Corporate Alert

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Insolvency and Bankruptcy Code – Making Directors Personally Liable

Section 66 of the Insolvency and Bankruptcy Code, 2016 ("IBC") provides for liability of directors for fraudulent or wrongful trading during a specified time period, which may be referred to herein as a "statutory look back period". A director can be made liable under this section if he had or ought to have had knowledge of the absence of a reasonable prospect of avoiding commencement of the insolvency resolution process and if he fails to exercise due diligence in minimising the losses of the creditors. The language of Section 66 is broad such that the director may be held personally liable upon the elements of the statute having been satisfied. In the absence of established jurisprudence and judicial interpretation with respect to the liability of directors under the IBC, this article briefly examines issues pertaining to the same.

The IBC provides for a robust and time-bound framework to deal with distressed businesses. It also facilitates an early identification of potential insolvency, and deters further erosion of the net worth of a company.

In order to protect the interests of the creditors, the IBC has made the directors of a company liable for losses suffered by such creditors on account of undervalued as well as fraudulent transactions. The operation of these director liability provisions has had the effect of extending the fiduciary duty of directors to the creditors of a company.

In order to hold the directors and officers of a company liable for their actions which are detrimental to the interests of the creditors, the IBC has specified a time period which may be identified as a '*statutory look back period*'. The statutory look back period permits the authorities under the IBC to look back and scrutinize transactions executed within a specified time period from the insolvency commencement date and the impact such transactions have on the interests of the creditors & other stakeholders. As a practical matter, the operation of thisstatutory look back period extends the directors' fiduciary duties for the benefit of the creditors of a company. During this period, directors are obligated to take decisions which are beneficial for the interests of the company and its assets, as well as for the interests of the creditors generally. In the same vein, the directors are required to avoid any transaction which is either undervalued or is in furtherance of the interests of only a specific creditor.

For the purpose of undervalued transactions, the statutory look back period is 2 years preceding the insolvency commencement date for related party transactions, and 1 year preceding the insolvency commencement date for all other transactions. If any undervalued transaction is found to have been executed by the board of directors or other officers of a company within the said time period, such transaction may be avoided by the adjudicating authority by virtue of Section 48 read in conjunction with Sections 45 and 46 of the IBC.

For fraudulent transactions, the statutory look back period commences upon the director either acquiring knowledge the company's inability to avoid the commencement of corporate insolvency resolution process or reasonably being expected to have acquired such knowledge and failing to exercise due diligence in minimizing the potential loss to the creditors of the company. Where a director is found to be liable under the aforesaid statutory look back period for executing a transaction with fraudulent intent or undertaking wrongful trading, he may be directed to make such contribution to the assets of the company as may be deemed fit by the adjudicating authority under Section 66(2).

The extension of liability of a director for the acts committed for and on behalf of the company indicates a legislative intent to permit piercing of the corporate veil,and holding individuals liable for the acts / omissions undertaken in the guise of acting for the corporate entity. The Supreme Court in the matter of *LIC v. Escorts Limited and Others*[1] upheld the lifting of corporate veil if the same was permitted in a statute. Therefore, while some may be uncomfortable with the extension of the liability of an individual director for the decisions taken in his capacity as an officer of the company, the probable legislative intent is to hold each individual liable for their actions which have a detrimental impact on the interests of the company and its creditors.

In addition to the contribution to the assets of the company, Section 69 prescribes punishment for transactions undertaken by any officer of a company with the intent of defrauding the creditors of the The provisions of Section 66 have been analysed by the Allahabad Bench of the National Company Law Tribunal in the matter of *IDBI Bank Limited v. Jaypee Infratech Limited*[2]. In this matter, when the account of Jaypee Infratech Limited was declared as a non-performing asset by the bank, its previously un-encumbered land was mortgaged in favour of its parent company named Jaiprakash Associates Limited. The tribunal observed that creation of the charge in the absence of sufficient consideration indicated that the said charge was created with the intent of reducing the unencumbered assets of the company and consequently hampering the recovery of dues by the creditors. The impugned transaction was declared as fraudulent and undervalued under Section 66 and 45 of the IBC. Accordingly, the tribunal ordered the property to be discharged of all security interests created on such property by the company. While this matter saw a reversal of a transaction which was detrimental to the interests of the creditors, the tribunal did not analyse or examine the extent of liability of the directors who had approved the creation of the charge. Therefore, at present, the extent to which directors may be required to contribute to the assets of the company is yet to be adjudicated. company as imprisonment for a term not less than 1 year, extending up to 5 years or a minimum fine of Rs. 1 lakh, which may extend up to Rs. 1 crore, or both. However, an act investigated under this provision must not be committed more than 5 years before the insolvency commencement date and the relevant officer must fail to prove that no intent to defraud the creditors existed at the time the act was committed.

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[1] 1986 AIR 1370

[2] Civil Appeal No. 26/2018 in Company Petition No. (1B)77/ALD/2017

Provisions extending the liability of directors of a company to its creditors must be interpreted carefully. An errant director may be required to contribute to the assets of a company. However, the said provision does not clarify if the contribution is to be limited to the shareholding or monetary compensation payable to the director or if it may extend to the personal assets held by such director. Further, while failure to exercise due diligence in minimising loss to the creditor has been identified as one of the criteria for holding a director liable, the constituents of 'due diligence' have not been elaborated upon. Directors must be required to contribute to the assets of the company only to the extent such contribution is necessary to bring the company back to the position in which it would have been had the impugned transaction not been executed. While the contribution determined based on the aforesaid reasoning may be a substantial sum of money, it does impose an upper limit on the liability of the directors. Other factors to be considered while interpreting the provisions governing liability of directors and their implementation may be identified in greater detail by the tribunals and courts with time.

While the IBC creates a fiduciary duty of the directors towards creditors of a company during the statutory look back period, it also provides for avoidance of transactions or decisions which grant preference to the interests of one creditor to the detriment of the interests of the company through Section 43. This highlights that commencement of the statutory look back period does not result in cessation of the duty of the directors to uphold the interests of the company.

Fiduciary obligations of directors towards the creditors of a company are justified on account of participation of the directors in the decision-making procedure. Interpretation and implementation of such provisions require utmost care. An established jurisprudence in this regard will be established with time through practical implementation of relevant provisions of the IBC by the tribunals.

For further queries/clarifications, please write to:

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