Corporate Insolvency- Extension of Liability on Directors and Parent Company
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Introduction

Corporate insolvency and bankruptcy has been the subject matter of various legislations in India, some of which are the Companies Act 2013/1956, SARFAESI Act 2002 and Sick Industrial Companies Act 1985. However, these legislations failed to comprehensively address the issues surrounding the insolvency process specifically amongst others the time taken to resolve insolvency, investor confidence and the situation of non-performing assets. The implementation of the Insolvency and Bankruptcy Code 2016 ("IBC 2016") is a significant reform which provides for a robust framework and time-bound road map to deal with distressed or failed businesses; a welcome contrast from the previous, seemingly never-ending process.

While for the layman the words insolvency and bankruptcy may be interchangeable, these stand as two different financial conditions in the legal world. Insolvency can be mere short term inability of the company to meet its liabilities during the course of their business whereas bankruptcy takes place when the courts get involved to determine insolvency and gives an order to resolve the same. IBC 2016provides a very clear distinction between both the processes. A corporate entity faces insolvency on account of cash flow insolvency or balance sheet insolvency. In case of cash flow insolvency the company is unable to pay debt as it falls due and in balance sheet insolvency the total liability exceeds its realisable assets.

IBC 2016 prescribes new approach towards insolvency which helps in early determination of insolvency by moving from erosion of net worth to payment defaults. Thus, default of payment of more than INR 1 Lakh can invoke the insolvency process against the debtor under IBC 2016. Further, IBC 2016 seeks to reorganise corporations within the prescribed timeframe, failing which the entity shall be liquidated and wound up. During the insolvency resolution process there may arise circumstances pointing towards dubious transactions conducted by the corporate debtor which may seem to contribute towards its own insolvency

IBC 2016 vests power in the resolution professional to question such transactions of the corporate debtor and inform the NCLT accordingly. Further, NCLT has the power to scrutinize the questioned transaction and extend liabilities as arising from

such transaction on any person so involved. This article focuses only on the extension of liability on directors and parent company, therefore only such statutory provisions have been analysed.

Statutory Extension of Liability

IBC 2016 ensures to safeguard the interest of the creditors and in doing so it extends the liability to the persons involved in transactions leading otherwise. IBC 2016 extends the liability on two kinds of transactions namely, preferential transactions undertaken before the commencement of insolvency but during the twilight period and fraudulent or wrongful trading carried out during the corporate insolvency resolution process.

General extension of liability

As per Section 48 read with Section 45 and Section 46, if the liquidator or resolution professional on an examination of a preferential transaction of the corporate debtor held during the twilight period determines that such transaction was undervalued, in that case it shall inform the adjudicating authority. Adjudicating authority in case of such applications shall make an order to declare the transaction void and reverse the effect of such transactions.

Twilight period as detailed out in Section 46 shall mean such transaction made with any related party within two years and with any other person within one year preceding the insolvency commencement date. Section 5(24) of the IBC Code 2016 provides for broad and extensive definition of related party which includes the director of the corporate debtor and a body corporate which is a holding company of the corporate debtor.

As per section 48(1)(c), the adjudicating authority may direct any person to pay such sums, in respect of benefits received by such person, to the liquidator or the resolution professional as the case may be. Thereby, it is evident that the order of the adjudicating authority is aimed at reversing the effect of the undervalued transaction and requiring the person who benefits from such transaction to pay back any gains made as a result of such transaction. Section 48(1)(c) uses the word “such person” wherein there seems no distinction between natural and legal person. Therefore, both directors and parent company can be brought in the ambit of the order passed under this section in case it is established that either of them have made benefits from such preferential transaction.

In the case of *Tristar Consultants vs. M/s. VCustomer Services India Pvt. Ltd. & Anr.*[1] the Delhi High Court has clearly held that directors are agents of the company to the extent they have been authorized to perform certain acts on behalf of the company. They owe no fiduciary or contractual duties or any duty of care to third parties who deal with the company and liability would arise only if they derive any personal benefit while purporting to act on behalf of the company. Therefore, the judiciary has accepted the extension of liability as a general norm in cases where the directors obtain personal gain/benefit from any transactions while acting

on behalf of the company.

Section 66 deals with the second transaction under scrutiny by this Code i.e. fraudulent or wrongful trading during the corporate insolvency resolution process. As per section 66(1), if during the corporate insolvency resolution process or liquidation process, it is found that any business of the corporate debtor was carried out with the intention of defrauding creditors or for any fraudulent purpose then, the resolution professional shall make an application to the adjudicating authority informing the fraudulent transaction.

Adjudicating authority upon receiving such application may pass an order that any person who were knowingly parties to the carrying on of the business in such manner shall be liable to make such contributions to the assets of the corporate debtors as it may deem fit. Section 66(1) extends liability on "any person" who were knowingly party to such transaction, thereby bringing both directors and parent company under its ambit if it is proved before the adjudicating authority that either of them were knowingly party to such fraudulent/wrongful transaction. In case the same is proved, they may be called upon to make "such contribution" as the adjudicating authority deems fit. The word "such contribution" has been left to the discretion of the adjudicating authority thereby not limiting the liability in any manner.

Specific extension of liability

Section 66 (2) unlike Section 48 and 66(1), specifies the extension of liability to the directors. As per Section 66(2) the adjudicating authority may pass an order directing the director of the corporate debtor as the case may be to be liable for making such contributions to the assets of the corporate debtor as it may deem fit. Such extension of liability is subject to the fact that the director knew or ought to have known that there was no reasonable prospect of avoiding commencement of insolvency process and they failed to exercise due diligence in minimising the potential loss to the creditors. For the purpose of Section 66 (2), general presumption is in favour of the director i.e. it is presumed that they have exercised the due diligence as is reasonably expected out of a person carrying out the same function as are carried out by such director.

In the case of *LIC vs. Escort Limited and Ors*[2] the Supreme Court held that the corporate veil may be lifted where a statute itself contemplates it or in case of prevention of fraud or improper conduct. As the provisions of IBC 2016 clearly contemplates the extension of liability on its director and parent company, therefore the intention of the legislation would remain unfulfilled if the same is not accompanied with the power to pierce the corporate veil as and when such case arises.

Further, in the case of *IDBI Bank Limited vs. Jaypee Infratech Limited*[3] a petition was filed to declare the transaction entered into by promoters and directors of corporate debtor creating mortgage of property as illegal. It is pertinent to mention that when the account of the corporate debtor was

declared as NPA, the directors of the corporate debtor, in utter disregard to their fiduciary duties and duty of care to the creditors of the corporate debtor, mortgaged 858 acres of unencumbered land owned by the Corporate Debtor to secure the debt of the related party i.e. Jaiprakash Associates Ltd (parent company). The value of the land mortgaged by the corporate debtor was estimated to be in the range of 5000 to 6000 crores approximately, as per the valuation report prepared at the time of mortgage of the said land. The mortgage of land was created without any counter guarantee from a related party. The mortgage of land is in nature of asset stripping and entered into with the intent to defraud the creditors of the corporate debtor.[4]

The impugned transactions, was declared as fraudulent, preferential and undervalued transactions as defined under section 66, 43 and 45 of IBC 2016 as it was carried on during the period of two year preceding the commencement of insolvency. Therefore, the Tribunal passed the order for release and discharge of the security interest created by the corporate debtor in favour of lenders of the parent company and the properties mortgaged by way of preferential and undervalued transactions were made to be deemed to be vested in the corporate debtor.

Therefore, the Allahabad National Company Law Tribunal may not have extended the liability to the directors under Section 48 and 66 however, the intention to reverse the transaction was definitely fulfilled. It is pertinent to note that an assumption that the Tribunal may never extend liability to the directors and parent company shall be an early miscalculation especially when IBC 2016 itself provides such an exclusive right to the Tribunal.

Restriction on extension of liability

It is important to understand whether liabilities extended under Section 48 and 66 are unlimited and whether the extension of the same can be avoided by directors and parent company.

The liabilities extended under Section 48 and 66 are made with an intention to reverse the position of the corporate debtor as it would have stood had the transaction not taken place. Therefore, it can be safely assumed that the extension of liability shall be limited to the amount of such reversal of transaction and not more.

For the purpose of Section 48, in order to avoid the extension of liability one may have to prove that there were no benefits received by them as a result of such undervalued transaction. In case of absence of any benefit, the adjudicating authority cannot pass an order for payment of any amount for such benefits incurred.

For the purpose of section 66, it is important for the person to prove

the absence of intention of defrauding the creditors or any such similar fraudulent intentions in relation to such transaction. Further, while the general presumption under 66(2) is in favour of the directors, in case the same
becomes questionable, the director needs to ensure to evidence the reasonable due diligence exercised by them in minimising the potential loss and the lack of foreseeability on the commencement of corporate insolvency.

Conclusion

We observe that IBC 2016 has provided for a crystal clear extension ofliability on the directors and parent company of the corporate debtor as andwhen a transaction involving them is brought under question. Such an extensionof liability can be made to the extent of reversing the transaction or makingreasonable contribution to the assets of the corporate debtor to ensuresafeguarding of the creditor's interest. However, same can be avoided if thetwilight period is kept in mind and reasonable due diligence is undertaken withlack of fraudulent intention. While there exists no precedent under IBC 2016extending personal liability on directors or parent company till date, it wouldnot be farfetched to see a judgement on these lines in the near future, giventhat the cases of Jaypee infrastructure and Religare are still awaiting averdict.

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[1] MANU/DE/7339/2007
[2] MANU/SC/0138/1966
[3] MANU/NC/5257/2018
[4] id

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