Insolvency Code and Its impact on Role of Directors

Since its introduction of Insolvency & Bankruptcy Code (the Code) in 2016, the theme of insolvency has taken centre stage in Indian commercial law. The Code has impacted present way of carrying on of business, behavioral change with respect to default to creditors and the companies can ignore its provisions at their own peril.

The directors of a company are responsible for management of the company and under Section 166 of the Companies Act, 2013 (the Act), the director should act in good faith in order to promote the objects of the company for the benefit of all stakeholders. As long as the company is meetings its obligations, paying its creditors on time, the board of the company mainly focus on operational parameters, compliance, long-term vision, CSR, etc. However, most of the boards and directors are largely unaware of their role when the company is in financial distress, impact of default to creditors and possibility of admission of insolvency against the company under the Code and the resultant impact on the company's board and its role.

Section 166 of the Act does not expressly recognize duty of directors in the event of potential or actual insolvency. Historically, the directors are accustomed to monitor the company's payments to its banks and ensure its timely payments. However, the Code also empowers operational creditors, who supplies goods and services to company, to initiate insolvency against the company in the event of default above certain threshold. As services sector has grown recently, companies reliance on operational creditors, have increased substantially. Accordingly, director are inter alia expected to:

- Review the company's performance at meetings of the board and its committees
- Ensure company's solvency to meet its obligations in a timely manner
- Monitor and ensure compliance with financial or other covenants of loan agreements
- Evaluate up to date information on the company's overall obligations to its both financial and operational creditors including cash flow mismatches
- Current and projected position of payment to company's creditors and defaults, if any

Once the company is under financial distress, the duties of the directors shift to maintaining the company as going concern. In developed insolvency jurisprudence, above period is known as *twilight period* and is considered as the period between the point of knowledge or awareness of no real prospects of avoiding an insolvency proceeding against the company, and its actual commencement. During the *twilight zone*, directors are expected to exercise reasonable skill, care and diligence and have a duty to protect the interests of the corporate creditors and preserve the assets of the company so that the creditors may ultimately realize the debt out of those assets.The *twilight period* is a challenging time for distressed companies and their directors as they have responsibility to keep business afloat as well act in in the interest of creditors also.

Question arises whether the management would bring these issues before the board in a timely manner. Directors therefore have to re-engineer existing Management Information System and information flow to boards to ensure that they are not caught unaware of cash flow mismatches and resultant defaults.

It has been observed that a number of times, directors are caught unaware of the defaults made by the company and directors quit the board in a hurry. Such incidence further exacerbates the problem on hand.

During financial distress, many directors are reluctant to cross the line between management and governance. Such financial difficulties limit the ability of the company to raise further resources, impacts goodwill, and adversely affect the rating of the company. However, deep board engagement with management is required to provide guidance to the management to enable them to take proactive steps to overcome financial distress.

The proactive actions may inter alia include plan for deferring or meeting liability by additional borrowings, sale of assets, working capital management, restructuring of borrowings, etc. including initiating corporate insolvency resolution process by the company itself under Section 10 of the Code. Above actions ensures that not only stakeholders are not caught with sudden adverse actions but also receive co-operation from stakeholders in overcoming difficulties.

There is an additional responsibility on the directors to prioritize the interest of the creditor above the shareholders. Further, as per Section 46 of the Code, a director can also be held responsible for actions taken up to one year preceding the commencement of insolvency proceedings, and two years in case of related party transactions. Moreover, NCLT can declare void, set aside undervalued transactions and preferences which were entered by the company up to two years before the commencement of insolvency process under Section 45 of the code.Pursuant to Section 66(2) of the Code, a director may be ordered to minimize losses to creditors and require a director to have exercised such due diligence as may be reasonably expected. It is therefore imperative that new liabilities should be carefully scrutinized and the company prevented from incurring them until it is clear how they will be paid. In addition, alienation and transfer of assets should be done at appropriate valuations.

Section 166 of the Act, 2013, 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. The Code provides for certain transactions that may be undervalued, preferential, extortionate, fraudulent, or amount to wrongful trading.

Once insolvency under the Code commences, as per Section 17(1)(b) of the Code, the powers of board of directors stand suspended without any further direction and are exercised by the interim resolution professional. Thereafter, resolution professional is duty bound to file undervalued and preferential transactions as per Code before NCLT. Therefore, directors of a company in financial difficulty should be aware that their conduct will be under close scrutiny later statutorily if the company falls into insolvency under IBC.

The Code has brought significant changes for the companies which are in financial difficulties and may be admitted into insolvency. Above requires board to re-design information systems so that board be aware of such situations in advance. Although the directors have fiduciary relationship towards the company under the Act, the directors have additional obligations towards the creditors under the *twilight zone* which have been identified and bestowed upon the directors under the Code. The directors are expected during financial difficulty period to act in the bona fide interests of the creditors and simultaneously ensure that adequate steps are taken to keep company off insolvency. Above require board to have deeper engagement with the management to guide them to overcome difficulties and take correct decisions.