Insolvency and Related Considerations for Directors

Directors of a company in financial difficulty should be aware that their conduct may be subject to close scrutiny if the company falls into insolvency under the Insolvency and Bankruptcy Code, 2016, as amended. Courts have held that unless all measures have been taken to revive the company, the making of a winding-up order may not be in the best interests of creditors, and going concern values may result in higher repayments to the creditors. The directors should therefore take all steps to ensure that the company continues as a going concern. In this regard, directors should be able to defend their actions provided that they were made in good faith. However, when there is no reasonable prospect of the creditors ever recovering debts due to them from the company, courts may infer that any efforts to carry on the business were attempts to defraud creditors.

Section 166 of the Companies Act, 2013, as amended, which codifies the duties of directors, does not expressly recognize a duty in the event of potential or actual insolvency towards creditors as the company's primary risk-bearers. Further, courts have held that the code is a beneficial legislation intended to put a corporate debtor back on its feet and not merely a statute for recovery by creditors. However, the code does contain protective provisions in relation to transactions that may be undervalued, preferential, extortionate, fraudulent or amount to wrongful trading. The conduct of directors who have authorized such transactions may be called into question and, in certain circumstances, such directors may incur personal liability. Following insolvency, such transactions may be declared void upon an application by the insolvency resolution professional or liquidator. Directors must therefore ensure that: (i) any transfer of property or assets transferred is valued appropriately and does not give preference to any creditor; (ii) the terms of any credit transaction do not involve exorbitant payments; and (iii) the company does not enter into any transactions that may be viewed as fraudulent or wrongful trading.

Pursuant to section 66(2) of the code, a director may be ordered to contribute to the company's assets if such director: (i) knew or ought to have known that there was no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process; and (ii) did not exercise due diligence in minimizing the potential loss to the company's creditors. This provision implies a duty to minimize losses to creditors and requires a director to have exercised such due diligence as may be reasonably expected. Accordingly, new liabilities should be carefully scrutinized and the company prevented from incurring them until it is clear how they will be paid.

Nominee directors of a potentially insolvent company are in a particularly sensitive position. They are likely to face a conflict between the interests of the appointer and their fiduciary duty to act in the best interests of the company, shareholders and other stakeholders (including creditors). Nominee directors may reasonably take the interests of their appointers into account so long as they do not conflict with the collective interests of the shareholders and the creditors, and are likely to promote the success of the company. This is often a very difficult task to achieve.

In addition, directors are expected to: (i) actively monitor the company's performance at meetings of the board of directors and its committees, including taking part in regular discussions; (ii) evaluate up to date financial information in a timely manner; (iii) monitor and ensure compliance with financial or other covenants in loan agreements; (iv) demand follow-up reports within a reasonable timeframe; (v) communicate any concerns or apprehensions to other board members; (vi) avoid any conflict of interest and, where not avoidable, make prompt disclosure; and (vii) apply independent judgement.

The board of directors should seek financial and legal advice in relation to their duties and decisions where necessary. All advice and decisions should be documented. Accurate and up to date board minutes will assist in establishing that the board acted correctly and tried to minimize potential loss to creditors. Any unresolved concerns or issues should be appropriately recorded in the board minutes. This is also important from the perspective of a director who concludes that there is no reasonable prospect of the company avoiding an insolvent liquidation, but who fails to persuade the other board members and, accordingly, wishes to resign from the board, so that a resignation by such director is not viewed by the courts as an abdication of responsibility. However, such resignation will not absolve the director of liability for any acts or omissions during the period of directorship.

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