before insolvency (…)"). Retrieved from: https://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part4-ebook-E.pdf.
[265] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 15
[266] See ibid., at p. 18 regarding the definition of "paramount". The author defined the word quoting Pearsall, J. *New Oxford Dictionary of English*. Oxford, O.U.P., 2001, at p. 1346.
[267] [2002] EWHC 2748 (Ch); [2003] 2 B.C.L.C. 153 at [74].
[268] See e.g., Lowry, John. "The Recognition of Directors Owing Fiduciary Duties to Creditors – Re Pantone 485 Ltd and Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd", in the article preview of *Chase Cambria, Company Publishing Limited*, vol. 0, issue 1, 2004. Available at: http://www.chasecambria.com/site/journal/article.php?id=83 [Accessed on 12.02.2020]; Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 18; McKenzie-Skene, Donna W. "Directors' Duty to Creditors of Financially Distressed Company: A Perspective from Across the Pond". *Journal of Business & Technology Law*, vol. 1, issue 2, art. 13, 2007, at p. 510; Davies, Paul. "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency", at pp. 327 and follow.
[269] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 18.
[270] In Re MDA Investment Management Ltd [2004] 1 B.C.L.C. 217 at 245; [2004] B.P.I.R. 75 AT 102; in the same line of thinking see Lewison J in Ultraframe (UK) Ltd v Fielding [2005] EWHC 1638 (Ch) and Re Kudos Business Solutions Ltd [2011] EWHC 1436 (Ch).

Some scholars argue that the priority of creditors' interests is easier to be applied in practice because it involves less balancing of interests by directors[271]. However, we cannot leave the observation aside that the vicinity of insolvency is much more difficult to define that the insolvency in fact[272]. In fact, during insolvency, the corporation's assets belong to creditors, for this reason, it seems prudent for a shifting in fiduciary duties to occur, in order to ensure that creditors will be paid. However, when the corporation is in the vicinity of insolvency, it cannot be stated with certainty whether the payment of the creditors is compromised or not. Consequently, and as professor ANDREW KEAY suggested, the way directors will act on the brink of insolvency to protect the interests of creditors will depend on the "actual state of the company's finances"[273]. For this reason, courts in the UK use a case-to-case basis in the judgment of possible breaches in fiduciary duties during the vicinity of insolvency.

Although we can say that the duty shifting to creditors had led to a significant level of creditors protection, we cannot deny that the shifting duties recognition in such imprecise and undefined financial stage creates huge problems to directors that do not know with certainty how should they act to protect themselves against personal liability; and compromise the risk taking of the corporation and a possible turnaround.

3.3. The Portuguese perspective:

In Portugal, similarly to what happens in the two jurisdictions previously studied, there is no precise definition in the law, namely in the CIRE, for the vicinity of insolvency. Nevertheless, unlike the UK and the US, Portuguese courts have not yet suggested any definition or guidance regarding fiduciary duties during the brink of insolvency. This lack of definition creates uncertainty for legal practitioners that do not have confidence in how to interpret this ambiguous zone[274]. In 1964, already PEDRO DE SOUSA MACEDO alerted for the dangerous ambiguity that the lack of definition of the zone of insolvency creates[275].

Some authors[276], however, defend the already accepted notion that the vicinity of insolvency

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[271] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 20.

[272] About this issue see e.g., Keay, Andrew and Adamopoulou, Rodoula. "Shareholder Value and UK Companies: A Positivist Inquiry". *European Business Organization Law Review*, vol. 13, issue 1, 2012, pp. 1-29; Spindler, Gerald. "Trading in the Vicinity of Insolvency", at p. 348 ("triggering the duties of creditors subject to a loss of equity implies that we are able to assess exactly at what point in time shareholders have lost their equity (...) which in reality is difficult to do (...)").

[273] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 20.

[274] Epifânio, Maria do Rosário. *Manual de Direito da Insolvência*, at p. 31 (the author argues that the zone of insolvency in Portugal does not have any auxiliary criterion for the interpretation and reach of the concept).

[275] Macedo, Pedro de Sousa. *Manual de Direito das Falências*. Prefácio do Prof. Doutor A. Ferrer Correia. Volume I. Coimbra: Almedina. 1964, at pp. 230-231.

[276] See e.g., Fernandes, Luís Carvalho; Labareda, João. *Código da Insolvência e da Recuperação de Empresas Anotado. Sistema de Recuperação de empresas*

(*insolvência imimente*) exists when the financial situation of the company leads to the almost certain conclusion that, in the short term, the company will not be able to meet its obligations when they are due. Similar to the UK and US, one of the main problems about the lack of definition regarding the zone of insolvency in the Portuguese view is the impossibility to disclose with certainty the precise moment in time that the company entered in the "zone". In this sense, the assumption that the company is in the twilight zone is based on subjective criteria that will differ regarding the debtor and its business activity[277].

The Portuguese jurisdiction, contrary to the US and the UK, equates the situation of insolvency with the vicinity of insolvency according to article 3(4) of CIRE. In this sense, when there is an assumption that the company is operating in the vicinity of insolvency, the law gives to the debtor (and his directors) the possibility to file for insolvency and to open the insolvency proceedings[278]. However, the equivalence of insolvency and the vicinity of insolvency regarding the possibility to file for insolvency has divided opinions within the Doctrine. Some authors, as CARVALHO FERNANDES & JOÃO LABAREDA, argue that this possibility to file for insolvency is not a mere possibility and rather an obligation, equally to what happen with the insolvency itself. For these authors, article 3(4), does not establish any difference between the two financial periods[279], for that reason, directors of companies in the vicinity of insolvency have a formal obligation to file for insolvency, under penalty to be found guilty of culpable insolvency.

On the other hand, ALEXANDRE SOVERAL MARTINS argues that the obligation to file for insolvency during the vicinity of insolvency is not the best approach during this already uncertain period[280]. Although the approximation between the vicinity of insolvency and insolvency, established in article 3(4) may lead the reader to the conclusion that both terms are equal regarding the formal obligation to file for insolvency, this is not the objective of the article. Additionally, the author also argues that article 18(1) of CIRE mentions the definition of insolvency situation as described in article 3(1) and , therefore, it is this "insolvency situation" that is relevant and not the vicinity of insolvency addressed by article 3(4)[281].

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por Via Extrajudicial (SIREVE) Anotado. Legislação Complementar, at p. 87 ("the imminence of insolvency is characterized by the occurrence of circumstances that, having not yet led to default, will determine in the short term, due to the insufficiency of the liquid assets (...)"); Serra, Catarina. *Lições de Direito da Insolvência*, at p. 63 (the vicinity of insolvency is the situation where is expectable that the debtor, in short-term, will not be able to meet its obligations); Martins, Alexandre Soveral. *Um Curso de Direito da Insolvência*, at p. 56 (in the opinion of the author a company is in the vicinity of insolvency when its insolvency is more plausible than its ability to avoid that); Abreu, Jorge Manuel Coutinho de. *Curso de Direito Comercial (Introdução, Atos de comércio, Comerciantes, Empresas, Sinais distintivos),* volume I. 12° Edição. Coimbra: Almedina, 2019, at p. 135 (for the author the vicinity of insolvency is characterized by previous period in which there is the assumption that the debtor will not be able to meet its obligations in the time they become due).

[277] Martins, Alexandre Soveral. *Um Curso de Direito da Insolvência*, pp. 57-58.

[278] See e.g., AC do Tribunal da Relação de Lisboa, proc. 505/12.0TYLSB.L1-7, relator Pimentel Marcos, of 18.12.2012. Available at: http://www.dgsi.pt/jtrl.nsf/33182fc732316039802565fa00497eec/55878ea7baedad5e80257b1d005ede71?OpenDocument. [Accessed on 17.02.2020].

[279] Fernandes, Luís Carvalho; Labareda, João. *Código da Insolvência e da Recuperação de Empresas: Anotado,* p. 84.

[280] MARTINS, Alexandre Soveral. *Um Curso de Direito da Insolvência*, p. 58-59. This opinion is shared also for LEITÃO, Luís Manuel Teles Menezes. *Direito da Insolvência*, p. 144; Albuquerque, Pedro. "Declaração da situação de insolvência*" in O direito*, Ano 137, no 3, 2005, p. 513.

[281] Ibid., p. 59.

According with MANUEL REQUICHA FERREIRA the insolvency and the vicinity of insolvency are "profoundly different from each other"[282] and this difference justifies why only the debtor and its directors are able to file for insolvency when the company is operating in the vicinity of insolvency. According to the author, this exclusivity is understandable if we consider the fact that the debtor and its directors have a better knowledge of the actual situation of the company, which can lead them to the conviction that the company will recover, avoiding therefore, insolvency proceedings. When the court tries to define if a breach has occurred in the obligation to file for insolvency, it would experience some difficulty to accurately examine whether the company is in the vicinity of insolvency or not[283]. For this reason, and considering article 18(3), the debtor and its directors are not obliged to file for insolvency if they are in the vicinity of insolvency[284].

For MARIA DO ROSÁRIO EPIFÂNIO, the equivalence between two different concepts – the vicinity of insolvency and the insolvency itself – can be extremely dangerous because the zone of insolvency is very ambiguous and poorly regulated. In fact, the author believes that the debtor' ability to file for insolvency can quickly "transform itself into an escape route to insolvency" – with the objective of avoiding individual "executive actions"[285]. Despite the ambiguity and uncertainty of the law regarding the link between the zone of insolvency and insolvency itself, MARIA DO ROSÁRIO EPIFÂNIO admits that article 3(4) of CIRE is clear in one aspect[286]; by prohibiting other subjects to file for insolvency when the company is operating in the vicinity of insolvency, the legislator wanted to prevent pressure from creditors during that time, which could be detrimental for the business enterprise.

CATARINA SERRA has also written about the issues regarding the "zone". For this author, the link between the two concepts has the ultimate objective of preventing an unjustified declaration of insolvency by other subjects that not the debtor and its directors – the ones that will know with more safety what is the company's financial condition – and all the consequences that are inherent to it[287]. According to the law, only the debtor (and its directors) can file for insolvency. The prohibition of creditors and other subjects to file for insolvency when the company it is in the twilight zone makes sense; if we have in mind that filing for insolvency may cause the company to lose the credibility in the market, which

[282] Ferreira, Manuel Requicha. "Estado de Insolvência" *in Direito da Insolvência estudos*. 1ªEdição. Coimbra: Coimbra editora, 2011, p. 307.
[283] Ibid., p. 307.
[284] Ibid., p. 308.
[285] See footnote no. 55 of Epifânio, Maria do Rosário. *Manual de Direito da Insolvência*, *op. cit.,* at p. 31.
[286] Epifânio, Maria do Rosário. *Manual de Direito da Insolvência*, at p. 32; arguing the same see e.g., Abreu, Jorge Manuel Coutinho de. *Curso de Direito Comercial (Introdução, Atos de comércio, Comerciantes, Empresas, Sinais distintivos),* at p.136.
[287] Serra, Catarina. *Lições de Direito da Insolvência*, at p. 64.

can quickly "transform an ephemeral crisis in a situation of insolvency"[288].

Like in other jurisdictions, the concept of "vicinity of insolvency" and "financial distressed" are usually confused. The definition for being in a "financial distress situation" or "difficult economic situation" is given by article 17-B of CIRE[289]. In fact, a company that "faces serious difficulties to meet its obligations on time (...) namely due to lack of liquidity or unable to obtain credit" is considered to be in a situation of financial distress[290]. There are two terms in the article that need to be explained: "difficulties" and "serious". JOSÉ MANUEL MACHADO clarifies both these concepts. The first one, according to the author, seems to describe a situation where there's a partial insufficiency of the corporation's economic resources, meaning that the latter are limited to fulfil all the corporation's obligations. From that perspective, difficulty "does not translates in the absolute incapability to compliance"[291]. The second term can be explained as "difficulty that is less serious than the absolute inability to fulfil all obligations, but is, however, more serious than the inability to pay only some debts"[292]. From this perspective, for JOSÉ MANUEL MACHADO, the legislator did not want to exclude the criterion of financially distressed from other situations, which may lead to the deterioration of the company's financial situation[293].

However, we cannot dismiss the similarity between the definitions of the vicinity of insolvency and the condition expressed in article 17-B. Therefore, as LUÍS MENEZES LEITÃO argued, it is "difficult to do a precise delimitation between the two concepts"[294] since both of them might fall under the notion of pre-insolvency regimes – both terms are criteria for the application to PER or to RERE. Additionally, JOSÉ MANUEL MACHADO has also made some observations about the definitions of "zone of insolvency" and "the situation of financial distress". In the attempt to clarify both concepts, the author suggests that we look at the situations of financial distress; the zone of insolvency; and actual insolvency "on an increasing scale of economic and financial deterioration"[295], where the zone of insolvency should be interpreted as

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[288] Abreu, Jorge Manuel Coutinho de. *Curso de Direito Comercial (Introdução, Atos de comércio, Comerciantes, Empresas, Sinais distintivos),* at p.136; in the same line of thinking: Serra, Catarina. *Lições de Direito da Insolvência*, , at p. 64. With another view see Machado, José Manuel Gonçalves. *O Dever de Renegociar no âmbito Pré-Insolvencial. Estudo comparativo sobre os principais mecanismos de recuperação de empresas.* Coimbra: Almedina, 2017, at p. 129 (the author defends that the link between insolvency and the vicinity of insolvency, regarding the obligation to file for insolvency, is useful because it permits companies that are operating in the "zone" to file for insolvency and escape from the presumption of serious liability).

[289] See also the definition of the: AC do Tribunal da Relação de Lisboa proc. 7214/08.3TMSNT.L1-8, relator Carla Mendes, of 25.06.2009. Available at: http://www.dgsi.pt/jtrl.nsf/0/17b51aef2ae8355a802575ee0053d59f?OpenDocument. [Accessed on: 19.02.2020]

[290] Article 17-B of CIRE. Available in: https://dre.pt/web/guest/legislacao-consolidada/-/lc/118376176/202002191837/73661603/diploma/indice [Accessed on 19.02.2020].

[291] Machado, José Manuel Gonçalves. *O Dever de Renegociar no âmbito Pré-Insolvencial. Estudo comparativo sobre os principais mecanismos de recuperação de empresas*, *op. cit.*, at p. 126.

[292] Ibid.

[293] Ibid.

[294] Leitão, Luís Manuel Teles Menezes. *A Recuperação Económica dos Devedores: RERE, PER, PEAP, plano de insolvência, plano de pagamentos e exoneração do passivo restante.* Coimbra: Almedina, 2019; see also the opinion of Serra, Catarina. *Lições de Direito da Insolvência*, at p. 310 (the lack of definition of the vicinity of insolvency challenges its distinction from the notion of the financial distress situation).

[295] Machado, José Manuel Gonçalves. *O Dever de Renegociar no âmbito Pré-Insolvencial. Estudo comparativo sobre os principais mecanismos de recuperação de empresas, op. cit.,* 130.

the "period between the situation of financial distress and the actual insolvency"[296].

Up until the moment of writing, the question of the shifting duties to creditors does not appear to be controversial or problematic in Portugal, unlike in the other two jurisdictions already analysed. In fact, although the doctrine recognises the limitations and problems surrounding the definition of the vicinity of insolvency and the confusion between financially distress situations and the "zone", the fiduciary duties of directors to creditors are not seen as a hot topic. In her book, MADALENA PERESTRELO DE OLIVEIRA addressed the question of fiduciary duties based on the different financial stages where a company may find itself[297]. For this author, the company's insolvency does not bring about any shift of fiduciary duties to creditors. As MADALENA PERESTRELO DE OLIVEIRA defended, when a corporation becomes insolvent "the already existing fiduciary duties remain the same, even if the needs of them change"[298]. In other words, the fiduciary duties of directors during solvency, which we have previously discussed, are the same as those existing when the corporation is approaching insolvency. For this reason, no shift occurs in relation to the directors' fiduciary duties priorities because the fiduciary duties of directors in insolvency times "remain, clearly functionalized under the tutelage of shareholders and creditors; and do not change in light of the previous situation"[299].

Taking all this information into account does not seem to make the situation any easier for directors. As JOSÉ MANUEL MACHADO defended in situations of financial distress; in cases the vicinity of insolvency, or even during insolvency itself, directors "must be especially cautious with the vicissitudes which the company might suffer in its day-to-day basis that can compromise its long-term's business activity"[300]. In fact, directors that fail to comply with their fiduciary duties to the corporation can be subjected to personal liability, which can, in some situations, have criminal consequences – as we are going to explore in the final chapter of this dissertation.

3.3.1. The new Directive (EU) 2019/1023:

Portugal, unlike UK and US, is part of the EU, and because of that the Portuguese law is also influenced by the legislative acts of the EU. In 26 June of 2019 a new directive (EU) 2019/1023 was

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[296] Ibid.

[297] See Oliveira, Madalena Perestrelo. *Limites da Autonomia dos Credores na recuperação da Empresa Insolvente*, at p. 58.

[298] Oliveira, Madalena Perestrelo. *Limites da Autonomia dos Credores na recuperação da Empresa Insolvente*, at p. 74. The conclusions of Madalena Perestrelo de Oliveira go in the same line than the conclusions of the authors: Campbell, Rutheford B. and Frost, Christopher W., in their article: "Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)", supra note 38.

[299] Machado, José Manuel Gonçalves. *O Dever de Renegociar no âmbito Pré-Insolvencial. Estudo comparativo sobre os principais mecanismos de recuperação de empresas, op. cit.*., at p. 73.

[300] Ibid., *op.cit.,* at p. 321.

approved by the European Parliament and the Council on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, which amends the Directive (EU) 2017/1132 (on restructuring and insolvency). According to article 35, the Directive comes into effect on the twentieth day following its publication in the Official Journal of the European Union; and the Member States have until 17th July 2021 to transpose its provisions and objectives.

When it comes to the objective of this dissertation, in this study we will, above all, stress the applicability of those norms and articles that influence the fiduciary duties of directors and the management of companies on the verge of insolvency. One of those articles, article 19 of the Directive 2019/1023, clearly states that "Member States shall ensure that, where there is a likelihood of insolvency, directors, have due regard, as a minimum, to the following: (a) the interests of creditors, equity holders and other stakeholders; (b) the need to take steps to avoid insolvency; and (c) the need to avoid deliberate or grossly negligent conduct that threatens the viability of the business"[301]. It is important, however, to understand what "interests of creditors" imply and how directors view them when the company is in the zone of insolvency.

The (71) of the Directive says that in those situations in which the debtor is near insolvency "it is also important to protect the legitimate interests of creditors from management decisions that may have an impact on the constitution of the debtor's estate, particularly when those decisions could have the effect of further diminishing the value of the estate available for restructuring efforts or for distribution to creditors"[302]. This can be interpreted in the sense that directors of corporations operating in the vicinity of insolvency, similarly to what happens in the UK, shall see creditors' interests as paramount[303]. COUTINHO DE ABREU justifies this shift of priority, arguing that during the vicinity of insolvency "the greatest risk lies with creditors"[304]. Furthermore, for the author, if directors continue to act to satisfy the interests of shareholders when the company is facing serious financial difficulties, the payment of credits to the company's creditors may be compromise.

Article 19(b) also establishes a new duty for directors: the duty to prevent insolvency. Some authors question whether directors will have a new general duty to prevent insolvency[305]. The answer to

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[301] Directive (EU) 2019/1023, article 19. Retrieved from: https://eur-lex.europa.eu/eli/dir/2019/1023/oj.

[302] Directive (EU) 2019/1023, in (70).

[303] Although the (71) did not clearly state that the interests of creditors must have priority over the shareholders' interests, the text lives the decision for the Member States, "which must have a symbolic value". In this sense, see e.g., Abreu, Jorge Manuel Coutinho de. "Administradores e (novo?) dever geral de prevenção da insolvência" *in V Congresso de Direito da Insolvência/ coord. Catarina Serra.* Coimbra: Almedina, November 2019, *op.cit.,* p. 232.

[304] ABREU, Jorge Manuel Coutinho de. "Administradores e (novo?) dever geral de prevenção da insolvência, *op.cit.,* p. 231.

[305] See e.g., ABREU, Jorge Manuel Coutinho de. "Administradores e (novo?) dever geral de prevenção da insolvência" *in V Congresso de Direito da Insolvência/*

this is not a simple "yes or no". Indeed, according to COUTINHO DE ABREU, directors have general duties of loyalty and care, as well as specific duties inherent to the first ones. Although the duty to prevent insolvency is closer to the general duties (loyalty and care), it is not a permanent duty like the general duties of loyalty and care. Indeed, the duty to prevent insolvency is imposed on directors only when there is a probability of insolvency; a strong enough probability to affirm that the insolvency will happen. Therefore, and in the author's opinion, the duty to prevent insolvency presented in article 19(b) is a particular duty[306]. The (70) of the Directive provides guideline for directors to prevent the insolvency situation[307], but leaves the objective norms and guidelines to be imposed on directors up to the member states[308]. It is important to also point out that the prime objective of the Directive is to harmonize the national insolvency law of the Member States. However, the shifting of duties occurs in a very small number of jurisdictions across the EU. We can therefore raise the question of whether the shifting duty theory is applicable to every jurisdiction in the EU, and whether it is the best approach when dealing with the vicinity of insolvency. In this thesis, we do not offer an answer to the first question. Regarding the second question, we believe that the approximation of the UK approach regarding the fiduciary duty of directors in the "zone" may cause problems that until now have not been an issue in the Portuguese jurisdiction.

Article 3 of the Directive, also relevant for this dissertation, clearly states that "Member States shall ensure that debtors have access to one or more clear and transparent early warning tools which can detect circumstances that could give rise to a likelihood of insolvency and can signal to them the need to act without delay"[309]. However, it is worth mentioning that in the requirement of the early warning norm expressed in the article 3 of the Directive, Portugal took early steps. In fact, the DL no. 47/2019, of April 11[310], introduced in the Portuguese legal Framework the Early Warning Mechanism (MAP). The MAP refers to a procedure of disclosure of economic and financial information, on an annual basis, to the members of the management bodies of micro, small and medium-sized non-financial corporations and

coord. Catarina Serra. Coimbra: Almedina, November 2019, p. 229.

[306] Ibid., p. 230.

[307] Directive 2019/1023, (70): "(…) Where the company experiences financial difficulties, directors should take steps to minimise losses and to avoid insolvency, such as: seeking professional advice, including during restructuring and insolvency, for instance by making use of early warning tools where applicable; protecting the assets of the company so as to maximise value and avoid loss of key assets; considering the structure and functions of the business to examine viability and reduce expenditure; refraining from committing the company to the types of transaction that might be subject to avoidance unless there is an appropriate business justification; continuing to trade in circumstances where it is appropriate to do so in order to maximise going-concern value; holding negotiations with creditors and entering preventive restructuring procedures".

[308] Important to note also the first part of the text (70) of the Directive in which is clearly said that "to further promote preventive restructuring, it is important to ensure that directors are not dissuaded from exercising reasonable business judgment or taking reasonable commercial risks, particularly where to do so would improve the chances of a restructuring of potentially viable businesses". As a result, Member States have freedom to take the best approach to secure the objective of this directive; "second life" for viable companies.

[309] Directive (EU) 2019/1023, article 3. Retrieved from: https://eur-lex.europa.eu/eli/dir/2019/1023/oj.

[310] Available at: https://dre.pt/pesquisa/-/search/122074191/details/maximized.

limited liability companies (LLC) corporations incorporated in Portugal[311]. For CATARINA SERRA the value of MAP has to do with its automatic character[312]. Indeed, the MAP operates regardless of the will of the entrepreneur or the company's directors. This new mechanism increases the level of control over the financial situation of the company and alerts directors for situations which can lead to an insolvency[313]. As a result, the activity and decisions of directors are subject to higher control. Thus, if directors do not comply with their fiduciary duties and do not respect the examination of the MAP, they may see their personal liabilities trigger because it will be very difficult for a director to justify their inaction after being alerted regarding to the company's financial situation.

4. Comparative analysis:

The vicinity of insolvency is a very problematic period and the question of the shifting duties, especially in regard to the US and the UK, is consistently debated by the Doctrine. The US strategy gives directors more freedom to act and to decide what is the best course of action for the company.

Under Delaware law, directors do not have any obligation to file for insolvency or to stop trading when the company is in the vicinity of insolvency and even in the insolvency period. Indeed, the US law permits that directors continue to manage the business activity and to do whatever they consider necessary to create firm value or to the possible company turnaround. Additionally, since the *Gheewalla* case law, directors do not own any specific duty to creditors during the vicinity of insolvency. This means that director should continue to manage the company with the ultimate goal to benefit the company' shareholders. The US strategy gives to directors more flexibility "to pursue the course of action most likely to maximize firm value"[314], without being afraid of civil or criminal consequences for those actions. Directors are seen as loyal people who will act in the best interests of the corporations with the objective to increase the value of the company and are protected by the BJR. In fact, the BJR plays a central role

[311] For more information about MAP see e.g., PLMJ. Mecanismo de Alerta Precoce (MAP). Nota informative, April 2019. Retrieved from: https://www.plmj.com/xms/files/v1_antigos_anteriores_a_abr2019/newsletters/2019/abril/NL_O_mecanismo_de_alerta_precoce_-MAP-.pdf.

[312] Serra, Catarina. "Em Torno da Diretiva 2019/1023 sobre Reestruturação e Insolvência de 20.06.2019" in *Sessão de estudo sobre direito da insolvência,* p. 3.

[313] Paragraph 7 of the DL no. 47/2019 explains the objective of MAP, "The implementation of the measure will make available to the companies economic and financial indicators compiled from the Central Balance Sheet of Banco de Portugal and analysed by IAPMEI, I.P., based on the data contained in the Simplified Business Information (IES), in conjunction with the National Institute of Statistics (as the Statistical Authority responsible for Structural Business Statistics transmitted to the European Commission (Eurostat), relating to the financial health of each company, as well as a brief express mention of possible mechanisms available and a reference to IAPMEI, I.P., in case This information will appear on the IAPMEI, I.P.'s website, and will be disseminated through the Finance Portal"; and the article 4 of the DL explains how the process will happen. Available at: https://dre.pt/pesquisa/-/search/122074191/details/maximized.

[314] Wood, Justin. "Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan", *op. cit.,* at p. 166.

in the corporate law of the United States because it permits directors to escape from "bad" business decisions if those decisions were taken in an informed way and in good faith. Directors who are not afraid to see their personal liabilities triggered unfairly will be more efficient in the balance of the conflict of interests; and will have more autonomy to take riskier business decisions with the objective to increase the firm's wealth. On the other hand, some argue that this excessive freedom can lead to overinvestment, which in case of failure, may compromise the payment of creditors.

The UK approach is similar to the US regarding the lack if obligation to file for insolvency. However, it is completely different when it comes to the brink of insolvency. In that case, we can argue that in the UK the shifting duties to creditors during such an uncertain period create significant problems not only for directors but to the business activity itself. In fact, as GERALD SPINDLER argued, although the shifting of duties to creditors in an earlier period (before insolvency) creates a more efficient mechanism for the creditors' protection, the difficulty of determining the exact time when the company entered in the vicinity of insolvency amplifies the already existing uncertainty[315]. Although it can be argued that the shifting duties to creditors make it easier to balance the conflict of interests (giving priority to interests of creditors), since acts *ex-ante*, the difficulty to define precisely what are the boundaries of the zone of insolvency makes directors reluctant and fearsome in the decision-making process. Because of that and with the added creditors' pressures, directors will adopt the least risky decisions, which will not benefit or increase the firm's value, only the creditor's.

To date, unlike the UK and the US, when the company is insolvent in Portugal, its directors have the formal obligation to file for insolvency and to stop trading. However, if this obligation was applied during the zone of insolvency, the freedom of directors to continue to transact and a possible turnaround of the company would be compromised. Because of that, most of the Doctrine defends that article 3(4) of CIRE does not impose an obligation to file for insolvency and rather the possibility to do so; despite that option existing, it should be avoided if possible. Different from the other two jurisdictions, the Portuguese law gives directors much more clarity and certainty regarding what their duties are and to whom they are owned in the different financial stages in which a company may find itself. As we saw earlier, the question of the shifting duties is not a problematic question for the Portuguese doctrine, while it is to the US and the UK ones. Indeed, the duties that directors owe to creditors are the same in the different financial stages of the corporation; and only after the opening of an insolvency proceeding, are

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[315] Spindler, Gerald. "Trading in the Vicinity of Insolvency", at p. 344 ("(...) even if the theory of *ex-post* rules like the liability of directors may serve the same purpose of deterring engagements in overly risky projects, there are cases when shareholders and directors had been overly optimistic from the very beginning of their corporation").

the creditors' interests prioritised. Thanks to this differentiation in Portugal, it is much easier for directors to balance the conflict of interests and to know what they must do to comply with their fiduciary duties and to avoid personal liabilities. However, the new Directive (EU) 2019/1023 may change this situation. In fact, article 19 of the Directive introduced some novelties to the Portuguese law, and more precisely the duty to prevent insolvency and the inherent possible shift of whom the fiduciary duties are owned to. This new Directive may change drastically the way Portugal sees the "zone", and will possibly give rise to much more debate within the doctrine about the topic.

CHAPTER III – POSSIBLE LIABILITIES FOR DIRECTORS OPERATING IN THE ZONE

1. What are the liabilities which directors may face in the zone of insolvency[316]?

The modern economic theory, interprets the company as a separate legal entity from any of its members, thus limiting the personal liability of those who run, manage or control the company. Additionally, directors are seen as agents of the company, which means that they have to act in the best interests of the corporation and its shareholders. This is the position defended by the United States, while in the UK and Portugal directors are more expected to act in the best interests of the corporation and its stakeholders as a whole. Therefore, a failure on the part of a director to accomplish the company´s goals or any legal requirement to which the company is bound will be treated as a failure on the part of the company[317] and will not lead to personal consequences.

However, this shield of protection will only be possible if directors comply with their fiduciary duties. Therefore, directors must be aware that certain situations are susceptible to triggering their personal liability. In fact, directors who fail to comply with their fiduciary duties and intentionally harm the company or any stakeholder can face both civil and criminal consequences, depending on the jurisdiction in question. These measures of triggering liability have as a goal to discourage any type of disloyal or negligent actions on the part of the directors. For this reason, to protect themselves, directors must always be conscious of what are their fiduciary duties and act with good faith and proper diligence to avoid the legal consequences of a misconduct.

The question of the necessity to have personal liabilities for directors during the vicinity of insolvency is debatable. PHILIP R. WOOD, in the report of INSOL INTERNATIONAL GROUP THIRTY-SIX, listed the pros and cons of the personal liability of directors. Indeed, the advantages of imposing directors' personal liability can be divided in three. The first has to do with the "early stoppage before it is too late" with the objective to protect creditors from "greater losses"[318]. The second one is in regard to the imposition of a higher control of the business' management by "the imposition of a tough sanction"[319].

[316] It is important to disclose that, for the purpose of this study, we will only analyse those circumstances which relate directly with the vicinity of insolvency and directors.
[317] Davies, John (Head of Business Law, ACCA). *A guide to directors' responsibilities under the Companies Act 2006.* The Association of Chartered Certified Accountants, 2007, p. 82.
[318] Wood, Philip R. "Overview" *in Directors in the Twilight Zone V*, p. ix.
[319] Ibid.

And the final advantage, according to the report, has to do with the pressure that a possible liability places on directors, encouraging them to obtain specialised advice when the financial situation of the company is deteriorating[320]. On the other hand, the report also lists the drawbacks of imposing personal liability on directors. According to the report, the disadvantages – relevant to this study – include: (1) a possible premature closure of a viable company; (2) "the liability erodes the veil of incorporation and weakens enterprise incentives (...)"[321]; (3) the risk of liability adds more uncertainty and ambiguity to the "zone"; (4) "liability may increase the risk of unexpected liabilities for banks and others who are deemed to be *de facto* directors due to their involvement in the company, particularly at the time of insolvency"[322].

As we already analysed the zone of insolvency is a particularly dangerous financial stage for directors. This reality is more conspicuous in the UK's approach to the "zone". Indeed, the lack of definition of the zone and the difficulty for directors, to know with certain where the shift duty to creditor will occur can aggravated the hazardousness piercing the corporate veil[323].

1.1. Under the US' approach:

Before we analyse the potential liabilities for directors during the vicinity of insolvency, we should first recognise the array of jurisdictions, in the US, "whose law may apply to address the various issues"[324]. For the propose of this study, we will focus our analysis on the Delaware law. Indeed, Delaware stands out among the other federal states when it comes to corporate law, since most of the companies incorporated in the US are in Delaware, as we previously analysed.

The directors' personal liability is a characteristic of the BJR that has as its main objective the protection and promotion of the "full and free exercise of the directors' managerial scope insulating their business decisions from judicial review and shielding directors from liability from those decisions, even if they subsequently turn out to be a mistake and lead to insolvency"[325]. As a result, if directors comply with their fiduciary duties, act in a loyal way and with the objective to benefit the company and its shareholders, they will be protected from liability, under the BJR. The BJR is especially influential in the US's courts, especially in the Delaware courts. Therefore, it is not odd that the United States, regarding the risk of

[320] Ibid.
[321] Ibid., p. x.
[322] Ibid., p. x.
[323] Term used to define those occasions where the limited liability of directors, shareholders or officers will be triggered. To a better understanding about limited liability and the "piercing the corporate veil" doctrine see: Bainbridge, Stephen M., and Henderson, M. Todd. *Limited Liability: A Legal and Economic Analysis*. Cheltenham: Edward Elgar Pub, 2016.
[324] Marcus, Benjamin E & Piampiano, Jeffery T. "United States of America" *in Directors in the Twilight Zone V*, edited by INSOL International Group Thirty-six, 2017, p. 1. Retrieved from: https://www.insol.org/_files/Publications/TwilightV/Twilight%20V%209%20May%20BM%20linked%202017.pdf.
[325] Wood, Philip R. "Overview", *in Directors in the Twilight Zone V*, *op.cit.,* p. x.

liability, occupies the "Low Risk" group, according to the international survey conducted by INSOL INTERNATIONAL GROUP THIRTY-SIX[326]. Additionally, the courts' decisions in Delaware are particularly relevant and often protect directors from liability if they can prove the trustworthiness of their character. This does not mean that litigations against directors do not happen, quite the contrary. In fact, actions against directors are particularly common in Delaware and tend to be usually settled. Indeed, according to the report of the DOING BUSINESS United States 2020, with the indicator "Resolving Insolvency", which analyses the time, cost, outcome and recovery rate for a commercial insolvency and the strength of the legal framework for insolvency, the United States (Los Angeles) occupied the second position in the ranking of easiness to do business[327].

Unlike the UK and other European jurisdictions, Delaware law does not recognise any personal liability for directors that make decisions that led to aggravating of the insolvent situation of the company. Indeed, in *Trenwick*[328] the Chancery Court of Delaware rejected any creditors' claims against directors for breach of fiduciary duties generated by bad decisions that had aggravated the financial situation of the company. This position of the court was reinforced in the *Gheewalla*[329] decision, which highlights even further Delaware's tendency to incentivize directors to carry on with their "profit-maximization" objectives without fearing the creditors' claims. Moreover, *Quadrant Structured Products Company*[330] has recently summarized the state of directors' liability law. Regarding the "deepening insolvency" the court said that "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"[331]. Indeed, according with ANNA MANASCO DIONNE in "the vicinity of insolvency, directors owe no special duties to creditors. As a result, creditors do not have any explicit rights to lay claims for injuries resulting from fiduciary breach"[332].

Directors of Delaware, in most cases, will have civil liability, the criminal liability being very uncommon and more frequent in cases of fraudulent acting under tax laws and federal laws. Indeed,

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[326] Ibid., p. xi. See also the Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del.1989).

[327] To understand better this ranking, see "Doing Business in United States 2020" report of World Bank Group at p. 106 and following. The analysis of 190 economies is based on the eleven indicators, corresponding to the year of 2019. The report is available at: https://www.doingbusiness.org/content/dam/doingBusiness/country/u/united-states/USA.pdf. Comparing with Portugal and the UK, the US occupies a must more satisfactory position. In fact, for same indicator "Resolving Insolvency", the UK occupies the fourteenth position of the ranking, see "Doing Business UK 2020" at p. 59, available at: https://www.doingbusiness.org/content/dam/doingBusiness/country/u/united-kingdom/GBR.pdf; and Portugal the fifteenth position of the ranking, see "Doing Business Portugal 2020" at p. 58, available at: https://www.doingbusiness.org/content/dam/doingBusiness/country/p/portugal/PRT.pdf.

[328] *Trust v. Ernest & Young, L.L.P.,* 906 A.2d 168 (Del. Ch. Aug. 10, 2006) aff'd, 2007 WL 2317768 (Del. Aug. 14, 2007).

[329] *NACEPF v. Gheewalla,* 2006 WL 2599971 (Del. Ch. Sept. 2006) aff'd, 2007 WL 1453705 (Del. May 15, 2007).

[330] *Quadrant Structured Products Company, Ltd. v. Vertin*, CA 6990-VCL (Del. Ch. 2015).

[331] Marcus, Benjamin E & Piampiano, Jeffery T. "United States of America" *in Directors in the Twilight Zone V*, p. 7.

[332] DIONNE, Anna Manasco. "Living on the Edge: Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency", p. 6.

under Uniform Fraudulent Transfer Act (UFTA) and Uniform Voidable Transactions Act (UVTA), which govern those situations "under which the transfer of property or the incurrence of an obligation by an insolvent entity may be avoid by creditors of the entity"[333]. Generally, under UFTA and UVTA, directors are under risk of liability only if they are receivers of the insolvent company's property. However, directors that vote or permit an undertake of a fraudulent transfer breach their fiduciary duties to creditors, and for that reason, may be held liable. Other situations where directors may have their civil liability trigger, are related to the unlawful dividends and redemptions. Indeed, directors of Delaware are "severally liable to the corporation and its creditors for the full amount paid out in dividends or on account of the redemption"[334], if they act wilfully or for a negligence breach of Delaware's provisions which rule the redemption of stock or the issuance of dividends[335]. A dividend made by a company operating in the vicinity of insolvency or already insolvent is suspicious and, for that reason, directors who vote for a dividend may trigger their personal liability in the amount of the dividend taken.

Under Delaware law and court case[336], directors may also be liable for misappropriation of corporate opportunities. According to ERIC TALLEY & MIRA HASHMALL, the corporate opportunities theory is a common law creation that has the prime objective to limit "corporate fiduciary's ability to pursue new business prospects individually without first offering them to the corporation"[337]. In other words, the theory prohibits fiduciaries to provide themselves with a "new opportunity that belongs to the corporation, unless they first present it to the corporation and receive authorization to pursue it personally"[338]. The corporate opportunities theory shall be seen in the light of the duty of loyalty. This connection makes sense if we take into consideration the fact that the fiduciary duty of loyalty prohibits directors from profiting improperly with conflict of interests and requires them to take decisions that they believe in good faith that will benefit the corporation. Indeed, as we had the opportunity to explain earlier, the fiduciary duty of loyalty is the most important duty of any fiduciary relationship and especially relevant in the corporate context, as well as the subject of the majority of litigations[339]. In this sense, liability under the misappropriation of corporate opportunities leads to a breach of the fiduciary duty of loyalty and for

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[333] Ibid., p.8.
[334] Ibid., p. 9.
[335] Ibid., p. 9.
[336] See some relevant case regarding the misappropriation of a business opportunity: *Broz v. Cellular Info. Sys.,* 673 A.2d 148 (Del. 1996); *Thorpe v. CERBCO, Inc.,* 676 A.2d 436 (Del. 1996); *Benerofe v. Cha,* 1998 Del. Ch. LEXIS 28; In re Digex, Inc. Shareholders Litig., 2000 Del. Ch. LEXIS 171 (2000); *International Equity Capital Growth Fund v. Glegg,* 1997 WL 208955 (Del. Ch.); *Kohls v. Duthie*, 2000 Del. Ch. LEXIS 103; *Odyssey Partners, L.P. v. Fleming Co., Inc.*, 735 A.2d 386 (Del. Ch. 1999), 1999 Del Ch. LEXIS 88
[337] Talley, Eric & Hashmall, Mira. "The Corporate Opportunity Doctrine" prepared for the 2001 U.S.C. Institute for Corporate Counsel, February 2001, p. 1. Retrieved from: https://weblaw.usc.edu/why/academics/cle/icc/assets/docs/articles/iccfinal.pdf.
[338] Rauterberg, Gabriel & Talley, Eric. "Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers", Forthcoming, Columbia Law review, January 2017, p. 10. Retrieved from: http://www.law.nyu.edu/sites/default/files/Paper%20Talley.pdf.
[339] Ibid., p. 8.

that there is no protection from the BJR. Directors are considered to wrongly take advantage of a business opportunity when: (1) the company is able to financially assume that opportunity; (2) the opportunity is in the same line of business as the company's; (3) the corporation has an interest or a reasonable expectation from it; (4) in the case that, by personally pursuing the opportunity, the director will be placed in a position which may create conflicts of interests[340].

However, it is important to understand that if the prospect is not a corporate opportunity, a director does no breach any duty by taking that opportunity for himself/herself even without informing the corporation[341]. Additionally, if the prospect is, in fact, a corporate opportunity and the company "has properly rejected that opportunity – paradigmatically, by the majority vote of disinterested directors – then the fiduciary again does no harm by pursuing it (...)"[342]. Corporations operating in the vicinity of insolvency or financial distress are not in the position to take new business opportunities. However, this cannot "prevent a representative of the failed company's creditors from seeking damages from an officer or a director that misappropriates a corporate opportunity"[343].

The remedies for misappropriation of a business opportunity "can be either legal or equitable"[344]. However, the last option seems to be the general inclination. The monetary remedy for a misappropriation of a business opportunity is based on the gains that a director had with that opportunity rather than the harm cause to the company[345]. As ERIC TALLEY & MIRA HASHMALL explained "the presumptive remedy for such a breach is the imposition of a constructive trust on the disputed enterprise, effectively disgorging all of the fiduciary's verifiable profits (...)"[346]. Furthermore, beyond the misappropriation of a business opportunity may also impose punitive damages if that appropriation was particularly oppressive or in bad faith, which tend to be even greater for appropriation following nondisclosure to the company[347].

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340 Ibid., pp. 10-11; see also *Equity Corp. v. Milton*, 221 A.2d 494 (Del. 1966).

341 Ibid., 11; see also Talley, Eric & Hashmall, Mira. "The Corporate Opportunity Doctrine", pp. 9-10.

342 Ibid., 11.

343 Marcus, Benjamin E & Piampiano, Jeffery T. "United States of America" *in Directors in the Twilight Zone V*, p. 14.

344 Talley, Eric & Hashmall, Mira. "The Corporate Opportunity Doctrine", p. 11.

345 See Talley, Eric & Hashmall, Mira. "The Corporate Opportunity Doctrine", p. 11 (footnote 43: "Milbank, Tweed, Hadley & McCloy v. Boon, 13 F.3d 537, 543 (2d Cir. 1994) ("[B]reaches of a fiduciary relationship in any context comprise a special breed of cases that often loosen normally stringent requirements of causation and damages."); see, e.g., Thorpe v. CERBCO, Inc., 676 A.2d 436, 445 (Del. 1996) ("Once disloyalty has been established, [Delaware law] require[s] that a fiduciary not profit personally from his conduct, and that the beneficiary not be harmed by such conduct."); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.").

346 Ibid., p. 11.

347 Ibid. p. 12. See also e.g., Thorpe v. CERBCO, Inc., 676 A.2d 436 (Del. 1996).

1.2. Under the UK's approach:

The UK, unlike the US, belongs to the "medium risk" group regarding the risk of liability of directors during the vicinity of insolvency and actual insolvency. Before the IA of 1986, the only liability faced by directors, regarding the company's debts, was the fraudulent trading. The wrongful trading is a statutory and civil offence regulated by section 214 and Section 246ZB of the IA 1986 and was introduced into the British insolvency law by the reform in 1986[348], and should not be confused with the fraudulent trading. According to section 214 of the Insolvency Act 1986, the wrongful trading exposes to personal liability directors and also shadow directors[349] of a corporation who, from the moment that they had knowledge or should have had that the company had no reasonable prospects of avoiding insolvency liquidation, fail to take action to minimize the losses to creditors[350]. As KRISTIN VAN ZWIETEN argued "the wrongful trading rule is compensatory in nature, and more specifically is concerned with compensation for loss caused to the company by the director's failure to take every relevant step"[351]. For this reason, if it appears to the court that a director – after the opening of the insolvency proceedings – failed to comply with his duty to take every step to avoid liquidation, it can oblige the director to make all the necessary contributes to the corporation's assets as necessary[352].

The opening of wrongful trading proceedings can only be done by a liquidator and is based on objective criteria. Indeed, these proceedings must respect the standard in which a "reasonable director ought to have done, irrespective of the cognitive and executive talents of the particular directors in question"[353]. In other words, this objective standard presupposes that the conduct of directors will be the conduct of a reasonably diligent person having the general knowledge, skill and experience that would be expected from a person carrying out the same functions as he/she[354]. However, it is important to be aware of the fact that section 214 does not establish any specific course of action to protect creditors

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[348] Declercq, Peter J.M. "An English Law Perspective on Directors' Liability in the Zone of Insolvency", in *Directors' Liability in the Twilight Zone,* edited by Lennarts, Loes *et al.* Eleven International Publishing, 2017, at p. 70.

[349] According to section 251 of IA 86, "shadow director" is a "a person in accordance with whose directions or instructions the directors of the company are accustomed to act – but so that a person is not deemed a shadow director by reason only that the directors act on the advice given by him in a professional capacity". Retrieved from: http://www.legislation.gov.uk/ukpga/1986/45/section/251#commentary-key-6e9b7039a2d6795507aac05913e90081 [Accessed on 13.03.2020]. This section also articulates with Section 251 CA 2006. Available at: http://www.legislation.gov.uk/ukpga/2006/46/section/251.

[350] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", footnote 131, at p. 4.

[351] Zwieten, Kristin van. "Director liability in insolvency and its vicinity". (Final draft: March 2018), published in *Oxford Journal of Legal Studies*, Volume 38, Issue 2, 1 June 2018, p. 2. Retrieved from: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2970913.

[352] Conway, Lorraine. "Company insolvency: potential liabilities of directors". *House of Commons Library* (Briefing paper) no. CBP 7936, December 2019, at p.8. Retrieved from: www.parliament.uk/commons-library; see also Zwieten, Kristin van. "Director liability in insolvency and its vicinity", p. 2 (citing *Grant v Ralls* [2016] BCC 293, following Re Purpoint Ltd [1991] BCC 121 and *In re Continental Assurance Co of London plc*; *Singer v Beckett* [2007] 2 BCLC 287; Brooks v Armstrong [2017] BCC 99, [120]).

[353] Davies, Paul. "Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency", at p. 316.

[354] See Section 214 (4)(a) IA 86. Retrieved from: http://www.legislation.gov.uk/ukpga/1986/45/section/214 [Accessed on 13.03.2020]; and Section 246ZB(4)(a) IA 86. Retrieved from: http://www.legislation.gov.uk/ukpga/1986/45/section/246ZB [Accessed on 13.03.2020].

and, as a result, the actions of directors are assessed *ex post* by the court and in the case-to-case basis.

The "no reasonable prospect requirement"[355], for being such a central requirement for liability under the wrongful trading deserves a more detailed explanation. In simplistic terms, the court will not consider a director liable under Section 214 and Section 246ZB(3) of IA 86 if two situations emerge side-by-side: (1) that there was no reasonable prospect that the corporation would successfully avoid going into insolvent liquidation or insolvent administration; and (2) that the director took every step necessary to minimise the possible damage to the company's creditors as he/she must have taken. For this reason, it is highly recommended that directors do not confuse rational prospects with a "willfully blind optimism"[356] or any unreasonable hope that "everything would turn up"[357] because when they fail to do so they will be held accountable for wrongful trading provision.

As we have already explored, in the UK there is no specific obligation to stop trading when the company is in the vicinity of insolvency nor when the company is insolvent. However, directors must be aware that when the company is in the vicinity of insolvency their liabilities are much easier to trigger. As we have seen, during the vicinity of insolvency creditors rights are usually seen as paramount and, for this reason, directors must be especially careful with the business decisions they will make because they may cause harm to creditors. Thus, the question of whether the corporation can properly continue to trade is a central one and must not be ignored by directors[358]. Additionally, as we know, directors must always be aware of the financial situation of the company not only because their duties require that but also to better protect themselves from personal liability. In this sense they must consider , not only the balance sheet of the corporation but also "the corporation's ability to pay its debts as and when they fall due"[359] to know when the company is (potentially) entering the "zone"; and what is the course of action they should take to protect the creditors' interests and avoid losses.

The wrongful trading provision can also give rise to a disqualification order under the Company Directors Disqualification Act 1986, where the minimum period of disqualification is 2 years and the maximum period is 15 years[360]. According to the British law this provision will be decide in a case-by-case basis and is not dependent of gross incompetence[361]. The violation of this disqualification caries a full range of criminal and civil liabilities for directors, under Section 13 of Company Directors Disqualification

[355] About the requirement of "no reasonable prospect" see section 214(2)(b) IA 86/Section 246ZB(2)(b) Insolvency Act 1986.
[356] Ibid., at p. 72 (citing the case *Langreen Ltd (in Liquidation)* [2011] LTL 26/10/2011).
[357] Ibid., at p. 72 (citing the case-law *Singla v. Hedman* [2010] EWHC 902 (Ch)).
[358] Ibid., at p. 72.
[359] Conway, Lorraine. "Company insolvency: potential liabilities of directors", *op.cit.,* at p.9.
[360] See Section 10(2) of CDDA 86. Available at: http://www.legislation.gov.uk/ukpga/1986/46/section/10 [Accessed on 13.03.2020].
[361] Declercq, Peter J.M. "An English Law Perspective on Directors' Liability in the Zone of Insolvency", at p. 81.

Act 1986 (CDDA) and Section 15 of CDDA 86.

The vicinity of insolvency is a dangerous period for directors, who are constantly exposed to the risk of triggering their personal liability. For this reason, and to protect themselves from the wrongful trading provision, some authors defend that directors should be especially prudent in their business decisions and to seek always for legal and financial opinions. Furthermore, it is highly recommended for directors to keep "a detailed written record and hold regular full board meetings to consider the company's financial position with detailed minutes reflecting discussions, options considered plans, projections, assumptions and providing fully reasoned explanations for decisions made"[362].

Despite the advantages of the creation of the wrongful trading provision, some authors argue that Section 214 of IA 86 lives open space or can even create significant problems. Professor ANDREW KEAY in its articles lifts up these problems[363]. The first one has to do with the difficulty for the liquidator to find the precise point in time from which the directors might be liable for the creditors' losses. Indeed, the liquidator must provide to the court strong evidence of the negligence of the directors. However, this is not easy to do because the liquidator will need to choose a specific point in time where "the director knew or ought to have realised that there was no reasonable prospect of the company avoiding going into insolvent liquidation"[364]. Since the vicinity of insolvency has not its economic or legal boundaries defined, deciding what the specific point should be from which on directors can be blamed for wrongful trading is extremely hard. Some authors suggested that the point from which the liabilities begin is expected to be a critical moment when directors have to acknowledge the inevitability of the insolvency liquidation[365].

The second problem is in regard to the requirement expressed in law, in which directors must look at the future and analyse if the company is heading for insolvency liquidation[366]. Since the vicinity of insolvency is not well defined by the law or case law, this requirement seems to add more uncertainty to the "zone". Additionally, directors are not clairvoyant and, for that reason, they will not necessarily know if the company will be winding-up. The third problem, in the author's opinion, has to do with the principle of case-to-case. As we have already explained, the cases regarding the vicinity of insolvency and, consequently, the alleged wrongdoing of directors is made based on each case individually and, for this reason, some judges "appeared to look for some clear wrongdoing on the part of directors, before holding

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[362] Ibid., *op.cit.,* p. 94.

[363] See Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 4; and also, Keay, Andrew. "Wrongful Trading: problems and proposals". *Northern Ireland Legal Quarterly,* vol. 65, no. 1, 2014, pp. 63-79. Retrieved from: http://eprints.whiterose.ac.uk/id/eprint/78501.

[364] Keay, Andrew. "Wrongful Trading: problems and proposals", *op.cit.,* p. 7.

[365] Ibid., p. 7.

[366] Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 4;

them liable"[367]. However, "the provision does not seem to require any need to establish blameworthiness on the part of directors"[368]. Additionally, ANDREW KEAY also argues that the UK courts tend to "favour" directors when in stake are claims against them[369].

All these relevant problems of wrongful trading provision leave creditors exposed to losses. For this reason, a large number of authors and scholars defend the application of the shifting duty to creditors during the vicinity of insolvency, since the duty may protect creditors *ex ante* from the director's wrongdoing[370].

When it comes to fraudulent trading, it creates civil and criminal liability for directors, in a different way from wrongful trading. Fraudulent trading is regulated by Section 213 of IA 86 and has to do with situations where there appears to had been an intent to defraud creditors, in the course of the winding up or administration of the company. The fraudulent trading proceedings, contrarily to the wrongful trading proceedings, can be initiated by the liquidator and also by the administrator. In fact, under Section 246ZA of the Small Business, Enterprise and Employment Act 2015 extended the powers of who can take actions against director for fraudulent trading to an administrator[371]. Unlike section 214, section 213 applies not only to directors, but to everyone who intent to defraud creditors. The fraudulent trading provision may be invoked even if only one business operation is involved and only one creditor is deceived[372].

Similar to what happens with section 214, wherein stake is fraudulent trading judgment, the court may require the director to make a personal contribution to the company's assets. Additionally, under section 213 of IA 86, "an intent to defraud may be inferred if a person obtains credit when he knows that there is no good reason for thinking that funds will be available to pay the debt"[373]. The dishonesty of a director is a serious offence under the British insolvency law; directors who are found guilty of disloyal behaviour will not only be liable to contribute to the company's assets but will also be found guilty of a criminal offence[374], and may go to jail, under Section 993 of CA 2006.

According to section 993(3)(b)(i) if a director (or other person) carried the business of the enterprise with the intent to defraud creditors will be sentenced "to imprisonment for a term not exceeding

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[367] Ibid., p. 4.
[368] Ibid., p. 4.
[369] Ibid., p. 4; see also the case *Re Continental Assurance Co of London* plc [2001] BPIR 733.
[370] Defending this position see Keay, Andrew. "The shifting of directors' duties in the vicinity of insolvency", at p. 4; McKenzie-Skene, Donna W. "Directors' Duty to Creditors of Financially Distressed Company: A Perspective from Across the Pond", at p. 526; see in general Zwieten, Kristin van. "Director liability in insolvency and its vicinity", *supra* note 351.
[371] Conway, Lorraine. "Company insolvency: potential liabilities of directors", at p. 10.
[372] Ibid.
[373] Ibid.
[374] Ibid.

twelve months or a fine not exceeding the statutory maximum (or both)"[375], in England and Wales; and "to imprisonment for a term not exceeding six months or a fine not exceeding the statutory maximum (or both)"[376], in Scotland or Northern Ireland. Beyond that, directors who are found guilty under Section 213 of IA 86 may also have a disqualification order under CDDA 1986.

1.3. Under the Portuguese jurisdiction:

According with PHILIP R. WOOD, Portugal belongs to the "the high risk" group regarding the risk of liability for directors, unlike the US and the UK. Indeed, similar to other Member-States of EU, Portugal imposes a negligent standard on the director's actions[377]. The negligent performance of the directors' obligations can cause the insolvency of the company, and the insolvency of the company normally represents a great damage to the corporations, the shareholders, while also representing an aggravated danger to creditors, who may see the payment of their credits compromised. It also brings risk to the other stakeholders. For that reason, the Portuguese law provides a series of ways for the protection of interested parties: for example, we have the company action grounded in article 75(1) of the CSC; the liability action proposed by a shareholder, in the article 77(1); and the action brought by creditors against directors (article 78(1)).

The first situation able to trigger the directors' liability is the qualification of the insolvency as culpable. Indeed, the insolvency may be classified as culpable or fortuitous (article 185 of CIRE)[378]. According to the text of the article 186(1) of CIRE establish the general rule for the qualification of insolvency as culpable. According to this, the insolvency is considered culpable if it was created or aggravated as a result of gross negligence by the company's directors in the three years prior to the initiation of the insolvency proceedings[379]. On the other hand, the insolvency will be fortuitous in the

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[375] See Section 993(3)(b)(i) of CA 2006 regarding "Offence of fraudulent trading". Available at: http://www.legislation.gov.uk/ukpga/2006/46/section/993 [Accessed on 14.03.2020].

[376] See Section 993(3)(b)(ii) of CA 2006 regarding "Offence of fraudulent trading". Available at: http://www.legislation.gov.uk/ukpga/2006/46/section/993 [Accessed on 14.03.2020].

[377] WOOD, Philip R. "Overview" *in Directors in the Twilight Zone V*, p. x.

[378] The present topic will not focus on the analysis of the problematics surrounding the qualification of insolvency as culpable. The prime objective of this topic is to enumerate the legal consequences of the misconduct of directors and the remedies provided by the Portuguese law. However, to understand the problems surrounding the nature of qualification of insolvency as culpable and the presumptions of article 186 that divide opinions within the Doctrine see e.g., Antunes, Henrique Sousa. "Natureza e funções da responsabilidade civil por insolvência culposa" in V Congresso de Direito da Insolvência / coord. Catarina Serra. Coimbra: Almedina, 2019, pp. 135-167; Serra, Catarina. "Decotor ergo Fraudator? A Insolvência Culposa (Esclarecimentos sobre um Conceito a Propósito de umas Presunções)" *in Cadernos de Direito Privado,* no.21, January/March, 2008, pp. 59 and following; Frada, Manuel A. Carneiro da. "A responsabilidade dos administradores na insolvência", supra; Antunes, José Engrácia. "As Pessoas Coletivas na Insolvência Culposa". *RCEJ/Rebules,* no. 30, 2018, pp. 69-97. Retrieved from: https://recipp.ipp.pt/bitstream/10400.22/13429/1/Jose%20Engarcia%20Antunes.pdf.

[379] See e.g. Epifânio, Maria do Rosário. *Manual de Direito da Insolvência*. 7ª Edição. Coimbra: Almedina, 2019; Costeira, José Maria. *A insolvência das pessoas coletivas. Efeitos no insolvente e na pessoa dos administradores, supra* note 153; Martins, Alexandre Soveral. *Um Curso de Direito da Insolvência, supra* note 151; FRADA, Manuel A. Carneiro da. "A responsabilidade dos administradores na insolvência", *supra* note 120. See also the AC do Tribunal da Relação de Coimbra proc. 2273/10.1TBLRA-B.C1, report HENRIQUE ANTUNES, of 07.02.2012. Available at:

situations where the article 186 does not apply[380]. The culpable insolvency should not be confused with the wilful insolvency. The culpable insolvency results from the insolvency qualification incident of the insolvency process[381] and has a civil liability nature rather than criminal. The wilful insolvency, on the other hand, is considered to be a criminal offence, in which, according to article 227 of the Portuguese Criminal Code, may impose on the director an imprisonment of up to 5 years or fine up to 600 days[382]. However, it is important to be aware that the same behaviours enumerated by article 186 can also give rise to the opening of criminal proceedings for wilful insolvency. The qualification of insolvency as culpable entails serious consequences for a director. According to article 189(2) these consequences can be: (1) a disqualification and prohibition to manage third party assets for a period of 2 to 10 years; (2) the inhibition of commerce's exercise for a period of 2 to 10 years, as well as for the occupation of any position of holder of a commercial or civil society organ, association or private foundation of economic activity, public company or cooperative; (3) the obligation to indemnify the company's creditors in the amount of the credits not satisfied[383]; (4) loss of any claims on insolvency or on the insolvent estate held by the persons affected by the qualification and their belief in the refund of the amounts already received in the context of the payment of those claims.

Another situation that can trigger the directors' liability involves the duty to renegotiate under pre-insolvency regime. Indeed, the pre-insolvency recuperation regimes – for our study, the PER and the RERE – were influenced, to a large extent, by *Chapter 11* of the United States Bankruptcy Code (USBC), which permits, to viable companies on verge of insolvency, a second chance in the business. As we had opportunity to explain, under the Portuguese law both "situation of financial distress" and the "vicinity of insolvency" fall under the concept of pre-insolvency. As a result, companies that are viable and are in a situation of financial distress or in the vicinity of insolvency are eligible for recuperation under PER or RERE[384]. The performance of directors during the period of renegotiations under the pre-insolvency

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http://www.dgsi.pt/jtrc.nsf/8fe0e606d8f56b22802576c0005637dc/53c50519210a487e802579ac003c53c5?OpenDocument.

[380] For more information regarding the "fortuitous insolvency" see e.g., Oliveira, Rui Estrela. "Uma Brevíssima Incursão pelos Incidentes de Qualificação da Insolvência", pp. 931-987; see also Duarte, Rui Pinto. "Responsabilidade dos administradores: coordenação dos regimes do CSC e do CIRE" *in III Congresso de Direito da Insolvência* / coord. Catarina Serra, December 2015, pp. 166-167.

[381] The legislator in *DL No. 53/2004*, of 18th March, a diploma that decided to institute "insolvency qualification incident" in CIRE, with a view to obtaining greater accountability for "business owners" and their directors when they – with intent or serious fault – create or intensify the insolvency situation of the corporation. See e.g., Oliveira, Rui Estrela. "Uma brevíssima incursão pelos incidentes de qualificação da insolvência" *in O Direito*, Ano 142, no 5, 2010, pp. 932- 933.

[382] See e.g., AC do Tribunal da Relação de Lisboa proc. 770/10.8TATVD.L1-9, report Maria do Carmo Ferreira, of 21.05.2015. Available at: http://www.dgsi.pt/jtrl.nsf/33182fc732316039802565fa00497eec/42e2ad3e55311e5980257e5000570209?OpenDocument.

[383] The obligation to indemnify depends on the level of culpability of the director, which relates itself to the presumptions of article 186(2) and (3). See e.g., Antunes, Henrique Sousa. "Natureza e funções da responsabilidade civil por insolvência culposa" in V Congresso de Direito da Insolvência / coord. Catarina Serra. Coimbra: Almedina, 2019, p. 136. See also the authors cited in *supra* note 378.

[384] For more information about PER and RERE see in general e.g., LEITÃO, Luís Manuel Teles Menezes. *A Recuperação Económica dos Devedores: RERE, PER, PEAP, plano de insolvência, plano de pagamentos e exoneração do passivo restante*, supra mentioned; Serra, Catarina. "Processo especial de revitalização – contributos para uma rectificação" *in ROA 72,* 2012, II-III; Epifânio, Maria do Rosário. O processo Especial de Revitalização. Coimbra: Almedina,

regimes should be especially diligent and qualified[385]. Directors, in order to comply with their duty to renegotiate under the pre-insolvency regimes, are obliged to: (1) cooperate with the company's creditors, initiating the renegotiation procedure and adopting a proactive and constructive performance of their duties; (2) directors must also act in a transparent manner and always respecting their general duties of care and loyalty expressed in article 64 of the CSC; among others[386]. As a result, "directors have the duty to renegotiate with creditors, in order to reach the best agreement leading to recovery"[387]. Directors who fail to comply with these duties and objectives may trigger their civil liability under the Portuguese law[388].

The new Directive (EU) 2019/1023 seems to create more control of directors' management and for that reason it also increases the risk of liability from them. Indeed, the new duty to prevent insolvency, introduced by this Directive, has a preventive effect of insolvency and fills some gaps of the general duties of loyalty and care by exposing directors to a higher risk of liability, when they fail to comply with the standard of diligence[389]. The duty to prevent insolvency has a positive character[390], which imposes on directors the right path to follow when the company is on the verge of insolvency. In this sense, and similar to the wrongful trading provision of the UK, the new directive will expose directors to the risk of liability if they aggravate the financial situation of the company when it is operating in the vicinity of insolvency. Directors will have to answer to the corporation, according to article 72(1) of CSC[391]; to the creditors, according to article 78(1).

2015; and Martins, Alexandre Soveral. *Um Curso de Direito da Insolvência*, p. 509 and following.

[385] Machado, José Manuel Gonçalves. *O Dever de Renegociar no âmbito Pré-Insolvencial. Estudo comparativo sobre os principais mecanismos de recuperação de empresas*, *op. cit.*, at p. 320.

[386] Ibid., p. 324.

[387] Ibid.

[388] Ibid., 336.

[389] Serra, Catarina. "Em Torno da Diretiva 2019/1023 sobre Reestruturação e Insolvência de 20.06.2019" in Sessão de estudo sobre direito da insolvência. E-book Formações, Delegação da Ordem dos Advogados de Braga, 24 de janeiro 2020, p. 3.

[390] ABREU, Jorge Manuel Coutinho de. "Administradores e (novo?) dever geral de prevenção da insolvência, p. 234.

[391] Ibid., p. 235.

CONCLUSION

Fiduciary duties are historically very complex concepts surrounded by controversy, beginning in their nature and ending on their application. As we had the opportunity to explore, the nature of fiduciary duties, even with different theories, is a creation of trust law that in its turn is a creation of Equity. As a result, and thanks to the separation of law and equity in the common law tradition, the fiduciary duties were able to proliferate to other areas of law and not only the contract law, the corporate law being a prime example. We can conclude that even if some authors argue that fiduciary duties have been present in the civil law world for many years, in their pure form the objective was a creation of equity, which is intrinsic to the common law tradition and not the civil law one.

The fiduciary duties are present in the English law for at least 250 years and some years later were legally brought to the US. Only recently were fiduciary duties legally transferred to the world of civil law. For example, the fiduciary duties of loyalty and care were only introduced in the Portuguese jurisdiction – a civil law country – in 2006 with the reform of CSC. This does not mean that concepts of loyalty, care and good faith did not exist in the civil law world, quite the contrary. However, these concepts were usually linked to contract law, which does not happen in the common law tradition. For instance, for the common law jurisdictions, such as the US and the UK, the fiduciary duty of loyalty and the consequent duty to act in good faith is much more than a simple duty to perform the exact terms of a contract; rather, it is a moral duty, a duty that is seen as a synonym of good character. For the civil law jurisdiction, until recently, the duty to act with good faith was a fundamental duty when there were negotiations and the performance of a contract on the table.

Nowadays, in both common and civil law countries, directors are bound by the general duties of care and loyalty and by specific duties, which derive from the general ones. These duties are not particular; they are permanent; they bound directors regardless of the size, type, business activity or financial stage of the company. These general duties of care and loyalty are much more abstract and general in the US and Portugal than in the UK – thanks to the reform of the CA 2006. The fiduciary duties in the modern corporate law intend to give an answer to the principal-agent problem, which is inevitable and in the same way may increase possible costs for the business. Consequently, we can determine that fiduciary duties are the fundamental tool to control and mitigate the possibility of directors' abuse of power and dishonest behaviour, as we explored in Chapter I of this dissertation.

There are five different financial stages where a company may find itself: solvency, vicinity of

insolvency, insolvency and bankruptcy. It is important to clarify that insolvency and bankruptcy are usually used as synonyms in both civil and common law countries, but that there are actually different from one another in terms of terminology. Thanks to the evolution and globalization of the US law, we can argue that although "insolvency" and "bankruptcy" are historically and technical different, they may be used as synonyms without compromising the message or the comparative study. Regarding the first financial stage, solvency, we can conclude that the approaches and definitions of the three jurisdictions in the analysis were very similar. Additionally, the fiduciary duties during the times of insolvency are also interpreted in the same line of thinking.

When we talk about the vicinity of insolvency and insolvency, we can argue that, although the US and the UK share some similarities, in the end, the approaches for these financial stages are profoundly different. Indeed, it is interesting to observe that Portugal, a civil law country, is much more similar – regarding the vicinity of insolvency – to the US than the UK and US, which share the same legal system. On the other hand, when we are talking about the insolvency itself, Portugal and the UK are much more similar when compared to the approach of Delaware state law. Indeed, the approach of Delaware defends that when the company is insolvent, the interests of creditors should also be considered, whereas in Portugal and the UK, they are not seen as paramount.

The vicinity of insolvency is a particularly problematic financial period. Indeed, the vicinity of insolvency is usually mentioned as an ambiguous stage between solvency and insolvency, where it is almost certain that the corporation will be insolvent very soon. The lack of both economic and legal definitions and the different approaches to the "zone" intensifies the problem of agency cost and increase the business costs. Shareholder and creditors have different risk appetites and different objectives for the company. When the company is solvent, shareholders are the residual claimants and, for that reason, they profit from business decisions that intend to maximize the value of the company's assets. Creditors, on the other hand, have generally fixed dues of the corporate assets and thus do not profit from investments beyond the value of these dues. However, when the company is facing financial problems or is in the vicinity of insolvency, creditors will bear the full burden of that distress, unlike shareholders, who are protected by limited liability. Therefore, it makes sense why creditors prefer low-risk investments and why shareholders will almost certainly prefer riskier investments where the expectations for higher profits are superior. Because of this, we can claim that directors during the vicinity of insolvency have much more difficulties managing and balancing the conflict of interests and are more susceptible to actions against them.

As previously explained, the brink of insolvency has no precise definition nor defined legal boundaries, which makes it very difficult for directors to know when the company is operating in the "zone" or not. This leads us to a very important question: should there be any especial duty for creditors during this period? Should the fiduciary duties of directors shift to creditors? In our opinion, the correct answer is no. In fact, the fiduciary duty shift theory is dangerous not only for directors but for the business itself. Why? Because the shifting of fiduciary duties to creditors depends on the assumption that the company is in the vicinity of insolvency. Thus, when we make business decisions having as a starting point an assumption and not certainty, we can compromise the company's turnaround and the creation of value; because, as previously explained, the prime objective of creditors is the satisfaction of their credits and not the company's recovery. Indeed, it is impossible to define precisely when the company entered the vicinity of insolvency and, for that reason, establishing duty shifting to creditors is very problematic. For instance, when comparing the three jurisdictions – Portugal, the US and the UK – we can conclude that the legal approach to the vicinity of insolvency of the UK is the most problematic and controversial of the three and the only one to apply the shifting duty.

The UK law establishes a shifting obligation on directors' fiduciary duties during the brink of insolvency. This means that when directors believe that the company may be in the vicinity of insolvency the interests of creditors are regarded as paramount. But why is this problematic? Well, even if some authors believe that this shift grants more protection to creditors, this shift also creates fear for directors. Indeed, directors fear of having their personal liability triggered, and indeed they should. The UK is one of the most creditor-friendly regimes in the world and, for that reason they are strongly protected by the law and contracts. Directors may therefore be found guilty and accused of bad business decision making during the "zone", leading to civil consequences – through wrongful trading – or criminal consequences – through fraudulent trading. As we know, risk is a very important part of the business and an essential tool for wealth creation; directors under the UK's law will restrain themselves from taking action or making riskier business decisions essential for the creation of firm value. Consequently, what could be a simply temporary crisis could be transformed into a permanent one.

The other two jurisdictions, the US and Portugal, on the other hand, do not apply the shifting duty theory. Regarding the US, after many years of controversy and uncertainty regarding the application of the shifting duty to creditors, the Delaware court decision in *Gheewalla* seemed to have created more uniformity across the different US's states. Indeed, since 2007, directors of companies operating in the "zone" do not owe any particular duty to creditors. This means that the prime objective of directors

remains the firm's value maximization and the satisfaction of the shareholders' interests. This approach, unlike the UK, gives directors more flexibility to decide what the best resolution is to comply with their prime objective. Without being afraid of civil or criminal consequences for those actions, directors will be more efficient in the balance of the conflict of interests; and will have more autonomy to take riskier business decisions to increase wealth for the firm. Additionally, we cannot dismiss the importance that the BJR has in the management of a company. Indeed, the BJR plays a central role in the corporate law of the United States because it permits directors to escape from "bad" business decisions if those decisions were made in an informed way and in good faith. However, even in the cases where directors cannot be protected by the BJR, the penalties are, in most cases, civil and not criminal.

For the Portuguese approach, we have to say that it is the most precise of the three and the one to give more clarity to directors during the different financial times that a company may find itself in. Indeed, the vicinity of insolvency is not as problematic in Portugal as it is in the UK and the US. The fiduciary duties of directors do not change during the different financial stages of the company; and only upon insolvency, are the creditors' interests prioritized over all others. As a result, it is much easier for directors to balance the conflict of interests and to know what they must do to comply with their fiduciary duties and to avoid personal liabilities. However, directors that fail to comply with their duties may face both civil and criminal consequences. The Portuguese law provides a series of means for the protection of interested parties. For an example, we have the company action; the liability action proposed by a shareholder; and the action brought by creditors against directors. However, we cannot forget to reaffirm that the new Directive (EU) 2019/1023 may change the paradigm of the vicinity of insolvency in Portugal. Its article 19, which introduces the duty to prevent insolvency, can be transferred to the national law as implementing the shifting duty theory. If this happens, problems that did not exist in Portugal will certainly start to appear, similar to the UK. Additionally, the new directive seems to create even more control on directors and, for that reason, higher risk of liability under the Portuguese law.

This comparative study between three different jurisdictions permitted us the conclusion that creditors do not need any shifting of duties to be protected by the law; they are strongly shielded by contract. This does not mean that directors should not be controlled; in fact, the control of directors is essential to the good business practices and for the protection of the long-term profits. We believe that the theory of the fiduciary duty shift creates more problems than those it tries to eliminate and, for that reason, is not the best solution for an already ambiguous and uncertainty financial period such as the "zone" of insolvency. Additionally, this study also permitted us to assert that regarding the three

jurisdictions in analysis, the approaches to the vicinity of insolvency of the US and Portugal are much more effective than the UK's approach that adds unnecessary problems and do not solves any.

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