Emerging Jurisprudence on Corporate Insolvency

Director Duties In The Twilight Zone

Introduction

"Insolvency is about financial death and ...financial rebirth."

- Elizabeth Warren

The directors of a company are integral to the everyday functioning of the company. Due to their stature and importance, they owe certain fiduciary duties towards the company, and are accountable to all the stakeholders. These duties are well recognized under common law, and have been codified under the Companies Act, 2013 ("the Act") in India. With the rise in non-performing assets and credit repayments in the country, there arose a need to make the directors more diligent, prudent and aware of decision making. It is in this backdrop that the Insolvency and Bankruptcy Code, 2016 ("the Code'') introduced specific duties that are owed by directors towards the creditors of their companies which are in financial distress. In this period of distress, that is, the twilight zone, where there exists a reasonable cause to believe that insolvency may commence, the directors have a duty to minimize the losses to the creditors, and protect the assets of the company. These directors must now act in the bona fide interests of their creditors, and not indulge in any fraudulent or wrongful trading.

In the course of this essay, the author reflects on the shift in the directors' duties from a financially sound/stable company to a company in financial distress. The author seeks to highlight the various responsibilities that the directors now have towards the creditors of their companies, and the liabilities they may incur if they do not take cognizance of such responsibilities. The author has raised a pertinent question *viz.* whether the directors of companies have any special duties/responsibilities during the twilight zone, or whether they have to carry out the same responsibilities as bestowed upon them under the Act. If special duties do exist during the twilight zone, it becomes pertinent to examine when exactly such duties arise. The author has answered the same by discussing and analyzing the existing international jurisprudence on insolvency laws, and examining similar provisions that have been adopted in the legal framework in India.

I. FINANCIAL DISTRESS: WHAT IS THE TWILIGHT ZONE?

The term "twilight zone" or "twilight period" has not been defined in any particular legislation, but in common business parlance, is referred to the period of trading when the company has insufficient funds to pay its debts, and is on the verge of insolvency. This situation may arise due to a number of reasons, most common of which include an immediate cash-flow crisis, or an unfavourable balance sheet arising from substantial losses over a significant period of time. In both the United Kingdom and the United States of America, the twilight period is considered to be "*the period between the point of knowledge or awareness of no real prospect of avoiding an insolvency proceeding against the company, and its actual commencement.*"[1] Thus, the twilight zone is that period where there exists no possibility of avoiding the liquidation of a company due to insolvency and the commencement of actual insolvency proceedings against the company under the insolvency laws of the country. During this period, the transactions that are entered into by the company are vulnerable to scrutiny, and might give rise to several liabilities on the part of the directors.

In India, section 66 of the Code identifies the twilight zone as the starting point of the period from the time when the director '*knew or ought to have known that there was no reasonable prospect of avoiding the commencement of corporate insolvency resolution*'.[2] This provision recognizes the specific duty of the directors towards the corporate creditors of the company when the company is on the verge of insolvency. It imposes a duty upon the directors to act in the best interests of such creditors, regardless of whether they are voluntary or involuntary creditors.[3] Voluntary creditors include those creditors who voluntarily enter into transactions with the company, such as trade creditors, institutional lenders, employees and debenture holders. Involuntary creditors, on the other hand, are those creditors who have entered into transactions with the company on a non-consensual basis, such as the State when it comes to levying corporate taxes on the company.[4] Further, creditors are categorized as secured or unsecured creditors, depending on whether a charge is created over the assets of the company when lending money to the company. Quite obviously,

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[1] D. Milman, *Strategies For Regulating Managerial Performance In The 'Twilight Zone' –Familiar Dilemmas & New Considerations,* 4 Journal of Business Law 493, 493 (2004).
[2] S. 66 (2), the Insolvency & Bankruptcy Code, 2016.
[3] P. Mulbert, *A Synthetic View of Different Concepts of Creditor Protection, Or A High Level Framework For Corporate Creditor Protection*, 7 European Business Organization Law Review 357, 365 (2006).
[4] S. Preetha, *The Fraudulent Trading Offence: Need For A Relook*, 4 NUJS Law Review 231, 233 (2011).

the twilight zone has serious business implications for any company, because it determines whether the company will eventually emerge from this situation of insolvency, or perish. Thus, the decisions taken by the directors on behalf of the company significantly impact the outcome of the insolvency process when the company or its creditors formally commences it.[5] In fact, the company will continue to be in the twilight zone unless the directors take initiatives of re-structuring and re-financing and appoint professionals who will help implement turn-around techniques to ensure the corporate renewal of the company. Hence, in this situation, the acts of the directors become very important for the sustenance of the company. If the directors fail to address the insolvency of the company during the twilight zone, the company will inevitably end up facing eventual bankruptcy.

II. Who Are Directors and What are their Fiduciary Duties?

The term "director" is defined under Section 2(34) of the Act[6] as "*a director appointed to the Board of a company*", wherein the Board of Directors ("the Board'') means the collective body of the directors of the company. These directors are the decision makers in the company, and their actions are attributable to the company itself and its best interests; they are responsible for the promotion of the success of the company.[7]

It is well established that these directors owe a fiduciary duty to the company,[8] and the nature and extent of the duty depends on the business of the company along with the knowledge and experience of the directors.[9] The primary fiduciary duties that are owed by the directors are (1) duty of good faith, (2) duty to avoid conflict with the company, (3) duty to exercise reasonable care, skill and diligence and independent judgment, and (4) duty to avoid undue gain or advantage. Under the Indian law, section 166 of the Act codifies the duties of the directors towards the company including its employees, shareholders and all other stakeholders.[10] These duties are owed by the directors, executive directors, non-executive directors, and even independent directors. Any

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[5] S. Dey, *Why Directors Should Be Wary of The Insolvency & Bankruptcy Code*, The Business Standard (22/10/2017), available at http://www.business-standard.com/article/opinion/why-directors-should-be-wary-of-insolvency-and-bankruptcy-code-117102200729_1.html, last seen on 13/02/2018.
[6] S. 2(34), the Companies Act, 2013.
[7] Dale & Carrington Invt. Pvt. Ltd. and Ors. v. P.K. Prathapan and Ors, (2005) 1 SCC 212.
[8] In Re: Lee Behrens & Co Ltd, 2 ChD 42 (1932, Companies Court).
[9] B. Hanton, *International Comparative Legal Guide to: Corporate Governance*, 4th ed. (London: Global Legal Group, 2011) at 1.
[10] S. 166, the Companies Act, 2013.

breach thereof invokes penal consequences.[11] To elucidate further, section 166 stipulates that when the company is solvent, the directors are expected to act in good faith, taking objective decisions in the interests of all the concerned stakeholders of the company. Thus, for a company that is in a solvent state, the directors are expected to fulfil their general fiduciary duties, and take bona fide, well-reasoned and objective decisions considering the beneficial interests of the company.

In light of the aforementioned provisions, a pertinent question that now arises is whether the directors in the company have any special or additional duties imposed on them during the twilight zone, as they already have certain responsibilities towards the company from the time they were appointed on the board as directors. Some insolvency experts are of the opinion that there exists no such additional obligation or responsibility on the board during the twilight zone, as it is a continuing and ongoing responsibility from the time they join the board itself. Some experts have also interpreted the existence of both such duties simultaneously due to a dearth of significant case law on this point. However, a point of distinction which must be brought to light is that under normal circumstances, the directors of a company enjoy only a fiduciary relationship[12] with the company, where they are responsible for protecting the interests of the shareholders as a whole.[13] This is because so long as the company is solvent, the shareholders are, in substance, the primary stakeholders in the company.[14] Hence, the nature of this fiduciary relationship revolves around the directors acting for or on behalf of these shareholders, thereby giving rise to a relationship of trust and confidence.[15] However, once the company is under financial distress, and has entered the twilight zone, there is an additional responsibility on the directors to prioritise the interests of the creditors above the shareholders.

III. THE SHIFT IN DUTIES: FROM SHAREHOLDER- CENTRIC TO CREDITOR-CENTRIC

Once the company has entered the twilight zone, the duties of the directors are affected as a result of the uncertainty involved regarding the company's financial conditions.[16] These directors are now expected to exercise reasonable skill, care and diligence, and have a duty to protect the

[11] S. 166(7), the Companies Act, 2013.
[12] Mothew v. Bristol and West Building Society, EWCA Civ 533, Ch 1, (1998, Court of Appeals).
[13] Sangarmsinh P. Gaekwad v. Shantadevi P. Gaekwad, (2005) 11 SCC 314.
[14] Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd, Ch. 258 (1983, Court of Appeals).
[15] *Supra* 11.
[16] *Directors and The Twilight Zone Law Essays,* Law Teacher, Available at https://www.lawteacher.net/free-law-essays/company-law/directors-and-the-twilight-zone-law-essays.php?cref=1, last seen on 22/02/2018.

interests of the corporate creditors and preserve the assets of the company so that the creditor may ultimately realize the debt out of those assets.[17] It is said that the protection of creditors' interests in a company that is fast approaching insolvency is based on ethical considerations and notions of fairness.[18] For example, in the UK, during the twilight period, the directors are expected to ensure that the company does not trade recklessly and that they act in good faith for the best interests of the creditors of the company.[19] This is because, during the twilight period, the interests of the company primarily coincide with the economic interests of their creditors.[20] Hence, the directors have an additional responsibility to *ensure that the affairs of the company are in order, and its property is not dissipated or exploited to the prejudice of such creditors*.[21]

Presently, there already exists a wide range of jurisprudence which confirms that "*when a company is insolvent, or of doubtful insolvency or on the verge of insolvency and it is the creditors' money which is at risk the directors, when carrying out their duty to the company, must consider the interests of the creditors as paramount and take those into account when exercising their discretion.*"[22] In the US, a Delaware court had held in the famous *Credit Lyonnais Bank Nederland, N.V v. Pathe Communications Corp*[23] case that when a company is operating on the verge of insolvency, the board of directors owes its duty to the creditors who, in essence, become the residue risk-bearers in the company. The court went on to clarify that when the company is solvent, it is the shareholders who are the residue risk-bearers and hence the primary stakeholders in the company. However, once the company is insolvent or is facing an immediate risk of insolvency, it is the creditors who become the primary risk-bearers, and hence their interests cannot be ignored. Thus, this remarkable shift in the focus of the directors' duties from shareholders to creditors during the twilight period is due to the fact that, during insolvency, the creditors have an economic interest in the company,[24] and such interests must be protected by the law. This insolvency-based

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[17] J. Lipson, *The Expressive Function of Director's Duties to Creditors*, 12 Stanford Journal of Law Business And Finance 224, 235 (2007).

[18] A. Keay, *Directors' Duties to Creditors: Contrarian Concerns relating to Efficiency and Over-protection of Creditors*, 66 Modern Law Review 665, 667 (2003).

[19] S. Barker, *Director Duties During The Twilight Zone And What They Mean For Financiers*, BFSLA Annual Conference (2016).

[20] Lonrho Ltd. v. Shell Petroleum Co. Ltd, 1 WLR 627 (1980, House of Lords).

[21] Winkworth v. Edward Baron Development Co. Ltd., 1 AIIER 114 (1987, House of Lords).

[22] Geyer v Ingersoll Publications Co, 621 A 2d 784 (1992 Delaware Chancery) 178; Kinsela v Russell Kinsela Pty Ltd (in liq), 4 NSWLR 722, 730 (1986, Court of Appeals, New South Wales).

[23] Credit Lyonnais Bank Nederland, N.V v. Pathe Communications Corp 1991 WL 277613 (1991, Delaware Chancery).

[24] West Mercia Safetywear Ltd (in Liquidation) v Dodd, BCLC 250 (1988, Court of Appeal).

creditor-centric approach ensures that the company does not incur any further liabilities, and maximum effort is directed towards ensuring that the company successfully emerges out of insolvency. If subsequently the company fails to come out of insolvency, only then will the liquidation process take place, and the creditors will be able to realize the monies owed to them from the assets of the company.

It is important to note that the law is still unclear and there exists a certain ambiguity as to when exactly this shift in interests from shareholders to creditors occurs. This is because there does not exist a specific requirement on the directors to automatically place the company into a formal insolvency process at the point at which they become aware that the company's cash flow has turned negative.[25] It was observed in *Nicholson v. Permakraft (NZ) Ltd* [26] that the creditors' interests are to be considered by the directors when the company was either '*insolvent, or near insolvent, or of doubtful insolvency, or if a contemplated payment or other cause of action would jeopardise its solvency.*' Quite similarly, in the landmark decision of *Brady v. Brady*,[27] it was confirmed that the interests of the creditors started from when the "*company was insolvent, or even doubtfully solvent."* Therefore, although it becomes very difficult to identify the exact circumstances that trigger insolvency, as per section 66 of the Code, the threshold appears to be whether or not the circumstances of the company are such that the director knows, or can reasonably expect, that any action they take could result or lead to the insolvency of the company. Hence, it can be argued that although there exists no clearly demarcated point after which the directors of the company should prioritize the interests of their creditors, a reasonable expectation of insolvency coupled with the knowledge that insolvency may be near will cause this shift in the directors' duties. After all, at this point, the directors also have a responsibility to act in accordance with insolvency laws and not in any arbitrary manner.

IV. THE SPECIAL DUTIES & RESPONSIBILITIES IN THE TWILIGHT ZONE

In English jurisprudence, the responsibilities of the directors towards the creditors during the twilight zone are well known. The directors of a company have been found to be liable for acts

[25] Re Marini Ltd. (The Liquidator of Marini) v Dickenson & ors, EWHC 334 (2003, England & Wales High Court).
[26] Nicholson v Permakraft (NZ) Ltd, 1 NZLR 242 (1985, Court of Appeal Wellington).
[27] Brady v Brady, 2 AII ER 617 (1988, House of Lords).

that take place during the twilight zone, as a consequence of specific insolvency-related offences.[28] For example, these directors have been held to be liable if they have completely disregarded the interests of the creditors. In *Yukong Lines Ltd of Korea v. Rendsburg Investments Corporation,*[29] the court held that although a director does not owe a direct fiduciary duty towards their creditors, indirectly, the creditors' interests are represented through the official liquidator, and the directors must have regard to the creditor's interests. Furthermore, it is well settled that the directors must not engage in fraudulent trading when the company is in the twilight zone. The UK Companies Act of 2006 specifically penalizes persons knowingly taking part in wrongful and fraudulent trading with an intention of defrauding the creditors.[30] Such wrongful/fraudulent trading has been defined to mean the incurring of further debts when there are reasonable grounds for suspecting that a company would not be able to pay off its principal debt.[31] The liability of the directors for such fraudulent trading during the twilight period will only be determined once the company goes into liquidation. In that case, in order to determine the said liability, the director's conduct in the period leading up to the insolvency will be taken into consideration.[32] Thus, the courts will hold the directors liable if '*the directors closed their eyes to the reality of the company's position, and carried on trading long after it should have been obvious to them that the company was insolvent and that there was no way out for it*."[33] In order to construe this intention, it will be necessary to prove that the debtor never intended to pay the creditor, and carried on trading even after such trading was prejudicial to their interests.[34] Hence, an intention to defraud creditors could be inferred if the company carries on business and incurs debt when, to the knowledge of the directors, there is no reasonable prospect of the company being able to repay. Thus, one of the primary duties which arise against the directors is to prevent wrongful and fraudulent trading during the twilight zone.

In India, when a company continues to operate in financial distress and is unable to recuperate, the Code provides for an insolvency resolution process, which could be initiated either by the creditors

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[28] V. Patnaik, *Directors in the Twilight Zone V,* 5 INSOL International 411 (01/05/2017), available at http://www.insol.org/_files/Publications/TwilightV/Twilight%20V%209%20May%20BM%20linked%202017.pdf, last seen on 03/02/2018.

[29] Yukong Line Ltd of Korea v. Rendsburg Investments Corporation, 4 All ER 82, 884 (1997, Queens Bench Division).

[30] S. 993, the Companies Act, 2006 (United Kingdom).

[31] T. Bachner, *Wrongful Trading – A New European Model for Creditor Protection*, 5 E.B.O.R 293 (2004).

[32] S. 66, the Insolvency and Bankruptcy Code, 2016.

[33] Re Continental Assurance Company of London Plc, All ER (D) 229 (2001, High Court of England and Wales).

[34] J. Dine, *Punishing Directors*, Journal of Business Law 325, 333 (1994).

or by the company itself. In this process, once the insolvency application is admitted, and the insolvency resolution professional ("IRP") is appointed, the Code suspends the powers of the board of directors.[35] The Code then bestows authority on the IRP to protect and preserve the value of the property of the corporate debtor and manage its operations.[36] Since the directors are not empowered to act beyond this period, they cannot be made liable for any further actions. However, the Code clearly imposes additional duties on the part of the directors during the twilight period, and if these duties are ignored, the directors could be held liable. For instance, section 66(2) of the Code recognises a specific duty of the directors towards the creditors, when the company is near insolvent. The directors are now obligated to conduct due diligence and minimise the loss to the creditors. Due diligence is considered to have been conducted if it was reasonably expected of a person carrying out the same functions as that of such director.[37] A breach of this provision makes the director personally liable to contribute to the assets of the distressed company.

Moreover, section 45 of the Code carves out an implied duty on the directors to undertake prior transactions carefully,[38] and provides for a 'look-back' provision where the directors can still be held liable for past actions. Such a period of look back encompasses the prior 12 months for regular transactions and the prior 24 months for related party transactions. Hence, the directors are now duty bound to ensure that the transactions which the company undertakes are bona fide, or they are liable to be set aside. Therefore, it could be argued that the legislative intent behind these provisions is to make the directors more responsible, and to prevent fraudulent activities during the twilight zone. Furthermore, the National Company Law Tribunal ("the NCLT") also has the power to examine the affairs of the company, and may impose liability on the directors for fraud on creditors or wrongful disposal of assets. The legal position in India seeks to undo any transaction entered into by the company during the twilight period when it is prejudicial to the interests of the company. Under section 66 of the Code, the directors of a company that has entered the process of insolvency could be held liable for any insolvency-related transactions, which include not only fraudulent and wrongful trading, but also preferential transactions with certain persons, concealment of property, undervalued transactions that are considered prejudicial to the interests of the creditors, or even fudging the books of accounts and not making disclosures. Even

[35] Ss. 17(1)(b) & 23(2), the Insolvency & Bankruptcy Code, 2016.
[36] *Ibid* s. 20(1).
[37] *Ibid* s. 66(2)(b).
[38] *Ibid* s. 45.

for sick industrial companies in India, the board of directors has a responsibility to submit a scheme of rehabilitation of the company to the NCLT. Once the winding up order is passed, any further disposition of property is void as the company ceases to be the beneficial owner of the assets, and it is the official liquidator who deals with the company's properties.[39]

Section 66 of the Code thereby requires that the directors exercise *reasonable due diligence* for any function carried out by the director in order to minimize the potential loss to creditors of the corporate debtor. It states that, in order to determine the sanctity of the directors' conduct, *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.* Thus, when the directors knew or ought to have known that there was no reasonable prospect of preventing the commencement of corporate insolvency resolution process ("CIR process"), they are obligated to conduct due diligence to minimize potential loss to the creditors. A breach of these provisions makes the director personally liable to contribute to the assets of the distressed company. This criteria as laid down by section 66 has been taken from English law, and carries with it both objective and subjective requirements. The objective requirements stipulate that the knowledge, skill and experience must be exercised of a reasonable person in his capacity as director towards the company.[40] The subjective requirement means that the knowledge, skill and experience of that particular director shall be factored in by the Court, when deciding these questions.[41] Finally, section 69 of the Code also recognises stringent criminal penalties for defrauding creditors if the defaulting person is an officer of the company.[42] The maximum stipulated punishment is 5 years' imprisonment and/or maximum fine of INR 1 crore. Therefore, section 69 adds an additional responsibility on the directors to be more vigilant in their conduct and seeks to deter fraudulent behaviour by imposing such steep punishments.

Hence, in order to prevent any personal liability from arising, it is expected that the directors should act with a view to *minimizing the potential loss to the creditors*, by conducting reasonable due

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[39] Official Liquidator v. P.A. Tendolkar, AIR 1973 SC 1104.
[40] Bishopsgate Investment Management Ltd. (in liq) v Maxwell (No.2), BCLC 1282 (1993, Court of Appeal).
[41] Re D'Jan of London Ltd., BCC 646 (1993, High Court of Justice Chancery Division).
[42] S. 69, the Insolvency & Bankruptcy Code, 2016.

diligence. These directors are also expected to disclose any material information and inform the creditors of any further loss that may arise. They must also prevent any arbitrary and fraudulent trading from taking place, thereby preventing exposure to any further risks. Thus, in addition to the general fiduciary duties prescribed under the Act, the Code clearly seeks to impose special duties on the directors, to ensure that there is proper conduct on their part prior to the actual insolvency, and prevent them from fraudulently trading with the creditors' money. The Code clearly lays these additional responsibilities on the directors during the twilight zone, in order to protect the bona fide interests of the creditors. Hence, it can be said that if a director breaches any of these provisions and engages in any fraudulent or wrongful activity during the twilight zone, then it will be "akin to walking a legal tightrope."[43]

V. CONCLUSION

At the very outset of this essay, the author had propounded a simple, yet significant question, that is, whether the directors of a company have any special duties/responsibilities when the company is in the twilight zone? The author has answered this in the affirmative. Although the directors owe a fiduciary relationship towards the company under section 166 of the Companies Act, the directors have additional obligations towards the creditors during the twilight zone. This is because although there existed no codified duties of the directors of a company towards its creditors, the Code has identified certain responsibilities of the directors when the company is insolvent or is fast approaching insolvency. In addition to the various duties of the directors under the Companies Act, the Insolvency Code bestows additional responsibilities on the directors towards their creditors during the twilight zone. The simple rationale behind this is to ensure that the directors do not engage in any wrongful or fraudulent activity, and do not mis-utilize the money that they owe to the creditors. Since the twilight zone means that the company is already in a precarious position, the directors must endeavor to act in the bona fide interests of the creditors and ensure that the company steers away from insolvency.

Another question which the author had raised subsequently was when exactly this shift in directors' duties occurs. It is the opinion of the author that reasonable knowledge of insolvency of

[43] H Hansen, *Tough Insolvent Trading Laws Hinder Corporate Restructuring (2009*), McCullough Robertson Lawyers, available at <http:/www.mccullough.com.au/articles/news.aspx?p=410&itm=2511>, last seen on 06/02/2018.

the company in the minds of the directors appears to be the point at which the directors should prioritize the interests of the creditors, over the shareholders. For this, a constant review the company's position is required. If this identification can be made at an early stage, the directors will be better equipped to deal with the situation of insolvency and take the requisite measures.