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Paper on Position of Directors in Twilight Zone

Introduction

Insolvency regime is emerging in Indian Economy and is in its nascent stage. Insolvency and Bankruptcy Code, 2016 has been introduced to build robust legal framework in India relating to resolving Insolvency in a time bound manner and increase in credit flow in the economy.

The phrase by J Paul Getty *'If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem'* depicts an economic problem that India had been facing for a long period post '91 economic reforms. Bankruptcy Law in India aims to streamline the process for resolution of a defaulting firm by moving form *'debtor in control' to 'creditor in possession'.* The earlier economic legislation introduced having failed, IBC has significantly improved the position of creditors in terms of recovering their dues.

In a limited liability company, directors, representing shareholders, act in fiduciary capacity for maximizing wealth of shareholders. The duties and responsibilities of a director is codified under Section 166 of Companies Act, 2013. Besides this, a director is required to adhere to good corporate governance and protect interest of all the stakeholders. While in a solvent limited liability company, it is presumed that liabilities of directors are just limited except in cases involving fraud or misrepresentation, but for a company in vicinity of insolvency, there arises personal liabilities on directors for any loss to creditors of company. This phenomenon has been recognized in international insolvency jurisprudence as Twilight zone period, prior to Insolvency and casts a greater responsibility on directors; specially during current economic situation prevailing on account of COVID-19.

By this paper, author throws light on predicaments arising out of failure of business in current economic situation and thereby companies entering into twilight zone.

Demystifying Twilight Zone

Twilight zone- Although there has been no reference in International insolvency legislation of this term but it is recognized as important concept in Insolvency Jurisprudence across the world. It has been seen that many Insolvency laws recognize that there is shift in duties and responsibilities of a

director on deterioration of financial position of a company from being solvent to being unable to service its debts. Twilight zone commences from the time when director of a company knew or ought to have known that there is no reasonable prospect of avoiding initiation of formal process of Insolvency till actual commencement of formal process of Insolvency.

Ordinarily, for a solvent firm, duties and responsibilities of directors are prescribed under Company law with more shareholder centric approach.

In Indian context, for a limited liability company, Section 166 of Companies Act, 2013 prescribes following duties of directors:

a. Director shall act in best interest of its members and company;
b. He shall exercise reasonable care and due diligence;
c. He shall avoid conflict of interest;
d. He shall not take undue gain/advantage

A limited liability company is a contract between equity holder and debt holder, pursuant to which equity holder get to manage the affairs of company, participate in the profit earned by company, absorb the risk associated with loss that could be incurred by company. As against this, debt holder or creditor are devoid of participating in profit or management of company and given priority in repayment of their debts at the time of winding up of the company over equity shareholders.

Once equity funds are exhausted and net worth becomes negative, company starts trading on creditors money. While for a healthy firm, it is expected that directors have to act in best interest of shareholders, for a company in zone of Insolvency which starts trading on creditors money, there is an additional duty on directors to protect the value for creditors and are expected prioritize the interest of creditors over shareholders. Actions (or inactions) of directors of a company which faces immediate risk of going into insolvency are vulnerable and subject to scrutiny by Insolvency Professional as per provisions made under Insolvency Laws.

A debatable question arises whether during twilight zone, directors of the company have additional special duties in addition to what has been prescribed under Companies Act, 2013. By way of this article, we will try to dwell upon different aspect concerning twilight zone.

Twilight Zone under IBC, 2016

Section 66 of IBC recognizes concept of twilight zone and casts additional duties on directors of a company to protect interest and minimize loss to the creditors. Relevant provision of Section 66 in this regard states as under:

Section 66(2)

On an application made by a resolution professional during the corporate insolvency resolution process, the Adjudicating Authority may by an order direct that a director or partner of the corporate debtor, as the case may be, shall be liable to make such *contribution* to the assets of the corporate debtor as it may deem fit, if-

a. before the insolvency commencement date, such director or partner *knew or ought to have known* that the there was no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process in respect of such corporate debtor; and

b. such director or partner *did not exercise due diligence in minimizing* the potential loss to the creditors of the corporate debtor

On a careful reading, the far reaching consequences of this provision under IBC can be understood as it casts personal liability on such directors to the extent any potential loss is incurred to the creditors during twilight zone and they failed to exercise due diligence in minimizing the loss. The phrase knew or ought to have known has been imported from international insolvency jurisprudence and has great significance as twilight zone is deemed to be commenced at point when director knew or ought to have known that there is no reasonable prospect of avoiding commencement of corporate Insolvency Resolution Process. The liability to be cast upon director of a company if he fails to minimize loss can vary on case to case basis and courts are empowered to decide the same on merits and circumstances.

Delaware court in a celebrated judgement in *Credit Lyonnais Bank vs PCC* had ruled that when a corporate is operating in vicinity of insolvency, directors are not merely agent of residue risk bearer i.e. shareholders but owe its duty to entire corporate enterprise. When a company is trading in the twilight zone, a conflicting situation may arise where directors continue to prioritize interest of shareholders over creditors and the fair and efficient course of action on director's part may diverge from choices that shareholders will make, if given opportunity to act.

During twilight zone, any trading by company which results in loss to the creditors thereby dipping in creditors money and in that given scenario if directors fail to exercise due diligence in minimizing loss to creditors, then they may be made personally liable to make good the loss that creditors have incurred.

Identifying Commencement of Twilight Zone

There is no straight jacket formula to identify when there is a shift in duties of directors and commencement of twilight zone. Being a potentially imprecise concept, there are various possibilities for determining the time from which obligations of director might commence. One such possibility is the point when there is deterioration of company's financial stability to an extent where it will be unable to service its debts as and when they fell due and approaching of Insolvency becomes imminent. Another possibility may be time when any application has been filed with the adjudicating authority for initiating corporate Insolvency Resolution Process against the company.

IBC, in line with global practices adopts an approach where a twilight zone is deemed to have commenced at a point of time when director knew or ought to have known that there is no reasonable prospect of avoiding commencement of corporate Insolvency Resolution Process in a company. It is the time when directors are required to exercise reasonable due diligence, skill and care to protect the interest of creditors. Any negligence on part of director would invite pecuniary liability on directors to contribute to the assets of company to the extent of loss incurred by creditors.

A difficulty that may arise in this approach is to examine and determine the point of time when such knowledge of imminent insolvency by the director can be imputed. The approach under section 66 requires the judgement of a director to be assessed against the action, a reasonable and competent person would have taken given the similar circumstances and context. Essentially an Insolvency(solvency) test by a director would include assessment of financial position on regular intervals, understanding present and future cash flows, ability of the company to service its debts in

near future by understanding the books of accounts of the company in its entirety.

Enforcement of liabilities and defenses

As explained earlier, the courts are empowered to determine the liability to be imposed on directors which can be potential asset of an insolvent entity and increase returns to the creditors. Section 67 of IBC, 2016 empowers NCLT to pass orders in case test of loss incurred to creditors in twilight zone due to negligence of director is passed. The various orders that can be passed by NCLT are as follows:

Section 67 – Proceedings under Section 66

> *"(1) Where the Adjudicating Authority passes an order under sub-section (1) or subsection (2) of section 66, as the case may be, it may give such further directions as it may deem appropriate for giving effect to the order, and in particular, the Adjudicating Authority may—*
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> *(a) provide for the liability of any person under the order to be a charge on any debt or obligation due from the corporate debtor to him, or on any mortgage or charge or any interest in a mortgage or charge on assets of the corporate debtor held by or vested in him, or any person on his behalf, or any person claiming as assignee from or through the person liable or any person acting on his behalf; and*
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> *(b) from time to time, make such further directions as may be necessary for enforcing any charge imposed under this section"*

Equally important is to point out the inherent power of NCLT to alter the waterfall mechanism prescribed under Section 53, if such director is also creditor of corporate debtor (by way of any unpaid dues, advance given to corporate debtor or otherwise) by virtue of Section 67(2) which states as follows:

> *"(2) Where the Adjudicating Authority has passed an order under sub-section (1) or (2) of section 66, as the case may be, in relation to a person who is a creditor of the corporate debtor, it may, by an order, direct that the whole or any part of any debt owed by the corporate debtor to that person and any interest thereon shall rank in the order of priority of payment under section 53 after all other debts owed by the corporate debtor."*

A counter-argument by a director in a situation involving director's liability could be business judgement rule as some business decision even if taken after considering accurate financial information and sound professional advice may tend to fail. Courts are inclined to accept such defense as business risk are unavoidable and it is only left to see if that director acted as if a person of ordinary prudence would have acted in the given circumstances.

Other defense to avoid such liabilities could be opting for director and officer liability insurance, recording of assent or dissent of director's decision in minutes of board meeting, timely filing for commencement of Insolvency process, if appears that any inaction may further deteriorate the value to the creditors.

Source

1. Insolvency and Bankruptcy Code, 2016
2. UNCITRAL Legislative Guide on Insolvency Law

3. Credit Lyonnis Bank vs. Pathe Communications Corporation

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