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M P Ram Mohan* & Urmil Shah$^{\Psi}$

Abstract

The life of a company depends upon the fine balance between its management led by Board of Directors and shareholder, and non-shareholder constituencies acting as the risk bearers. The Board of Directors therefore are subjected to fiduciary duties towards both these constituencies at all financial phase of the company – solvency, insolvency and borderline insolvency. The director liability framework in India is currently split with obligations enshrined under the Companies Act, 2013 during solvency and Insolvency and Bankruptcy Code, 2016 during insolvency and borderline stage. The lack of judicial interpretation and scholarly discourse on the insolvent and borderline insolvent director liability framework has resulted in several practical challenges. To understand parallels, the paper comparatively analyzes the liability framework as existing under the corporate and insolvency laws of the United States and the United Kingdom with Indian insolvency law. The paper suggests that there is a need to align the Indian corporate and insolvency law through statutory measures to increase the remedial protections available to creditors during borderline insolvency. The paper also highlights mitigation measures which can be undertaken by the management to reduce the scope for director liability, until legislative or judicial clarity is provided on the framework.

Keywords: Director liability framework; borderline insolvency; wrongful trading liability; derivative actions; out-of-court restructuring; Insolvency and Bankruptcy Code, 2016

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1. INTRODUCTION: DIRECTOR RESPONSIBILITY DURING CORPORATE FAILURE

A company being an artificial legal entity relies upon the wisdom and actions undertaken by the Board of Directors for its functioning. Accordingly, to protect the interests of the company, corporate law envisages certain set of affirmative and negative duties upon the board of directors. The nature of the duties envisaged on the directors varies, however, general duty obligations includes the duty of care, avoid any conflict of interest, loyalty, acting in good faith, promote the objectives of the company, initiate insolvency/liquidation proceedings etc.[1] Further, since the company doesn't operate in isolation but works within the macro and micro environment, these duties have to be exercised not only towards the company but also consider various stakeholders, including shareholders, employees and workers, creditors, community, government and regulators etc.[2]

In the lifecycle of a corporation, especially in the context of insolvency, an entity goes through different stages – solvency, borderline (the terms borderline and twilight zone are synonymously used) and insolvency. The nature and expectation of the duties of the board of directors also varies during all the stages. It is undisputed that the primary set of duties of the directors, in the stage of financial stability of the company, lies towards the shareholders, unless non-shareholders have specifically contracted for managerial protections.[3] The decisions taken by the directors during the stability/solvent stage are generally in respect of expansion of business, purchase of additional assets, increasing and diversifying business capital etc. Since the shareholders contribute towards the business loss of the company by being primary risk bearers during solvency, the inherent nature of the director actions directly affects the stakes

[1] SV Inv. Partners, LLC v. Thought Works, Inc., 7 A.3d 973, 987 (Del. Ch. 2010); In re Abbott Labs. Derivative S'holders Litig., 325 F.3d 795, 808 (7th Cir. 2003); In re Doctors Hosp. of Hyde Park, Inc., 474 F.3d 421, 428 (7th Cir. 2007); N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).
[2] Re Smith & Fawcett Ltd., [1942] Ch. 304; Weaver v. Kellogg, 216 B.R. 563, 582–84 (S.D. Tex. 1997); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003); Carroll U. Stephens et. al., *An Organizational Field Approach to Corporate Rationality: The Role of Stakeholder Activism*, 15 Business Ethics Quarterly 1 (2005).
[3] The private contract between the debtors and creditors may provide for contractual clause to afford duty of primacy over unsecured creditors during repayment of interest. The contract may provide for special circumstances for affording such primacy which includes fraud, insolvency or violation of any express law in this regard. See. Sawyer v. Hoag, 84 U.S. 610 (1873);. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992); Mutual Life Insurance Co. of New York v. Rank Organisation Ltd., [1985] BCLC 11; Re Pantone 485 Ltd., [2002] 1 BCLC 266.

of the shareholders.[4] This implies, that any non-shareholder constituency, including creditors do not have any direct remedy against the directors.[5] The policy rationale behind such protection lies in the genesis of the ownership of the company being in the hands of shareholders and opportunity for creditors to negotiate special protections through their debt obligation contracts.[6] Further, a lack of privity between non-shareholder constituencies like creditors and the company, and the presence of remedial measures for creditors in nature of clawback of fraudulent conveyance, implied covenants of good faith and fair dealing, protects the creditors bargaining capacity.[7]

Similarly, during the stage of insolvency of the company, there is a shift in duties of directors towards the creditors, who become residual risk-bearers and the best interest lies in conserving the remaining assets of the company towards either revival of the company or repayment of the obligated debt.[8] While courts are divided in their opinion over the complete termination of duties of directors towards shareholders during insolvency stage, there is some consensus that duties are primarily owed towards creditors and secondly, if afforded by statute law, towards shareholders.[9] Thus, in the absence of any statutory protections, shareholders are not afforded direct action against the directors during insolvency. The policy rationale behind this approach is to afford protection to creditors as they lend debt with expectation to earn interest o which can only be protected when the corporate assets are conserved,[10] resulting in deepening the insolvency.[11] The shifting of duties during insolvency is fruitful only when there is clarity over the legislative determination of insolvency. The Insolvency and Bankruptcy Code, 2016 (IBC) of India by envisaging a default-based cash flow test provides sufficient grounds for

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[4] Brown v. Vencap Inv. Corp., 2728 (Tenn. Ct. App. Mar. 31, 1984); Radhabari Tea Co. P. Ltd. v. Mridul Kumar Bhattacharjee, 2010 (153) CompCas 579 (Gau).
[5] Katz v. Oak Industries Inc., 508 A.2d 873 (Del. Ch. 1986); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc. 716 F. Supp. 1504, 1517 (S.D.N.Y 1989); Uppal Housing Pvt. Ltd., CS (COMM) 1079/2018.
[6] NACEPF v. Gheewalla, 930 A.2d 92, 101–02 (Del. 2007); Berg & Berg Enters., LLC v. Boyle, 178 Cal. App. 4th 1020, 1039 (Cal. Ct. App. 2009). [the proposition is long recognized but expressly explained in these two cases]
[7] Rutheford B. Campbell & Christopher W. Frost, *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 Journal of Corporate Law 491, 493 (2007).
[8] Wood v. Drummer, 30 F. Cas. 435 (1st Cir. 1824).
[9] Arnold v. Knapp, 84 S.E. 895, 899 (W. Va. 1915); Bank Leumi-Le-Israel, B.M. v. Sunbelt Indus., Inc., 485 F. Supp. 556, 559 (S.D. Ga. 1980);; Fredrick Tung, *Gap Filling in the Zone of Insolvency*, 1 Journal of Business and Technology Law 607 (2006-2007);.
[10] Elina Chechelnitsky, D*&O Insurance in Bankruptcy: Just another Business Contract*, 14 Fordham Journal of Corporate and Financial Law 825 (2009).
[11] In Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 168 (Del. Ch. 2006), the term "deepening insolvency" was defined as a catchy phrase to mean instances where the insolvent corporation and/or its creditors are harmed when the director of the former fraudulently disposes of corporate property. See. Stephen M. Packman, *Directors and Officers in the Zone of Insolvency: Take Action with Caution to Avoid Personal Exposure*, New Jersey Law Journal (2008).

understanding the ramifications of certain determination of insolvency.[12] The remedies available to creditors during the insolvency stage involves injuncting the directors from transferring, encumbering, liquidating corporate assets or to indulge in transactions which results in preferential treatment amongst different categories of creditors.[13]

During the borderline or twilight stage, where the company is facing economic and financial crisis and being on the verge/likelihood of failure, there is a shift in the duties of the board of directors[14]. The risk bearer of the duties during the borderline stage, however, varies from jurisdiction to jurisdiction, mainly, due to lack of recognition of such stage by company law statues. The shifting of director duties during borderline insolvency, the main thrust of this paper, remains a dilemma amongst the judiciary, practitioners and academicians precisely due to its lack of legislative codification.[15] One school of thought perceives that the directors owe duties during the borderline stage towards the shareholders since it is a stage which the company may eventually overcome and doesn't necessarily lead to insolvency.[16] The other school of thought however suggests that the duties have to be exercised in regards to the expectations of the creditors as the stage amounts to impeding circumstances which may result in insolvency of the company.[17] Accordingly, the legal remedies available to shareholder and

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[12] The US Bankruptcy Code, 1978 on one hand provides for incorporation of balance sheet insolvency test whereas judiciary over period of time evolved cash flow insolvency test to aid better valuation of insolvent debtor. See. Robert J. Stearn & Cory D. Kandestin, *Delaware's Solvency Test: What Is It And Does It Make Sense? A Comparison of Solvency Tests under The Bankruptcy Code and Delaware Law*, 36 Delaware Journal of Corporate Law 166 (2011). The UK Insolvency Act, 1986 on the other incorporates both cash flow and balance sheet test by which creditors can take recourse to either of the grounds as per the circumstances demand. See. Andrew Keay, *Challenging Payments made by Insolvent or Near Insolvent Companies*, 3 Nottingham Insolvency and Business Law Journal 11 (2015). This incorporation of both the tests led to significant conundrum over insolvency determination as a company may be deemed insolvent as per cash flow test and remain solvent under the balance sheet test and vice versa. See. Howship Holdings Pty Ltd v Leslie (1996) 14 ACLC 1; Stephen R. McDonnell, *Geyer v. Ingersoll Publications Co: Insolvency Shifts Directors' Burden from Shareholders to Creditors*, 19 Delaware Journal of Corporate Law 177, 196 (1994)

[13] Joseph Jude Norton, *Relationship of Shareholders to Corporate Creditors upon Dissolution: Nature and Implications of the "Trust Fund" Doctrine of Corporate Assets*, 30 The Business Lawyer 4 (1975).

[14] Ryan Purslowe, *Decisions in the Twilight Zone of Insolvency - Should Directors Be Afforded a New Safe Harbour*, 13 University of Notre Dame Australia Law Review 113 (2011).

[15] Teleglobe USA Inc. v. BCE Inc. (In re Teleglobe Commc'ns Corp.), 493 F.3d 345, 356 (3d Cir. 2007); Stephen Bainbridge, *Much Ado about Little - Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 Journal of Business and Technology Law 335 (2006-2007); Marshall Huebner & Hugh McCullough, *The Fiduciary Duties of Directors: Emerging Clarity*, Davis Polk & Wardwell (2008); Gaurav Joshi, *Position of Directors in Twilight Zone*, IBC Laws (2020)

[16] Hallinan v. Republic Bank & Trust Co., 519 F. Supp. 2d 340, 349 n.10 (S.D.N.Y. 2007); In re Adelphia Commc'ns Corp., 323 B.R. 345, 386 n.140 (Bankr. S.D.N.Y. 2005); George W. Kuney, *Fiduciary Duties of Directors and Officers Operating in the Zone of Insolvency*, California Business Law Review Practice (2002).

[17] Carrieri v. Jobs.com, Inc., 393 F.3d 508, 534 n.24 (5th Cir. 2004); Roselink Investors, L.L.C. v. Shenkman, 386 F. Supp. 2d 209, 215 (S.D.N.Y. 2004); David Shemano & Jenifer Walder Leland, *The War On Corporate Fiduciaries: Have the Fiduciaries Won?*, American Bankruptcy Institute (2007); Anu R. Singh & Harold L. Kaplan, *The Opportunity and "Duty" to Restructure Non-Profit Health Care Debt*, 28 American Bankruptcy Institute Law Journal (2009).

non-shareholder constituencies also varies during the borderline stage ranging from direct action to derivative action claims.[18] This stark distinction between the two schools of thought has been discussed in great detail in the succeeding sections.

The remedies available to the aggrieved persons against the directors and/or the company also depends upon the stage of the company and risk-bearer of the duty. For instance, a creditor cannot be afforded legal protection against claims of balance sheet insolvency during the solvency stage or minority shareholders cannot be granted defense against oppression and mismanagement during insolvency stage.[19] A literature review of the shifting of duties suggests that the law on subject has undergone excessive scrutiny which has in fact resulted in expansive application of the duties beyond known ventures[20], which is further discussed in the succeeding sections. The theoretical background to this shifting of duties lies in the application of the "*business judgment rule*"[21] and "*trust fund doctrine*"[22]: the solvency stage is governed by the *business judgment rule* and insolvency stage by the *trust fund doctrine*. Although being corollary of each other, both these principles impose an obligation upon the directors to act in the best interests of the company. The variance towards different stakeholders depends upon the interpretation accorded over the years by the judicial and legislative law-making.

The paper is organized as follows: Section 2 covers the doctrine of Business Judgment Rule and Trust Fund Doctrine and the legal framework of director responsibility as applicable in the US and UK. Section 3 seeks to understand the Indian director responsibility framework as provided during solvency, insolvency and borderline insolvency. Section 4 analyzes the challenges associated with the existing Indian framework on director responsibility and discussed possible solutions. Section 5 concludes with the liability mitigation measures which

[18] Terrence Arnold, *Directors' Duties In An Insolvency Or Near Insolvency Situation And Remedies Available To Creditors*, Judicial Colloquium Hong Kong (2015).
[19] Simon Mortimore, *Company Directors: Duties, Liabilities, and Remedies*, Oxford University Press (2013); Len Sealy, *Directors' Wider Responsibilities - Problems Conceptual, Practical and Procedural*, 13 Monash University Law Review 164 (1987).
[20] David Thomson, *Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppres*s, 58 University Toronto Faculty of Law Review 31 (2000); Jon Dwain McLaughlin, *The Uncertain Timing of Directors' Shifting Fiduciary Duties in the Zone of Insolvency: Using Altman's Z-Score to Synchronize The Watches of Courts, Directors, Creditors, and Shareholders*, 31 Hamline Law Review 147, 160 (2008)
[21] Michele Ubelaker, *Director Liability under the Business Judgment Rule: Fact or Fiction*, 35 Southwestern Law Journal 775 (1981-1982); Gerald Spindler, *Trading in the Vicinity of Insolvency*, 7 European Business Organization Law Review (2006).
[22] Gregory Varallo & Jesse Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 The Business Lawyer 239 (1992-1993); James Gadsen, *Enforcement of Directors' Fiduciary Duties in the Vicinity of Insolvency*, 24 American Bankruptcy Institute Journal 1 (2005).

can be undertaken by the directors until the challenges associated with the existing framework are resolved.

2. IMPUTATION OF RESPONSIBILITY: EVOLUTION OF *BUSINESS JUDGMENT RULE* AND *TRUST FUND DOCTRINE*

The foundational basis for director duties towards various stakeholders of a company are based on the Business Judgment Rule and Trust Fund Doctrine. The business judgment rule is a presumptive and affirmative duty cast upon the board of directors, that all the actions and decision undertaken by them based upon their commercial wisdom are necessarily in the best interest of the company.[23] The legal effect of the rule is that it absolves the directors from corporate and personal liability for good faith and honest errors in making business judgment.[24] It is not a substantive rule of protection but a set of evidentiary premises rebuttable in nature.[25] The rule was essentially developed as a judicial creation by the US courts to protect company directors from imposition of civil liability for the decisions they make on behalf of the company[26] and gradually adopted across the world to make debtor-friendly legislations.[27]

Under this rule, the plaintiff can present evidence to contradict the actions of the board of directors as not being in the best interests of the company. In a negative sense, the rule the jurisdiction of the Courts to test the validity of director conduct while being in the capacity of the officer of the company.[28] The policy rationale outlining the rule is that in its absence, directors would often remain under the threat of legal action being at the helm of aggrieved stakeholder.[29] However, there are certain circumstances under which safe harbor cannot be granted to directors under the rule such as fraud, undervaluation of corporate property, conflict

[23] SH Case, *The So-Called Business-Judgment "Rule" in the Chapter 11 Setting*, American College of Bankruptcy (2004).
[24] Joseph D. Zamore, Mary C. Sotera & Susan Ferraro Smith, *Business Torts*, Matthew Bender (2010).
[25] Andrew Keay et. al., *Business Judgment and Director Accountability: A Study of Case-Law Over Time*, 20 Journal of Corporate Law Studies 2 (2020).
[26] Stephen Bainbridge, Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, Vanderbilt Law Review 89 (2004).
[27] Friedrich Hamadziripi & Patrick Osode, *The Nature and Evolution of the Business Judgment Rule and its Transplantation to South Africa under the Companies Act of 2008*, 33 University of Fort Hare Review 1 (2019).
[28] Kelli Alces, Larry Ribstein, Alan Schwartz, & Simone Sepe, *Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies - Theory and Policy*, 1 Journal of Business and Technology Law 291 (2007)
[29] Andrew Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty*, 66 Maryland Law Review 398 (2007).

of interest, non-arm's length related transactions, unfair contracts etc.[30] Similarly, when directors deal in inter-corporate transactions or self-dealing not for the benefit of the company, then also the protection of the rule is not accorded.[31]

The trust fund doctrine on the other hand presupposes negative liability upon the directors to not utilize corporate assets in manner prejudicial to company's interest or to the detriment of stakeholders. While the trust fund is not a "trust" in a legalistic sense, however, corporate assets have to be held in "*quasi-trust*" for preservation during the liquidation of the company.[32] The essence of the doctrine is that the company assets are held in trust for distribution amongst creditors, imposing a fiduciary duty upon the directors to not dispose of those assets in contravention of rights of creditors.[33] Thus, a legal duty is cast upon the directors to act for the benefit of creditors and not necessarily for in respect of shareholders. The doctrine being a judicial creation[34] was incorporated for certain director obligation during insolvency; however, has been expanded to even cover instances of solvency and borderline insolvency[35], as highlighted in the succeeding paragraphs. Similarly, the remedies also depends upon its application in the respective life cycle of the company and existing protection available to shareholder and non-shareholder constituencies.

Historically, the director responsibility frameworks evolved quite differently in the US and the UK. In the US, it developed primarily through judicial interpretation of general statutory laws whereas in the UK specific protection were provided within the statute law itself.[36] While *Sundaresh* has provided a succinct account of the development of the legal position of the

[30] Jean Du Plessis & Jim Mathiopoulos, *Defences and Relief from Liability for Company Directors: Widening Protection to Stimulate Innovation*, 31 Australian Journal of Corporate Law 17 (2017); Andrew Lumsden, *The Business Judgement Defence - Insights from ASIC v. Rich*, 28 Companies and Securities Law Journal 3 (2010).
[31] FDIC v. Sea Pines Co., 692 F.2d 973 (4th Cir. 1982).
[32] The doctrine was applied initially by Courts during the stage of liquidation; however, with its extent in Wood v. Drummer, 30 F. Cas. 435 (1st Cir. 1824) and Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 34 (Del. Ch. Dec. 30, 1992) was made applicable in stages of borderline insolvency as well. See. Ann E. Conaway Stilson, *Re-examining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Director's Duties to Creditors*, 20 Delaware Journal of Corporate Law 1 (1995).
[33] Jewel Recovery, L.P. v. Gordon (In re Zale Corp.), 196 B.R. 348, 354-55 (Bankr. N.D. Tex. 1996).
[34] Wood v. Drummer, 30 F. Cas. 435 (1st Cir. 1824); James Ellis & Charles Sayre, *Trust-Fund Doctrine Revisited*, 24 Washington Law Review and State Bar Journal 134 (1949).
[35] Neil Ruben, *Duty to Creditors in Insolvency and the Zone of the Insolvency: Delaware and the Alternatives*, 7 New York University Journal of Law and Business 333 (2010-2011).
[36] Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DePaul Business and Commercial Law Journal 295, 296, 300–01 (2004).

shifting of duties in context of US and UK laws[37], it is essential to understand its impact on development of the nascent Indian insolvency laws vis-à-vis corporate laws.

2.1. Director Liability Framework in US:

The US Model Business Corporation Act, 2002, a federal law, which provides for minimum corporate governance norms for US companies, states that the director has a duty of good faith, care and loyalty.[38] The extent of recognition of these duties were left upon the State legislations with Section 141 of Delaware General Corporation Law, 1899 provides that directors and officers of all corporations shall have duties as defined by the bylaws.[39] Further, Section 102(b)(7) of Delaware General Corporation Law, 1899 states that the bylaws must not restrict the personal liability of directors, in any manner, with regards to their fiduciary duties. The term "fiduciary duties" was not defined by the General Corporation Law, 1899 and the Delaware Courts interpreted it to cover both the Business Judgement Rule and the Trust Fund Doctrine[40]. The US courts have often held that the directors are vested with the duty of care, obligation and are liable towards shareholders[41] though not ordinarily towards to bondholders or creditors.[42] Similarly Section 548 of US Bankruptcy Code provides for avoidance of fraudulent transfers made within the period of 2 years which involves intentionally fraudulent transfer or undervalued consideration outside the ordinary course of business.[43] The creditors at this stage are entitled to very limited protection under the "implied covenant of good faith" found in commercial contracts[44] and directors are constantly under the threat of legal action by the shareholders for granting contractual protection, not specified under law.[45] The judicial interpretation in the US on creditor rights during insolvency and borderline insolvency

[37] Gautam Sundaresh, *In Whose Interests Should a Company be Run? Fiduciary Duties of Directors during Corporate Failure in India: Looking to the West for Answers*, 8 Michigan Business & Entrepreneurial Law Review 291 (2019).
[38] Section 8.30 of US Model Business Corporations Act, 2002; Michale Dooley, *Rules, Standards, and The Model Business Corporation Act*, 74 Law and Contemporary Problems 45 (2011).
[39] The reference to Delaware state law is made as majority of the US corporations are incorporated in this jurisdiction, thereby making the state law applicable upon them. See. Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vanderbilt Law Review 83 (2019).
[40] Lawrence Hamermesh & Leo Strine, *Fiduciary Principles And Delaware Corporation Law: Searching For The Optimal Balance By Understanding That The World Is Not*, Oxford Handbook of Fiduciary Law (2017).
[41] In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005).
[42] Metropolitan Life Ins. Co. v. RJR Nabisco, Inc. 716 F. Supp. 1504, 1524–25 (S.D.N.Y 1989).
[43] Amir Licht, *My Creditor's Keeper: Escalation of Commitment and Custodial Fiduciary Duties in the Vicinity of Insolvency*, Washington University Law Review (2021); David Carlson, *Fraudulent Transfers: Void and Voidable*, 29 American Bankruptcy Institute Law Review 1 (2021).
[44] Katz v. Oak Industries Inc., 508 A.2d 873 (Del. Ch. 1986).
[45] Broad v. Rockwell Int'l Corp., 642 F.2d 929, 958 (5th Cir. 1981); Andrew Keay, *Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors* Modern Law Review (2003).

underwent significant change due to multiplicity of lawsuits being filed by creditors against directors over disposal of corporate assets.[46] Gradually, the US Courts accorded that during insolvency primacy must be given to creditor's expectations for preservation of value of the company.[47] This resulted in creditors being allowed to pursue direct action claims against the board of directors for breach of fiduciary duties.[48]

The shifting of duties during borderline insolvency remained a legal and policy challenge. This has resulted in several divergent court decisions being decided due to lack of clarity until the Delaware Chancery Court's decision in *Credit Lyonnais Bank v. Pathe Communications.*[49] The Court in this case was faced with judicial determination of board of directors of the debtor company challenged by the creditor bank on account of repetitive defaults and based upon conditions under the agreement to the leveraged buyout financing of the debtor company. The court, held, "*where a corporation is operating in the vicinity of insolvency, board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise*", and accordingly companies during borderline stage need to take into consideration interest of all categories of stakeholders, including shareholders, creditors, suppliers, customers etc.[50]

The *Credit Lyonnaies Judgement* provided path-breaking guidance to the board of directors as their fiduciary duties were extended to cover creditors even prior to the initiation of formal insolvency proceedings.[51] The different bankruptcy courts made varying interpretation of the judgment with one of the most immediate and expansive interpretation that Courts were not obligated to distinguish between the two instances of insolvency - based upon facts and claims of breach of fiduciary duties.[52] A restrictive interpretation to the judgement was applicable where the creditors can evidence actual fraud or preference by the directors.[53] Accordingly, under the latter approach, the creditors were required to prove that the fraud was involved in

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46 Harvey Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 Seton Hall Law Review 1467 (1992-1993).
47 Geyer v. Ingersoll Publications Comp., 621 A.2d 784 (Del. Ch. 1992); Steven L. Schwarcz, *Rethinking a Corporation's Obligation to Creditors*, 17 Cardozo Law Review 647, 666 (1995).
48 Production Resources Group v. NCT Group, 863 A.2d 772, 798 (Del. Ch. 2004).
49 Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 34 (Del. Ch. Dec. 30, 1992).
50 Robert Morris, *Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 Journal of Corporate Law 61 (1994).
51 Cory D. Kandestin, *The Duty to Creditors in Near-Insolvent Firms: Eliminating the "Near-Insolvency" Distinction,* 60 Vanderbilt Law Review 1235 (2019).
52 Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (In re Buckhead Am. Corp.), 178 B.R. 956, 968 (Bankr. D. Del. 1994).
53 Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 655-56 (Bankr. N.D. Ill. 1998); Vincent Buccola, *Beyond Insolvency*, 62 University of Kansas Law Review 1 (2013-2014)

the disposal of assets for the benefit of shareholders, but to the prejudice of the "entire" corporate enterprise and not in favour "any" particular creditor class,[54] thereby shielding the directors. This resulted in "*law of fiduciary duty being used to fill gaps in the legal position that did not exist*" as a matter of *ex abundati cautela* for which the creditors already possessed statutory protections in the nature of avoidable transactions under the law on implied covenants of good faith and fraudulent conveyance, leading to overprotection of creditors.[55]

The Delaware Supreme Court later overruled *Credit Lyonnaies* in *NACEP v. Gheewala*[56] holding that the former created such a situation wherein the directors were left vulnerable to legal action by creditors as and when the company nears financial distress resulting in completely altering their functioning.[57] The Court observed , "*directors of solvent companies operating in borderline stage owe fiduciary duties to the corporation and its shareholders and should use their business judgment in the best interest of the corporation for the benefit of its shareholder owners*." Thus, *Gheewala* reverted to rationale of existing remedies available for creditors and merely allowed recourse to derivative actions claims in exceptional circumstances.[58] This meant that the borderline stage was not to be considered as a triggering event for shifting of duties and the safe harbour of business judgment rule was applicable upon companies. In effect, in United States, as of now, directors owe no direct fiduciary duties to creditors simply by virtue of the company being in the borderline stage.[59]

2.2. Director Liability Framework in UK

In the UK, Chapter II of the UK Companies Act, 2006 incorporates the business judgement rule and imposes general fiduciary duties on the directors, during solvency. This includes the duty to promote success of the company (synonymous to the good faith statutory duty), exercise independent judgement, reasonable care and due diligence, avoid conflict of interest and

[54] Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Director's Duty to Creditors*, 46 Vanderbilt Law Review 1485 (1993).
[55] Mariana Pargendle, *Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered*, 82 Tulane Law Review (2008); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 797 (Del. Ch. 2004).
[56] North American Catholic Educational Programming Foundation Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).
[57] Anna Dionne, *Living on the Edge: Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency*, 13 Standford Journal of Law, Business and Finance 188 (2007-2008).
[58] These includes instances of decisions which have had an adverse impact on the company. See. Bryan Anderson, *Gheewalla and Insolvency: Creating Greater Certainty for Directors of Distressed Companies*, 11 University of Pennsylvania Journal of Business Laws 1031 (2008-2009).
[59] Quadrant Structured Products Company, LTD, 115 A.3d 535 (2015); Berg & Berg Enter., LLC v. Boyle, 178 Cal. App. 4th 1020 (Cal. Ct. App. 2009); Mark Chebi & John Lyons, *Delaware Court of Chancery Decision Clarifies Fiduciary Issues in Insolvent Company Context*, 11 Pratt's Journal of Bankruptcy Law. 244 (2015)

declare related party transactions. The duties are assessed from a reasonable man's perspective who has general knowledge, skill and experience as expected from the director.[60] These duties are subordinate to the company interest, meaning, that derivative action claims can be initiated by shareholders for breach of these duties during solvency[61] and non-shareholder constituencies are excluded from the protection.[62] The trust fund doctrine, on the other hand, has been not been frequently drawn on by the Courts due to express codification of director duties under Section 172 of UK Companies Act, 2006.

Section 172(3) of UK Companies Act, 2006 shifts the director duties towards creditors during actual insolvency due to their risk-bearing capacity.[63] Moreover, the courts in the U K have expansively interpreted Section 172(3) to cover fiduciary duties of directors even during the borderline stage as compared to the US.[64] For instance, in *Colin Gwyer Case* it was held that, "*when a company is on verge of insolvency and creditor's money is at risk of directors, when carrying out their duties, due regards must be had interests of creditors as paramount.*"[65] However, the risk-bearer during the borderline stage remained unclear due to incorporation of multiple insolvency determination criteria, seemly similar but interpreted differently.[66] Section 212 impose liability of malfeasance where the directors are held accountable for misapplication or retention of corporate property in breach of fiduciary or other duties, including negligence.[67] Where however, any payment is made for a proper corporate purpose and in the interests of the company's creditors, then liability is exempted.[68] Specifically with respect to borderline

[60] Richmond Pharmacology Ltd v Chester Overseas Ltd [2014] EWHC 2692 (Ch).
[61] Andrew Keay, *The Duty to Promote the Success of the Company: Is It Fit for Purpose?* 13 University of Leeds, Centre for Business Law and Practice, Working Paper (2010)
[62] Parker Hood, *Directors Duties under the Companies Act 2006: Clarity or Confusion?* 13 Journal of Corporate Law Studies 47 (2013).
[63] In Re Pantone 485 Ltd., [2002] 1 BCLC 266 (Ch) at ¶ 69 (Eng.); Gwyer Assoc. Ltd. v. London Wharf (Limehouse) Ltd., [2003] BCC 855 (Ch) at 909 (Eng.); John Armour, et al., *Shareholder Primacy and the Trajectory of UK Corporate Governance*, 41 British Journal of Industrial Relations. 531 (2003).
[64] GHLM Trading Ltd. v. Maroo, [2012] EWHC 61 (Ch), 168 [UK].
[65] Colin Gwyer & Associates Ltd. v. London Wharf (Limehouse) Ltd., (2003) 2 BCLC 153.
[66] In multiple judgments, there have been reference to criteria like "nearing insolvency", "borderline of insolvency", "verge of insolvency", "doubtful insolvency". See. The Liquidator of Wendy Fair (Heritage) Ltd. v. Hobday [2006] EWHC (Ch) 5803; Eastford Ltd. v. Gillespie, Airdrie North Ltd., [2010] CSOH 132; Colin Gwyer v. London Wharf (Limehouse) Ltd., [2002] EWHC 2748. 294; Williams v. Farrow, [2008] EWHC (Ch) 3663 (Eng.); Gautam Sundaresh, *In Whose Interests Should a Company be Run? Fiduciary Duties of Directors during Corporate Failure in India: Looking to the West for Answers*, 8 Michigan Business & Entrepreneurial Law Review 291 (2019). Due to minute differences between these criteria, Keay suggests that the nearer a company gets to actually being insolvent, the triggering of fiduciary duties of directors becomes more obvious. See. Andrew Keay, *The Shifting of Directors' Duties in the Vicinity of Insolvency*, 24 International Insolvency Review 2 (2015).
[67] Kristin van Zwieten, *Director Liability in Insolvency and Its Vicinity*, 38 Oxford Journal of Legal Studies 2 (2018).
[68] Re GHLM Trading Limited [2013] EWHC 61 (Ch); Re HLC Environmental Projects Limited (in liquidation) [2013] EWHC 2876 (Ch).

insolvency, Section 213 and 214 of the UK Insolvency Act, 1986 imposes the fraudulent and wrongful trading standards liability upon the directors pursuant to which they are not to misapply or retain corporate assets and avoid insolvent liquidation of the company.[69] Section 213 and 214 involves civil liability with discretion to Courts in ascertaining extent of personal liability of directors with the objective to compensate creditors for the loss caused by the director's conduct.[70] The remedies available to aggrieved parties includes restoration of the property along with interest thereon.[71] Further, the Section 214 of UK Insolvency Act, 1986 clearly articulates that the directors must undertake every step to minimise the potential loss to creditors during borderline insolvency. This seems to imply that creditors have recourse to direct and indirect action against directors unlike the US.[72]

However, the directors are granted exemption from rigours of wrongful trading liability if they undertook measures to minimise the potential loss to the company's creditors, subject to clear nexus between loss sustained by the company and director decisions,[73] this is elaborated in the later section of the paper. The standard for director liability during borderline insolvency as held by the Courts is to guide the company directors to make intelligent and honest decisions which could be reasonably believed to be for the benefit of the company.[74]

The scheme of avoidance transactions under the Insolvency Act, 1986 includes significant undervaluation of corporate property[75], preferring one creditor over other,[76] and extortionate dealing involving grossly exorbitant credit payments.[77] The director liability can be materially diminished if the company does not suffer losses on account of the concerned transaction.[78]

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[69] Howard Morris & Edward Downer, *The Truth about Dishonesty in Fraudulent Trading under English Law*, 16 Pratt's Journal of Bankruptcy Law 38 (2020).
[70] Re Bangla Television (in liquidation), Valentine v. Bangla Ltd [2009] EWHC 1632 (Ch); In Re Ralls Builders Limited (in liquidation) [2016] EWHC 243 (Ch).
[71] Liquidator of Marini Ltd v. Dickensen [2003] EWHC 334 (Ch); Hans Hirt, *The Wrongful Trading Remedy in UK Law: Classification, Application and Practical Significance*, 1 European Company and Financial Law Review 71 (2004).
[72] A. Keay & J. Loughrey, *An Assessment Of The Present State Of Statutory Derivative Proceedings* In Loughrey (ed), Directors' Duties and Shareholder Litigation in the Wake of the Financial Crisis, Edward Elgar Publishing (2013).
[73] In Re Continental Assurance Co. of London Plc., [2007] 2 BCLC 287 Court refused to impart liability because it had allowed the company to continue trading during borderline insolvency. See Chan Ho, *On Deepening Insolvency and Wrongful Trading*, 20 Journal of International Banking Law and Regulation (2005).
[74] Charterbridge Corp. Ltd. v. Lloyds Bank Ltd., [1970] Ch. 62; Colin Gwyer v. London Wharf (Limehouse) Ltd., [2002] EWHC 2748.
[75] Section 238 of UK Insolvency Act, 1986.
[76] Section 239 of UK Insolvency Act, 1986. A preferential transaction can be set aside if the transaction positively improve the creditor's position. See. In Re Cosy Seal Ltd (In administration) [2016] EWHC 1255.
[77] Section 244 of UK Insolvency Act, 1986. The transaction must necessarily involves taking improper advantage of unfair bargaining power in commercial dealing which results in oppression to creditors. See. Re St. George's Property Services (London) Ltd (in administration) [2010] EWHC 2748 (Ch).
[78] Re Ralls Builders Ltd (in Liquidation) [2016] EWHC 1812(Ch).

Thus the recourse to remedies against director's actions under wrongful trading liability standard can be ordered during insolvent liquidation whereas those under the Companies Act, 2006 can be ordered even during solvency or borderline insolvency[79], thereby providing creditors with adequate safety net at all stages.

3. DIRECTOR RESPONSIBILITY FRAMEWORK IN INDIA

Prior to the enactment of the IBC, corporate insolvency for industrial companies[80] was governed by the *Sick Industrial Companies (Special Provisions) Act, 1985* (SICA) whereas liquidation and winding-up for non-industrial entities was governed by the Companies Act, 2013. With the introduction of the IBC, the director responsibility frameworks for solvent companies is now solely governed by the Companies Act, 2013 and the insolvent companies by the IBC. While the focus of the paper is upon borderline insolvency, it is essential that the director responsibility framework as is applicable in case of solvency is deliberated due to fragmented director obligations under different legislations. In this section, the applicable framework for the different stages of the company in India is explained.

3.1.Solvency:

The Companies Act, 2013 read with the SEBI (Listing Obligations & Disclosure Requirements) Regulations, 2015[81] largely governs director-specific corporate governance of companies during solvency. It provisions for Board committees, auditors and auditor standards, internal controls and mechanism, disclosure and transparency compliances.[82] The director liability framework is governed by imputation of vicarious liability on directors responsible for conduct of business and on those who actually participated in commission of the offense.[83] The Companies Act, 2013 under Section 2(60) includes the whole-time director, independent directors and executive directors as "officers-in-default", and these company representative

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[79] Harry Rajak, *Director and Officer Liability In The Zone Of Insolvency: A Comparative Analysis*, 11 Potchefstroom Electronic Law Journal 1 (2008).
[80] An industrial company is defined to mean a company which owns one or more industrial undertakings and carries out work in one or more factories but excludes small scale industries and ancillary industries. See. Section 2(f) of Sick Industrial Companies (Special Provisions) Act, 1985.
[81] Securities and Exchange Board of India (SEBI) Regulation No. *SEBI/LAD-NRO/GN/2015-16/013* https://www.sebi.gov.in/legal/regulations/sep-2015/securities-and-exchange-board-of-india-listing-obligations-and-disclosure-requirement-regulations-2015-last-amended-on-may-5-2021-_37269.html.
[82] Devarshi Mukhopadhyay & Rudresh Mandal, *The End of Shareholder Primacy In Indian Corporate Governance - Says Who?*, 46 Commonwealth Law Bulletin 4 (2020).
[83] SEBI v Gaurav Varshney, (2016) 14 SCC 430.

shall be liable for any penalty or punishment imposed by law enforcement authorities in accordance with the law time being in force.[84]

The imputation of liability can be both civil and criminal under the Companies Act, 2013 depending upon the nature of offense. For criminal liability "*there must be specific averments against the director showing as to how and in what manner the director was responsible for the conduct of the business of the company and if the person responsible to the company for the conduct of the business of the company, was not in charge of the conduct of the business of the company, then he can be made liable only if the offence was committed with his consent or connivance or as a result of his negligence*."[85] Similarly, criminal liability can be imposed only "*if the statute stipulates the liability of directors and there is sufficient evidence of the director's active role coupled with criminal intent*"[86] The imposition of civil liabilities depends upon preponderance of probabilities whereas for imposition of criminal liabilities, the criminal conduct must be proved beyond reasonable doubt.[87]

The Companies Act, 2013 for the first time codified director fiduciary duties within the Indian director liability jurisprudence. Akin to UK, Section 166(2)-(6) of the Indian Companies Act, 2013 provides for the application of business judgement rule and civil obligations upon the directors who must act in good faith, foster the mission and vision of the company, in the best interests of the company, employees, shareholders, community and environment.[88] Similarly, Section 166(7) of Companies Act, 2013 incorporates the trust fund doctrine and imposition of penalty upon failure of fulfilment of duties as specified under Section 166(2).[89] However, unlike the US or UK, there has not been sufficient deliberation by Courts on the scope of

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[84] Shiv Kumar Jatia v.. State of NCT of Delhi, AIR 2018 SC 8008; Vyapak Desai & Ashish Kabra, *Director and Officer Liability in India*, 41 American Bar Association 4 (2015).

[85] The non-director personnel categorized as officers-in-default under section 2(60) of Companies Act, 2013 includes key managerial personnel, person charged with the responsibility of maintenance of accounts, person on whose advice the directors are accustomed to act and the share transfer agents, merchant bankers and bankers to an issue. See. K.K. Ahuja v V.K. Vora, (2009) 10 SCC 48.

[86] Sunil Bharti Mittal v CBI, Criminal Appeal No. 34 of 2015.

[87] Usha Chopra v. Chopra Hospital (P.) Ltd. [2005] 63 SCL 625 (CLB); Shubh Shanti Services Ltd. v. Manjula S. Agerwalla [2005] 60 SCL 439 (Bom.).

[88] Vikramaditya Khanna & Shaun J. Mathew, *The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidencer*, 22 National Law School of India Review 1 (2010). In Harinagar Sugar Mills Ltd v. Shyam Sundar Jhunjhunwala, 1961 AIR SC 1669, the Indian Supreme Court exacted the rule as, "*wherever any shareholder has proposed to transfer his shares to some new member, the court shall presume that their motives are arbitrary and capricious, or their conduct is corrupt unless you choose to tell the Court what their reasons were would amount to altering the whole constitution of the company*."

[89] Gautam Sundaresh, *In Whose Interests Should a Company be Run? Fiduciary Duties of Directors during Corporate Failure in India: Looking to the West for Answers*, 8 Michigan Business & Entrepreneurial Law Review 291 (2019).

Section 166 fiduciary duties and remedies available for their consequent breach. In the latest case dealing with breach of fiduciary duties and derivative actions under the Companies Act 2013, *Rajeev Saumitra v. Neetu Singh*[90], the Delhi HC was faced with allegation that the director attempted to gain undue advantage to himself over the company, as potential breach of fiduciary duties. The Delhi HC held that a breach of fiduciary duties under Section 166 of Companies Act, 2013 entitles the shareholder the right to initiate an indirect action claim against the defaulting director.. While the Court didn't clarify if a direct action claims exists during solvency due to non-codification of derivative actions under Companies, 2013; however, it can be implied that both direct and indirect action claims can be admitted on breach of director duties as there exists no prohibition on the same.[91]

On the procedural front, directors are expected to exercise independent judgment with reasonable care, skill and due diligence at par with the common law principles of fiduciary duties.[92] Although, director owes fiduciary duties they owe no contractual duty with respect to third parties excepting where they make themselves personally liable or induces a third party to act to their detriment.[93] In case the third party prove such fraudulent misrepresentation, a director may be held personally liable to the said third party. However over the period of time certain exceptions have been evolved for protection from liability for different categories of directors on account of their activities and involvement with the company affairs. While independent directors are required to observe Section 166 duties, they are only liable for the company's acts of omission or commission that occurred with their knowledge or attributable through Board processes, and with their consent or connivance.[94] A non-executive director is not considered as officer-in-default and is not liable for company defaults unless it is proved that he was at the helm of decision making process of the affairs of the company.[95] Further, the companies must take all precautions to ensure that civil or criminal proceedings are not unnecessarily initiated against the independent or non-executive directors unless sufficient evidence.[96]

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[90] Rajeev Saumitra v. Neetu Singh, CS (OS) No. 2528 of 2015.
[91] Umakanth Varottil, *Delhi High Court on Directors' Duties and Derivative Actions*, IndiaCorplaw (2016).
[92] Dale & Carrington Investment (P.) Ltd. v. P.K. Prathapan, AIR 2004 SC 601; Debanshu Mukherjee & Astha Pandey, *The Liability Regime For Non-Executive and Independent Directors in India A Case for Reform*, Vidhi Centre for Legal Policy (2019).
[93] Mukesh Hans v. Smt. Uma Bhasin, CM No. 495/2010.
[94] Section 149(12) of the Companies Act, 2013.
[95] Pooja Ravinder Devidasani v State of Maharashtra, Criminal Appeal Nos. 2604-2610 of 2014; Union Carbide Corporation v. Union of India, 1989 SCC (2) 540.
[96] Ministry of Corporate Affairs, General Circular No. 5/2020, dated 5 May, 2020. https://www.mca.gov.in/Ministry/pdf/Circular20_05052020.pdf.

3.2.Insolvency

The IBC follows a creditor-in-possession model of insolvency resolution and the business affairs and operational decision-making lie with the appointed resolution professional. The resolution professional will work within the mandate and guidance of the Committee of Creditors (CoC) and the elected board of directors of the company are ousted.[97] Importantly, in India, under Section 29A of IBC, the promoters of the company are disqualified from getting involved in the rehabilitation process and cannot submit a resolution plan for revival.[98] While the policy rationale behind Section 29A lies upon the moral argument of not diluting control of the revived company in hands of the promoters which led to its insolvency[99], however, it has also led to results hampering effective resolution. The lack of professional experience and business acumen of the resolution professional has resulted in erosion of value[100] and increased his burden who is already obligated to perform various administrative and representative activities concerning the resolution.[101] Similarly, there have been several attempts made to circumvent the strict rigors of Section 29A by the promoters and the board of directors which has resulted in lifting of corporate veil of the company. This has led to insurmountable transaction and insolvency costs for the eventual resolution applicant, and haircuts for creditors, in case of liquidation.[102]

3.3.Borderline Insolvency:

The borderline insolvency as discussed in the beginning, is the stage where the company is under financial stress (or where the net liabilities exceed the net assets) but it is has not entered formal insolvency proceedings. This twilight zone is critical for the survival of company and preservation of its value, whatever it may worth. The IBC while consolidates the winding-up

[97] Section 17 of the Insolvency and Bankruptcy Code, 2016; Ankeeta Gupta, *Insolvency and Bankruptcy Code, 2016: A Paradigm Shift within Insolvency Laws in India*, 36 Copenhagen Journal of Asian Studies 2 (2018).
[98] Section 29A of the Insolvency and Bankruptcy Code, 2016.
[99] Swiss Ribbons Pvt. Ltd. v. Union of India, 2019 SCC 73.
[100] Pratik Datta, *Value Destruction And Wealth Transfer under the Insolvency and Bankruptcy Code, 2016*, National Institute of Public Finance and Policy Working Paper No. 247 (2018).
[101] Golden Jubilee Hotels v. EIH Ltd., Civil Revision Petition No.4881 of 2018.
[102] In S.C. Sekaran v. Amit Gupta, (CA) (AT) (Insolvency) No. 496 of 2018 and Y. Shivram Prasad v. S. Dhanapal, (CA) (AT) (Insolvency) No. 224 of 2018, promoters of the company were allowed to enter into Section 230-232 of Companies Act, 2013 schemes for compromise and amalgamation during pendency of liquidation, which resulted in promoters buying back the company and circumventing the rigours of Section 29A of IBC. See. Sikha Bansal, *An Odd Scheme: Case for Exclusion Of Schemes Of Arrangement From Scheme of Liquidation*, Vinod Kothari Consultants (2021); Sikha Bansal, *Resurrecting the Dead- A Discussion Around Schemes of Arrangement in Liquidation*, Vinod Kothari Consultants (2019).

provisions under the Companies Act, 2013, provides for directors' liability not previously envisaged under any corporate legislation in India. Section 43 of the IBC imposes duty upon the company (and indirectly upon the directors) to not prefer a particular creditor over fellow creditors, outside of the ordinary course of business within the claw back period of 2 years. If such an arrangement has been undertaken, the NCLT under Section 44 of IBC will require the company to reverse the transaction and vest within itself the disposed property. Similarly, Section 45 of IBC also bars the directors from significantly undervaluing the corporate property and shall be required to reverse the transaction when it is declaring as void by the NCLT. Further, the directors are disallowed to carry on the business of the company with an intent to defraud creditors This wrongful trading liability under Section 66 of IBC can be imposed only "when the director knew or ought to have known that the there was no reasonable prospect of avoiding the insolvency proceedings" or "didn't exercise due diligence in minimising the potential loss to the creditors". The wrongful trading standard doesn't envisage a look-back period to ensure that dishonest directors are subjected to the liability even view of lapse of time.[103] The wrongful trading standard covers broad spectrum of actions which directors can undertake to mitigate losses and they will be evaluated as being in capacity of "reasonable competent director", which could include not incurring further debts and making active efforts of rehabilitation of the company.[104] In addition to civil liability, the directors are also subjected to criminal penalties for defrauding the creditors both during insolvency and borderline insolvency[105] The concerned director of the company is subjected to imprisonment of maximum term of 5 years, and with a maximum fine of Rs. 1 crore for defrauding creditors under Section 69 of IBC.

The jurisprudence and practice on undervalued and wrongful trading standards is yet to be developed in India and accordingly in scholarly discourse, there has been repeated reference to foreign judgements, especially from the UK for interpretation due to similarity in statutory law. The "*intent to defraud*" standard[106] can be proved when the director had actual or constructive

[103] Nandkishor Vishnupant Deshpande v. Worldwide Online Services Private Limited, C.P. 2556/I&B/MB/2019.
[104] Id..
[105] Section 69 of the Insolvency and Bankruptcy Code, 2016
[106] While the SEBI (Prohibition of Insider Trading) Regulations, 2015 and SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities) Regulations, 2003 do not provide for the term "intent to defraud/deceive", vide SEBI Policy dt. May 16, 2017 it stated that the intention to deceive/defraud is a sine qua non for establishing manipulation in case of self-trades, and that accidental or unintentional self-trades are not covered under FUTP Regulations. However, the standards under the SEBI regulations are not defined in context of insolvency and is is largely in nature of fraudulent securities trading. See. Jitesh Maheshwari, *SEBI's Policy on Self-Trades*, IndiaCorpLaw (2017).

knowledge that there are no reasonable prospects of ever receiving payment of debts.[107] Accordingly, when it continues to incur debt with no reasonable prospect of payment to creditors, it is a proper inference of carrying on business with intent to defraud creditors.[108] To determine if knowledge of commencement of insolvency duties can be imputed upon the directors, the litmus test of whether a reasonable man is aware of the precarious condition of the corporation would enter into such a transaction must be regarded.[109]

Thus, drawing from a comparative perspective, Indian directors can also be made liable where they did act dishonestly, but were only negligent while exercising their fiduciary duties.[110] The judicial bodies can take reference to the existing position in the context of director liability during borderline insolvency to interpret the liability standards until legislative clarity is brought about. In fact, in the *Jet Airways*[111] and *Videocon Case*[112], the NCLAT and NCLT took reference from the extant international position on cross-border and group insolvency instances to resolve the dispute in absence of any legislative provision to the effect under the IBC.

4. CHALLENGES TO DIRECTOR RESPONSIBILITY FRAMEWORK & SOLUTIONS IN INDIA

The Indian law on borderline insolvent director duties has not seen a high judicial interpretation by the Courts. This has led to several inconsistencies which the authors attempts to highlight in the succeeding section and provide solutions for resolving them. While the thrust of the paper is upon borderline insolvency; it is essential that certain substantive and procedural changes in the framework are made during the solvent and insolvent stages of the company so that the efficiency of director liability framework during borderline stage is strengthened as highlighted below:

4.1.Direct and Indirect Remedies for Creditors during Solvency

In India, Section 166 of the Companies Act, 2013 doesn't incorporate "creditors" as an independent class of non-shareholder constituency. It is therefore important to understand whether creditors are entitled to direct action claims pursuant to Section 166 read with Section

[107] Sequana S.A. v. Bat Industries PLC, [2019] EWCA Civ. 112.
[108] In Re William C. Leitch Bros. Ltd., [1932] Ch. 261.
[109]Morphitis v. Bernasconi, [2001] 2 BCLC 1. .
[110] Nandkishor Vishnupant Deshpande v. Worldwide Online Services Private Limited, C.P. 2556/I&B/MB/2019.
[111] Jet Airways (India) Ltd. v. State Bank of India, Company Appeal (AT) (Insolvency) No. 707 of 2019.
[112] State Bank of India v. Mr. Venugopal Dhoot, MA 1306/2018 in CP No. 02/2018.

408. The literature review of the limited Section 166 cases suggests that there has not been a single case initiated as direct-action claim by creditors for breach of director duties.[113] The rationale behind no cases of derivative actions by creditors in India could be associated with the lack of codification of director duties under the erstwhile Companies Act, 1956[114] and the lack of express codification of the term "creditors" under the incumbent Companies Act, 2013. There has however been overreliance by creditors to initiate oppression and mismanagement suits under the Companies Act, 2013, possibly due to its wider scope of application.[115] It covers actions like breach of fiduciary duties[116], conduct of management resulting in loss[117], conducting affairs of the company contrary to the charter of the company[118] and rights of stakeholders[119], collusive disposal of corporate assets to directors[120], diversion of corporate funds for benefit to particular class of stakeholders[121] etc.

While the scope of remedial measures in case of contravention of fiduciary duties is generally broader, in effect however, under the Companies Act, 2013 the scope of oppression and mismanagement remedies has had a significant role to play than the former. As seen in *Rajeev Saumitra* earlier that the indirect derivative actions claim can be brought before Courts by shareholders during solvency of the company. However, the distinguishing point is that along with *Rajeev Saumitra* all the other derivative action claims initiated before Indian courts have been shareholder driven. Unlike the US and the UK position, the lack of creditor driven derivative claims give rise to suspicion that if at all the legislative intent behind the derivative action framework was to be made applicable to creditors.

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[113] Vijay Singh, *Directors' Fiduciary Duties to the Company: A Comparative Study of the UK and Indian Companies Act*, Oxford Trusts & Trustees (2021).

[114] Umakant Varottil & Vikaramaditya Khanna, *Rarity of Derivative Actions in India: Actions and Consequences* In Dan W. Puchniak, Harald Baum & Michael Ewing-Chow (eds.), The Derivative Action in Asia: A Comparative and Functional Approach, Cambridge University Press (2012)

[115] Section 242 of Companies Act, 2013 which allows the NCLT to order regulation of conduct future affairs of the company, acquisition of shares or interests of any shareholders, restrictions on the transfer or allotment of the shares of the company, termination, setting aside or modification, of any agreement between the company and directors, setting aside of any transfer, delivery of goods, payment, execution or other act relating to property, removal of directors, recovery of undue gains of directors and imposition of costs. See. Umakanth Varottil, *Unpacking the Scope Of Oppression, Prejudice And Mismanagement Under Company Law In India*, NUS Law Working Paper No. (2020).

[116] Hemant D. Vakil v. RDI Print and Publishing Pvt. Ltd., [1995] 84 Comp. Cas. 838 (CLB)

[117] Thomas George v. KCG Verghese, (1996) 86 Comp. Cas. 213 (CLB)

[118] S.M. Ramakrishna Rao v. Bangalore Race Club Ltd. [1970] 40 Comp. Cas. 674 (Mys.).

[119] Bhajirao G. Ghatke v. Bombay Docking Co. (P.) Ltd. [1984] 56 Comp. Cas. 428 (Bom.).

[120] Col. Kuldip Singh Dhillon v. Paragaon Utility Financiers (P.) Ltd. [1986] 60 Comp. Cas. 1075; Mittal Dal Mills Ltd., Re [1992] 8 Corpt. LA 104 (CLB).

[121] Bhaskar Stoneware Pipes (P.) Ltd. v. Rajindernath Bhaskar [1988] 63 Comp. Cas. 184 (Delhi).

As a response to this, a two-pronged alternatives was suggested by *Varottil*, the first part of which considers Section 166 duties as a complete code of director duties and remedies thereof, thereby providing legal certainty. The second part considers Section 166 as partial codification, in addition to applicable common law principles, thereby providing for broad and basic principles with which Courts can derive detailed discharge mechanism for directors.[122] Certainly, there is a strong emphasis on having a statutory amendment within the Companies Act, 2013 to expressly allow creditors to take recourse to derivative actions claims against recalcitrant directors as they are key stakeholders during insolvency and borderline insolvency. A similar reference can be found in Section 172 of UK Companies Act, 2006 which in addition to provisioning for fiduciary duties of directors also takes into consideration that these duties must be exercised in light of interests of creditors of the company.[123]

4.2.Wrongful Trading Liability during Borderline Insolvency

As discussed earlier in Section 3 of the paper, the wrongful trading standards under Section 66 of IBC imputes liability upon directors during borderline insolvency if the director had knowledge (actual or constructive) of impending insolvency of the company. Further, when directors omission to avoid the impending insolvency and also exercise due diligence to minimize losses to creditors also constitutes ground to impute Section 66 IBC liability. The case laws are yet to develop on the effective interpretation of the phrase – "standard of knowledge"; however, importantly the standard takes into consideration subjective factors based upon fact-by-fact analysis to impute liability. As, the terms "*reasonable prospect of avoiding insolvency*"[124], "*due diligence*"[125] and "*potential loss*"[126] are not defined within the IBC, it can result in interpretational problems among Courts, leading to increased transactional costs for the parties.

Scholars also view that since the jurisprudence on director liability imposition during borderline insolvency is still evolving in emerging economies (including India) where the insolvency courts are not sophisticated, it is prudent to exclude the standard of knowledge to

[122] Umakanth Varottil, *Codification of Directors' Duties: Is Common Law Excluded?*, IndiaCorpLaw (2014).
[123] Collins Ajibo, *A Critique of Enlightened Shareholder Value: Revisiting the Shareholder Primacy Theory*, 2(1) Birkbeck Law Review 37, 37–58 (2014).
[124] Section 66(2)(a) of Insolvency and Bankruptcy Code, 2016.
[125] Section 66(2)(b) of Insolvency and Bankruptcy Code, 2016
[126] Id.

avoid commencement of insolvency proceedings as provided under Section 66(2) of the IBC.[127] The US and UK position on director liability framework as delineated in Section 2 suggests that there must be a strong coherence and relation between the company (or solvency) law and insolvency law, so that there is no isolated interpretation of the director duties. The absence of such correlation/guidance under the Indian Companies Act, 2013 for imposition of duties during borderline insolvency creates a situation as was prevalent prior to *Gheewala* in the United States. Prior to *Gheewala*, the directors were under the threat of creditors over every decision in favor of shareholders.[128] There is clearly a need for a legislative amendment within the Companies Act, 2013 clarifying that the duty of directors must be in consonance with those to be taken in interests of creditors under the IBC, similar to Section 172(3) of UK Companies Act, 2006.

In fact, the wrongful trading standard under Section 66 of IBC could be tweaked to incorporate a standard of imposition of a liability where the company could not be allowed to incur any new debts once the directors had knowledge that they will be unable to repay them.[129] It helps the stressed company to save costs associated with insolvency proceedings and also takes care of the interest of the creditors not to utilize the funds in inchoate manner. In our opinion, the wrongful trading standard could be also be made applicable in a phased-manner with existing standard under Section 66(2) of IBC made applicable upon top 1000 companies as determined by market capitalization. Consequently, the "standard of not incurring fresh debts" coupled with defense of "duty to minimize loss to creditors", as already provided under Section 66(2) of IBC, can be made applicable to start-ups and small businesses to foster value creation.

The deterrent effect of the wrongful trading liability (for error-in-judgments and good faith risky business decisions and not for fraudulent or negligent actions) can be reduced by allowing the company directors to initiate out-of-court restructuring proceedings to rectify the impeding insolvency at the earliest and work in interest of shareholder and non-shareholder

[127] Aurelio Gurrea-Martinez, *Towards an Optimal Model of Directors' Duties in the Zone of Insolvency: An Economic and Comparative Approach*, Singapore Management University School of Law Research Paper No. 22/2020.
[128] Aurelio Gurrea-Martinez, *Insolvency Law in Emerging Markets*, Ibero-American Institute for Law and Finance, Working Paper 3/2020.
[129] See Aurelio Gurrea-Martinez, supra note 139; Section 588G of Australian Corporation Act, 2001 which adopts a similar provision states that "directors knowledge" of inability to pay debts can be ascertained if the director was aware at the concerned time that there existed grounds for suspicion or a reasonable director in a like position in like circumstances be so aware. Further, incurring of debt includes instances of payment of dividend, buyback of shares, redemption of shares etc. See. David Morrison, *The Australian Insolvent Trading Prohibition: Why Does it Exist?,* 11 International Insolvency Review 3 (2002); Jason Harris, *Director Liability for Insolvent Trading: Is the Cure Worse than the Disease*?, 23 Australian Journal of Corporate Law 3 (2009).

constituencies.[130] It will have the effect of prioritizing the debts of existing creditors and protect the interest of potential creditors from any instances of impending insolvency. The condition precedent towards this development is to have an appropriate non-adjudicatory proceedings infrastructure with experienced mediators and institutionalized valuers.

4.3. Lack of Effective Out-Of-Court Restructuring Mechanism within the IBC

Usually early detection and resolution of financial distress is often helpful to save costs associated with formal insolvency proceedings.[131] In court-administered insolvency regime like that of the IBC, out-of-court restructuring and workouts reduces the burden of insolvency courts.[132] The director liability framework as provided under the Companies Act, 2013 read with the IBC can be better complemented by incorporating an out-of-court restructuring mechanism within the IBC and allowing directors recourse to it right from the onset of borderline insolvency. While there exists out-of-court workout mechanism independent of the IBC, their effect however has been limited to only certain category of creditors based upon certain set of factors.

For example, the RBI (Prudential Framework for Resolution of Stressed Assets), 2019[133] provides for restructuring efforts in form of private agreement between the lender and debtor however, it is only applicable upon RBI regulated banking creditors. Similarly, compromise or arrangement scheme under Section 230-232 of Companies Act, 2013 requires dual majority of shareholders/creditors and becomes binding on all stakeholders only if 75% of the creditors agree to the proposal.[134] Further, the RBI also rolled out other informal restructuring

[130] James Peck, David Hillman & Elizabeth Rose, *Deepening Insolvency - Litigation Risks for Lenders and Directors When out-of-Court Restructuring Efforts Fail*, 1 New York University Journal of Law and Business 293 (2004-2005).

[131] Horst Eidenmüller, *The Rise and Fall of Regulatory Competition in Corporate Insolvency in the Union*, 20 European Business Organization Law Review 547 (2019).

[132] As per the NCLT statistics more than 21,500 cases are pending before the NCLT as on 31 December, 2020. See. Lok Sabha Starred Question No. 86/2021. See also. Shreya Prakash, Debanshu Mukerjee & Ojithiya Sen, *Resolving Insolvency Faster by Recognising Out-of-Court Workouts under the IBC*, Vidhi Centre for Legal Policy (2020); Neeti Shikha & Urvashi Shahi, *Strengthening Informal Restructuring for Firms*, Indian Institute of Corporate Affairs (2020)

[133] Reserve Bank of India, Prudential Framework for Resolution of Stressed Assets Notification No. *DBR.No.BP.BC.45/21.04.048/2018-19* https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11580

[134] For e.g. if 1000 members holding 10,000 shares of Rs.10 participate in the scheme and vote and of these, one member holding 3,000 shares, votes against approval of the scheme and the remaining 999 members holding 7,000 shares vote in favour; the approval shall not granted as even though all but one member vote in favour, their aggregate share value falls short of 75% of the total share value of Rs.1,00,000. See. GK Kapoor & Sanjay Dhamija, *Company Law & Practice: A Comprehensive Textbook on Companies Act, 2013*, Taxmann (2019).

mechanisms like Corporate Debt Restructuring 2001 (as revised in 2003)[135], Strategic Debt Restructuring, 2015[136] and Scheme for Sustainable Structuring of Stressed Assets, 2016[137] but they all failed due to parallel conflicts amongst different legislation, leading to uncertainty over debt recovery.[138]

Moreover, the non-recognition of outside court workouts within the IBC leads to increased burden upon the insolvency courts.[139] While Chapter III-A has been added to the IBC vide IBC (Amendment) Act, 2021 recognizing pre-packaged insolvency for small business debtors, it is however necessary that it be extended to all kinds of debtors to provide mitigation measures to directors of large corporates as well. Further, the extension of prepacks to all categories of debtors can lead to legitimizing the benefits of insolvency threats on violation of the restructuring agreement by the debtor and reduce the overall costs associated with resolution.[140] Section 14 of the IBC; however, bars recoveries outside the IBC including *inter alia* institution of commercial suits, execution of judgment or decree and securitisation of property of the company.[141] Since, there is no express provision within the IBC which allows for outside court recoveries, aside of the pre-packaged insolvency for small businesses, it is essential that these recoveries be exempted from rigours of moratorium under Section 14 of IBC. It shall help in legitimizing outside court recoveries within the formal insolvency framework.

4.4.Lack of Coordination of Promoters/Directors during Insolvency

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[135] Reserve Bank of India, Corporate Debt Restructuring Notification No: *BP.BC. 15 /21.04.114/2000-01.* https://rbi.org.in/Scripts/NotificationUser.aspx?Id=440&Mode=0; Reserve Bank of India, Corporate Debt Restructuring Notification No DBOD. No. *BP.BC.68 /21.04.132/2002-03.* https://rbi.org.in/scripts/NotificationUser.aspx?Id=1062&Mode=0

[136] Reserve Bank of India, Strategic Debt Restructuring Scheme, *RBI/2014-15/627 DBR.BP.BC.No.101/21.04.132/2014-15.* https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=9767

[137] Reserve Bank of India, Scheme for Sustainable Structuring of Stressed Assets *RBI/2016-17/121 DBR.No.BP.BC.33/21.04.132/2016-17*, https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10446&Mode=0

[138] Aparna Ravi, *The Indian Insolvency Regime in Practice-An Analysis of Insolvency and Debt Recovery Proceedings*, 50 Economic & Political Weekly 46 (2015).

[139] The World Bank Principles for Effective Insolvency and Creditor/Debtor Rights Systems, 2015 recognizes negotiation and mediation as effective measures of informal workouts to resolve inter-creditor differences. See. Angana Shah & Nina Pavlova, *Mediation in the Context of (Approaching) Insolvency: A Review on the Global Upswing*, 4 Transnational Disputes Management (2017); Rajiv Mani, *Mediation in Insolvency Matters*, Insolvency and Bankruptcy Regime in India: A Narrative, IBBI Annual Publication (2020).

[140] Oijithya Sen, Debanshu Mukherjee & Shreya Prakash, *Resolving Insolvency Faster by Recognizing Out-of-Court Workouts under the IBC*, Vidhi Centre for Legal Policy (2020).

[141] Rajendra Bhutta v. Maharashtra Housing and Area Development Authority, Civil Appeal No 12248 of 2018; Embassy Property Developments Pvt Ltd v. State of Karnataka, Civil Appeal No 9170 of 2019.

The ownership structures of most Indian companies suggest that promoters of the company also act on the Board of Directors.[142] Section 29A of IBC was incorporated to disallow promoters/directors from running the operations of the company who have been responsible for its insolvency. It highlights not only the adoption of the creditor-in-possession model of insolvency resolution but stereotyping of the overall process. However, the resolution professional must be solely responsible for all legal compliance even outside of the IBC for smooth functioning of the insolvent company.[143] As a corollary, the company directors not required to perform any kind of management functions, except those incorporated under Section 19 of IBC.[144] Even, the duties of the professional under Section 18 of IBC are wide ranging and includes ascertaining financial position, monitoring assets and operations of the company, receiving creditors' claims and to take over control of company's assets.[145] Thus, it is difficult for a single professional to undertake all the duties and fulfill them in a time-bound manner as prescribed by the IBC.[146] Moreover, the increasing complexities in conducting business can at times lead to situation where the professional may not have adequate experience or knowledge of the concerned industry where the company operates.[147]

With the resolution professional as a profession being developed gradually in the country, it is necessary that guidance of the erstwhile directors and management is taken to better preserve the value of the company.[148] In addition to that, a specialized class of insolvency professionals can be groomed and certified by the Insolvency and Bankruptcy Board of India (IBBI) having the requisite expertise in conducting investigations into avoidable transactions. The professionals can be asked to take into consideration the opinion of the directors of the company as suspension of the board of directors under Section 18 of IBC isn't tantamount to

[142] Apu Manna, Tarak Nath Sahu & Arindam Gupta, *Impact of Ownership Structure and Board Composition on Corporate Performance in Indian Companies* 9 Indian Journal of Corporate Governance 1 (2016);; *Ownership Structure of Listed Companies in India*, OECD (2020).
[143] Insolvency and Bankruptcy Board of India Circular No. *IP/002/2018* https://www.ibbi.gov.in/webadmin/pdf/whatsnew/2018/Jan/CIRP%202_2018-01-03%2018:41:44.pdf
[144] Section 19 IBC mandates omnibus duty on the promoters and management of the company, including the directors to assist and cooperate the resolution professional as he may require, without highlighting any specific function. See. Kushagra Srivastava, *The (Active) Involvement of Directors during Insolvency Proceedings*, IndiaCorpLaw (2020).
[145] Anirudh Burman & Rajeswari Sengupta, *Regulating Insolvency Professionals under the IBC: Tracing Pathways To Regulation Based on A Study Of Professional Development*, National Institute of Public Finance and Policy (2019). Additionally, vide second amendment to IBBI CIRP Regulations, 2016 effective from 14 July, 2021, the resolution professional is required to form an opinion and make determination within 115 days of initiation of insolvency proceedings towards any avoidable transactions entered into by the corporate debtor to fast track the proceedings.
[146] Golden Jubilee Hotels v. EIH Ltd., Civil Revision Petition No.4881 of 2018.
[147] Subasri Realty Pvt. Ltd. v. N. Subramanian, (CA) (AT) (Insolvency) No. 290 of 2017.
[148] Abhishek Mittapally & Kokila Jayaram, *A Study of Insolvency Professionals in India*, Insolvency and Bankruptcy Regime in India: A Narrative, IBBI (2020).

suspension of the managing director or other directors of the company.[149] Further, the Companies Auditor's Report Order, 2020[150] can mandate the auditor's report to contain any likely instances of avoidable transactions.[151] The development can help in resolving the fraudulent conveyances during the solvency stage itself and save time and costs during the corporate insolvency of the company. There is clearly a need for clarificatory amendment within the IBC to increase the involvement of the erstwhile management and directors of the company within the insolvency resolution process to better facilitate the value preservation of the company.

4.5.Limited Deterrence Measures for Recalcitrant Directors

The civil consequences of the avoidable transactions regime under the IBC is limited to either claw back remedial measures in form of recovery of disposed corporate property or imposition of fines upon the errant directors. With the object of the wrongful trading liability standard to encourage responsible *ex-ante* behaviour on part of company directors it is necessary that the deterrence effect of such opportunistic behaviour be penalized appropriately.[152] A mechanism of director disqualification similar to Section 6 of UK Company Directors Disqualification Act 1986 can be adopted to penalize and disqualify recalcitrant directors on account of their unfit character to represent a company director.[153] Section 6 of this UK law states that where the conduct of the director is unfit to be regarded as being in management, even in matters arising out of or related to insolvency, a director disqualification order can be issued. While in India, Section 164 of Companies Act, 2013 doesn't provide contravention of wrongful trading liability as one of the grounds for director disqualification, a legislative amendment could be made to effectuate the spirit of IBC. The pre-requisite to such a mechanism is having an

[149] Section 19 of the IBC merely states that company personnel including directors, promoters, employees etc. of the corporate debtor are required to extend assistance to insolvency professional but doesn't specifically allow the latter to take into consideration opinion of directors and other personnel. See. Subasri Realty Pvt. Ltd. v. N. Subramanian, (CA) (AT) (Insolvency) No. 290 of 2017.
[150] The Companies Auditor's Report Order, 2020 is an audit report format for statutory audits under the Companies Act, 2013 which includes reporting upon inter alia working capital, inventory, assets, guarantees, investments, statutory liabilities and default in repayment of borrowings. Ministry of Corporate Affairs Notification No. *S.O. 849(E)* https://www.mca.gov.in/Ministry/pdf/Orders_25022020.pdf.
[151] Balvinder Singh, *IBC: Some Issues in the Processes and Improvements*, Insolvency and Bankruptcy Regime in India: A Narrative, IBBI (2020).
[152] Michelle Welsh & Helen Anderson, *Director Restriction: An Alternative to Disqualification for Corporate Insolvency*, 37 Company and Securities Law Journal 23 (2019).
[153] Peter Whelan, *The Emerging Contribution of Director Disqualification in UK Competition Law*, Oxford University Press (2020).

appropriate institutional set-up between the IBBI and the Registrar of Companies to coordinate to make the director disqualification system.[154]

An effective director disqualification system for recalcitrant directors can result in causing reputational loss, career damage and act as warning for directors of other companies.[155] Further, the mechanism can help in fostering and re-emphasizing director's duty to act in the best interest of the company, uninfluenced by his/her personal interests.[156] While the effectiveness of the deterrence measures within the wrongful trading liability standards remains to be tested; however, references from other commercial regulatory regimes suggests a strong need for internalizing the director disqualification mechanism.[157] The statistics clearly highlights the need for a director disqualification mechanism for establishing an effective director compliance culture as envisaged within the IBC.

Even outside of these specific challenges, there remains several structural problems which requires policy-based solutions. An optimal framework for director liability must also take into consideration that the peculiarities of different categories of corporate debtors. The micro, small and medium enterprises (MSMEs) forms the backbone of the Indian economy contributing almost 30% of the GDP[158], thereby effectuating the need for corporate MSMEs to have specialized framework. The corporate MSMEs can be granted certain exemptions from the strict rigors of director liability obligations as financially they may not always be in a position to take into consideration the interest of different stakeholders at the same time.[159] Accordingly, the avoidable transactions standards under the IBC should be made applicable in phased manner based upon their growth, especially the onerous wrongful trading standard

[154] Debanshu Mukherjee & Dinkar Venkatasubramanian, *Insolvency and Bankruptcy Code: The Journey So Far and the Road Ahead*, Vidhi Centre for Legal Policy (2018).
[155] Samet Caliskan, *Individual Behaviour, Regulatory Liability, and a Company's Exposure to Risk: The Deterrent Effect of Individual Sanctions in UK Competition Law*, 10 Journal of European Competition Law & Practice 6 (2019); Amelia Fletcher, *An Assessment of Discretionary Penalties Regimes*, UK Office of Fair Trading (2009).
[156] Nicole Kar, Robert Walker & Glen Davies, *Competition Disqualification Orders and the Lessons Which Can Be Learned from the Insolvency Context*, 10 Competition Law Journal 306 (2011)
[157] As per the Competition Commission of India (CCI) Annual Report 2018-19 out of the aggregate penalty imposed of Rs. 13,881.73 crore, merely Rs. 0.37 crore was imposed on individuals and out of which only Rs. 0.10 crore was realised. Similarly, as per the Securities and Exchange Board of India (SEBI) Annual Report 2019-20, recovery of penalty proceedings were initiated for Rs. 6851.18 crore of which only Rs. 70.48 crore could be realised.
[158] Ministry of Micro, Small and Medium Enterprises, Government of India Annual Report 2018-19.
[159] World Bank Group, *Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency* (2018). Hetal Doshi & Yashasvi Jain, *The Insolvency and Bankruptcy Framework and Principle of Business Efficacy across Different Jurisdictions*, 42 Kluwer Business Law Review 1 (2021).

towards the end where they maybe in a position to financially compete with the large conglomerates.[160]

5. MEASURES TO MITIGATE DIRECTOR LIABILITY

In absence of legislative and judicial guidance over borderline insolvency, it is suggested that the board of directors self-regulate their decisions and actions from the onset of financial distress and until its completion by devising strategies which reduces the scope for imputation of liability. Scholars suggest measures such as thoroughly documenting all director decisions by weighing the balance of competing interests amongst different stakeholders and make informed, reasonable and good faith decisions in the interest of the company.[161] Further, there can be put in place regular formal processes to review cash flow position, actual and contingent outstanding claims and possibilities of outside court restructuring at the onset of financial distress. The present section provides an overview of two such measures which can be undertaken by directors independently to avoid good faith director liability (in the nature of error in judgments or honest risky business decisions) for effective discharge of duties during borderline insolvency.

5.1.Compulsory Director & Officer Liability Insurance

During the lifetime of the corporation, not all decisions taken by the directors are detrimental towards any particular stakeholders. These decisions often involve legal and operational risks arising out complexities in changing landscape of conducting business amidst the legal, economic and financial constraints.[162] Thus, a director and officer (D&O) liability insurance provides safeguards in form of indemnification for personal liability arising out of negligence, default, misfeasance, misstatement, misrepresentation, breach of fiduciary duties

[160] Ronald Davis et al, *The Modular Approach to Micro, Small, and Medium Enterprise Insolvency*, Peter A. Allard School of Law Working Paper (2016)
[161] R. Paul Yetter, *Entering the Sixth Dimension: An Area Called "The Insolvency Zone*", Rocky Mountain Mineral Law Institute (2009); Justin Wood, *Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany and Japan*, 26 Penn State International Law Review 139 (2008); Ronald Davis & Janis Sarra, *Director and Officer Liability in Corporate Insolvency: A Comprehensive Guide to Rights and Obligations*, LexisNexis (2010).
[162] Li-Su Huang, *Directors and Officers Liability Insurance and Default Risk*, Geneva Papers on Risk and Insurance - Issues and Practice (2021).

or breach of trust by the company directors.[163] However, guilty actions which involves elements of malice, connivance and bad faith in nature of fraud are not covered as part of insurance.[164] Even in context of insolvency, where the company has limited assets, D&O insurance liability aids directors to cover litigation costs.[165] Since the directors are expected to act in the interest and betterment of the company, as per the business judgement rule, provisioning for D&O liability insurance presumes the trust of the company in their directors. While the legal coverage differs from policy-to-policy, most insurances covers defense and settlement costs, fines and penalties, environmental damages, and employment termination losses.[166]

For a successful claim, the acts or decisions of directors must necessarily be borne out of an error in judgment or negligence and if the violation has been committed with the consent or connivance of the director, there will be no effect of the insurance.[167] In the UK[168] and US[169] the law statutorily authorizes compulsory director and officer liability insurance to mitigate director liability risks against instances of negligence, default, breach of duty or breach of trust.[170] While in India, Section 197(13) of Companies Act, 2013 recognizes the company practice of undertaking D&O insurances for their directors, however Regulation 25 of SEBI (Listing Obligations & Disclosure Requirements) Regulations, 2015 mandates only top 500 companies by market capitalization to undertake the insurance. On account of borderline insolvency duties being imposed upon the directors under the IBC, it can be mandated that all public and private companies compulsorily undertake D&O insurance policies to reduce the stereotyping of business risks by directors. Similarly, the insurance cover should cover the risks arising out of claims relating to personal liability in instances of avoidable transactions like preference and undervalued transactions and wrongful trading liability under the IBC.[171] It will

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163 María Gutiérrez, *An Economic Analysis of Corporate Directors' Fiduciary Duties,* 34 Rand Journal of Economics 3 (2003).
164 Terrence Stolly, *Scienter under the Private Securities Litigation Reform Act of 1995: Unexpected Implications on Director and Officer Liability and D&O Insurance*, 29 Capital University Law Review 545 (2002).
165 Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance*, 14 Delaware Journal of Corporate Law. 1 (1989).
166 Kuei-Fu Li &Yi-Ping Liao, *Directors' and Officers' Liability Insurance and Investment Efficiency*, 29 Pacific-Basin Finance Journal (2014).
167 Adolfo Paolini & Deepak Nambisan, *Directors' and Officers' Liability Insurance*, Taylor & Francis (2015).
168 Section 233 of UK Companies Act, 2006.
169 Section 145 of Delaware General Corporation Law, 1899.
170 Andres Engert, Reid Feldman, Pamela L. Huff, & Donna McKenzie-Skene, *Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies - Comparative & International Perspectives*, 1 Journal of Business & Technology Law 313 (2007).
171 Jonathan Mukwiri, Directors' and Officers' Insurance in the UK, 28 European Business Law Review 547 (2017).

ensure that directors undertake business decisions, without the fear of litigation risks, in line with the spirit of entrepreneurship as also envisaged by IBC.[172]

5.2.Better Negotiation of Debt & Material Supply Contracts

The director's role is to maintain a fine balance between running smooth operations of the business and preserving and enhancing corporate value of the assets. Towards this, negotiation of material supply contracts assumes importance in context of borderline insolvency and director liability. Since the director liability framework often acts as contractual gap-fillers to protect the interest of shareholders and creditors, it is of essence that these contracts precisely define the instance of default, pre-conditions to initiation of insolvency resolution and options for outside court restructuring.[173] One way could be to have the contractual terms governing defective supply and consequent breach of terms and conditions be detailed to reduce the instances of unforeseeable contractual liability.[174]

Further, the contracts can also provide for alternative modes of recovery outside of the IBC, both during solvency and borderline insolvency, with time-bound dispute resolution clauses to preserve the business relationship between the company and its creditors.[175] The IBC doesn't explicitly invalidate *ipso facto* clauses on event of insolvency admission.[176] It is therefore essential that supply contracts are drafted in a manner that protects the commercial relationship between the parties even during the stage of resolution of financial distress.[177] While, prescribing restrictions on initiating simultaneous default claims against the corporate debtor and guarantor is unlawful[178], guarantee contracts can however, specifically debar the creditors

[172] MS Sahoo & Anuradha Guru, *Indian Insolvency Law*, 45 Sage Journals 2 (2020).
[173] Fredrick Tung, *Gap Filling in the Zone of Insolvency*, 1 Journal of Business and Technology Law 607 (2006-2007).
[174] Balvinder Singh, *IBC: Some Issues in the Processes and Improvements*, Insolvency and Bankruptcy Regime in India: A Narrative, IBBI (2020).
[175] It may include adjudicatory recovery before the Debt Recovery Tribunal under the Recovery of Debt due to Banks and Financial Institutions (RDBFI) Act, 1993 or under the Negotiable Instruments Act, 1881 under administratively the Securitisation & Reconstruction of Financial Assets & Enforcement of Security Interest (SARFAESI) Act, 2002. The contract can also as a pre-condition provide settlement recovery through mediation or conciliation. See. Adam Brenneman & Pamela Arce, *You Have Options: The Use of Alternative Dispute Resolution in Insolvency Proceedings*, 13 Pratt's Journal of Bankruptcy Law 336 (2017)
[176] They are contractual provisions that permit one party to terminate the contract with its counterparty on occurrence of an "event of default", which in context of insolvency implies admission of insolvency petition or commencement of formal insolvency proceedings. See. Gujarat Urja Vikas Nigam Limited v. Amit Gupta, Civil Appeal No. 9241 of 2019.
[177] Debanshu Mukherjee & Dinkar Venkatasubramanian, *Insolvency and Bankruptcy Code: The Journey So Far and the Road Ahead*, Vidhi Centre for Legal Policy (2018).
[178] State Bank of India v. Athena Energy Ventures Pvt. Ltd. CA (AT) (Insolvency) No. 633 of 2020.

from initiating simultaneous claims based upon the same set of debt and default against co-guarantors.[179] Further, the invoice of debt and supply contracts as a matter of good corporate practice can also provide for payment of agreed rate of interest in the instance of default by any of the parties, to avoid needless litigation.[180] Overall, the company directors can use creative and also detailed contractual terms to avoid unforeseeable liability of no fault of their own. This may also preserve the enterprising and risk-taking characteristics of the board.

6. CONCLUSION

The onset of financial distress within a corporate set-up can result in making hasty, negligent and judgment errors in decision making. This impact both the shareholder and non-shareholder constituencies. The law on fiduciary duties aims to minimize and channelize the director liability upon the responsible person during the life cycle of the company. The corporate governance norms applicable upon the company doesn't end with solvency but strengthens their application from the borderline stage, leading to efficient and disciplined value preservation of corporate assets. As seen in the paper, matured insolvency jurisdictions like the US and UK have devised deterrence mechanism for overt director behavior along with appropriate liability minimizing measures. The conjoint effect of fiduciary duties envisaged under the Companies Act, 2013 and the IBC leads to pre-*Gheewala* situation making directors susceptible to excessive and malicious litigation at the hands of opportunistic shareholders and creditors. The challenges highlighted to Indian directors liability framework above has resulted in lack of understanding regarding trigger shifting of duties, nature and beneficiaries of such shifting at different stages and applicability of specific corporate governance norms during borderline insolvency. The ease of doing business can be amplified by clarifying (and to certain extent modifying) the extant framework on director liability as suggested in the paper. In effect however, where governance norms are adhered to in letter and in spirit, the impact of financial distressed can be averted to a considerable extent.

[179] Vishnu Kumar Agarwal v. Piramal Enterprise Ltd., Company Appeal (AT) (Insolvency) No.633 of 2018. The question on whether simultaneous claims against co-guarantors can be barred as stated by the NCLAT in Piramal Case is pending in appeal before the Supreme Court of India.
[180] Krishna Enterprises v. Gammon India Ltd., Company Appeal (AT) (Insolvency) No. 144 of 2018.