DEVISING BETTER LEGAL MECHANISMS FOR DISCIPLINING WILFUL DEFAULTERS AND DETERRING SUCH CONDUCT

Debanshu Mukherjee

Shreya Garg

Chintan Chandrachud

Sowjhanya Shankaran

30 November 2014 www.vidhilegalpolicy.in

Authors

Debanshu Mukherjee is a Senior Resident Fellow at Vidhi. He heads Vidhi's Financial Regulation and Corporate Law vertical.

Shreya Garg is a Research Fellow at Vidhi.

Chintan Chandrachud and Sowjhanya Shankaran are Associate Fellows at Vidhi.

Anjali Ayachil provided research assistance on parts of this report.

Acknowledgments

We take this opportunity to thank Dr. Kristin van Zwieten (Clifford Chance Associate Professor of Law and Finance at the University of Oxford) for her comments on this report.

Errors and omissions, if any, are the Authors' alone.

Contents

1. Wilful Defaulters under RBI Guidelines

Pursuant to the Master Circular on Wilful Defaulters dated July 1, 2014 ("**Master Circular**") issued by the Reserve Bank of India (the "**RBI**")[1] which incorporates all instructions/guidelines issued on cases of wilful default issued till such date, the term "wilful default" is defined as under:

- The unit has defaulted in meeting its payment/repayment obligations to the lender even when it has the capacity to honour the said obligations.
- The unit has defaulted in meeting its payment/repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.
- The unit has defaulted in meeting its payment/repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.
- The unit has defaulted in meeting its payment/repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank/lender.

It may be noted that for the default to be characterized as wilful it is supposed to be *"intentional, deliberate and calculated"*.

Further, the terms "diversion of funds" and "siphoning of funds" have also been defined.[2] Certain key aspects of the circular also include that all the borrowing units identified as wilful defaulters or the promoters involved in diversion/siphoning off funds as per the above definition are subject to penal measures, which include that no additional facilities be granted to the borrower/promoter[3] of

---

[1] RBI/2014-15/73 DBOD No.CID.BC.3/20.16.003/2014-15

[2] Diversion of funds, includes *any one* of the following:

(a) Utilisation of short-term working capital funds for long-term purposes not in conformity with the terms of sanction;
(b) Deploying borrowed funds for purposes / activities or creation of assets other than those for which the loan was sanctioned;
(c) Transferring funds to the subsidiaries / Group companies or other corporates by whatever modalities;
(d) Routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender;
(e) Investment in other companies by way of acquiring equities / debt instruments without approval of lenders; or
(f) Shortfall in deployment of funds vis-à-vis the amounts disbursed / drawn and the difference not being accounted for.

Siphoning of funds should be construed to occur if any funds borrowed from banks/ financial institutions ("**FIs**") are utilised for purposes unrelated to the operations of the borrower, to the detriment of the financial health of the entity or of the lender. The decision as to whether a particular instance amounts to siphoning of funds would have to be *a judgement of the lenders based on objective facts and circumstances of the case.*

[3] Promoters may be debarred from institutional finance (for the purpose of 'floating new ventures') for a period of 5 years.

such borrowers by any institutional financier, imposition of criminal proceedings against the borrowers and adoption of a proactive approach to change the management of the borrower.

Pursuant to a clarification dated September 9, 2014, the RBI has clarified the term 'unit' in the definition of wilful defaulter would include individuals, juristic persons and all other forms of business enterprises, whether incorporated or not. In case of business enterprises (other than companies), banks/FIs may also report the names of those persons who are in charge and responsible for the management of the affairs of the business enterprise. The term 'lender' includes all banks/FIs to which any amount is due under a banking transaction and such banking transaction includes off balance sheet transactions such as derivatives, guarantees and letters of credit. Further, if a guarantor refuses to comply with the demand made by the creditor/banker, despite having sufficient means to make payment of the dues, such guarantor would also be treated as a wilful defaulter. This measure is to apply prospectively and not in cases when the guarantees were taken prior to the date of issue of the circular. This clarification is likely to specially affect project financing since in such transactions the borrowers are usually special purpose vehicles and the promoters (guarantors) are effectively the persons on whose credit the loans are extended.[4]

2. Origin and Development of the 'Wilful Defaulter' Concept

In its circular dated April 23, 1994, the RBI announced that in order to alert the banks and FIs and put them on guard against borrowers who have defaulted in their dues to other lending institutions, the RBI was putting in place arrangements for circulating among banks and FIs names of defaulting borrowers above a threshold limit (which was prescribed at Rs. 1 crore at the time).

In revision of the definition prescribed by the RBI in 1999, the RBI, on May 30, 2002 prescribed a fresh definition of the term 'wilful defaulters' which contained clauses (a), (b) and (c) as highlighted above in Section 1, and the threshold limit was revised to Rs. 25 lakh and above. This circular was prescribed as a result of the findings of the Working Group on Wilful Defaulters which was constituted under the chairmanship of S.S. Kohli and which submitted its report in November 2001.

The above read with the circular issued by the RBI July 29, 2003 titled *"Wilful Defaulters and action thereagainst"* prescribed that with a view to imparting more objectivity in identifying cases of wilful default, decisions to classify the borrower as wilful defaulter, in future, may be entrusted to a Committee of higher functionaries headed by the Executive Director and consisting of two GMs/DGMs as decided by the concerned bank/FI[5]. Further, the decision taken on classification of wilful defaulters was to be well documented and supported by requisite evidence. A grievance redressal mechanism (headed by the Chairman, Managing Director and two other senior officials) was to be created to present a fair hearing to borrowers who represented that they have been wrongly classified as wilful defaulters.

It is apparent that with the exception of the RBI clarification in September 2014, the scope of the definition of 'wilful default' has not changed much over the last two decades. However, the revised language in the clarification in relation to the group guarantors seems to be reasonable since it is presumable that such group guarantors are complicit with the defaulting unit in non-payment of the

[4] B. Sivaprakasam et al "Wilful Defaulter label: Usage by Banks" (2014) 56 *India Business Law Journal*

[5] http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=1279&Mode=0

invoked guarantee.[6] In keeping with the stringent regime of the RBI, the Securities and Exchange Board of India, which up until now only required disclosure in the event that promoters or directors of a company were on the RBI wilful defaulters, has now sought to prevent such defaulters from accessing capital markets as well. In its board meeting dated November 19, 2014, the SEBI has directed that SEBI Act, 1992 be amended in respect of restricting an issuer company/its promoter/directors, categorized as wilful defaulter, from raising capital. While this has been seen as a necessary move in the wake of several high profile companies, defaulting heavily on debt payments, it is even more crucial to put in place a mechanism that both effectively deters and counters wilful defaults.

3. The decision of the Court in Ionic Metalliks v. Union of india

On September 9, 2014, the Gujarat High Court in its decision on a challenge to the constitutional validity of the Master Circular held, inter alia, the following: (a) the RBI is within its powers to issue the Master Circular on wilful defaulters and is empowered to regulate the banking system pursuant to its mandate under the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. Such power is not impermissible delegation of a legislative power; (ii) the claim of *nemo judex in causa sua* (i.e. no one should be judge in his own cause, said to be engaged because the decision to classify a borrowing unit as a wilful defaulter is made under the Circular by the lending bank / FI) is not sustainable since the Master Circular does not restrict the jurisdiction of Courts and further, sufficient safeguards have been prescribed in the Master Circular to ensure that a reasoned and fair hearing is provided to borrowers before classifying them as 'wilful defaulters'; and (iii) that the provisions of the Master Circular, though not in violation of Article 19(1)(g)[7] of the Constitution of India, 1950, in its application to all directors of a defaulting borrower are arbitrary and unreasonable and deserved to be struck down to that extent. The order of the Gujarat High Court to the extent of striking down this provision of the Master Circular needs to be examined.

In coming to this conclusion, the Court observed the Master Circular *"shatters the concept of the identity of a company different and distinct from its directors, without providing any safeguard."* Further, despite Paragraph 5.2 of the Master Circular acknowledging the limited role of independent and nominee directors, the Master Circular has included them in the purview of the penal measures in Paragraph 2.5(d), relating to their ability to sit on the board of other companies having been on the board of a wilful defaulter.[8] The Court held that all the directors of the company, since they may not be involved in the day to day functioning of the company, could not be held liable for the default in repayment of the loan which might be for reasons beyond the control of the directors.

---

[6] S. Singh et al "Banking circles welcome circular on wilful defaults" (2014) 70 *India Business Law Journal*

[7] Article 19(1)(g) states that All citizens shall have the right to practice any profession, or to carry on any occupation, trade or business

[8] Paragraph 2.5 (d) states that "*A covenant in the loan agreements, with the companies in which the banks/notified FIs have significant stake, should be incorporated by the banks/FIs to the effect that the borrowing company should not induct a person who is a promoter or director on the Board of a company which has been identified as a willful defaulter as per the definition at paragraph 2.1 above and that in case, such a person is found to be on the board of the borrower company, it would take expeditious and effective steps for removal of the person from its Board.*"

It is submitted that the findings of the court suffer from the following infirmities:

Firstly, the penal measures prescribed under the Master Circular in Paragraph 2.5(a) only prohibit entrepreneurs and promoters who have been identified as wilful defaulters from obtaining institutional finance from scheduled commercial banks and/or FIs for a period of five years. The Gujarat High Court held a director cannot be restrained from availing financial facilities from banks and FIs if such director wants to start a new venture, and further added that such restraint is a direct infringement of the right of such director granted under Article 19(1)(g) of the Constitution. In coming to this conclusion, the Court has overlooked the restriction in Paragraph 2.5(a) which applies only to the wilful default unit itself, or to 'entrepreneurs and promoters' of these units (that is, a narrower class than all directors), who have significant, if not entire control over the functioning of a unit.

Secondly, the restriction in Paragraph 2.5(d) though applicable to all directors seems to be aimed at ensuring that directors who have had influence in the decision making process of companies which have been identified as wilful defaulters, do not further have control/influence over other borrowing companies, in order to ensure that both banks and borrowers are safeguarded. Having said that, the Master Circular itself does not provide any guidance on this issue. If a director who has disagreed with the decisions of the majority of the board, and perhaps subsequently resigned in consequence, is to be treated in the same way as the directors that authorized siphoning / diversion, this may appear arbitrary. Although some of the conduct within the meaning of 'wilful default' clearly would involve a breach of duty by directors, there is no safety valve for a director who establishes **no breach on their part: it appears sufficient to have been on the board at the relevant time, without more.**

Recommendations:

While the categorization of directors under the Companies Act, 2013 and the Listing Agreements of the stock exchanges is a guiding factor to determine which directors have a role in managing the day-to-day functioning of a company, the mere title of the director should not be a yardstick to determine whether such director should be under the purview of the Master Circular.

In cases of companies with private equity infusion which have nominee directors of investors on the board, a method to determine the extent of involvement of directors is to analyse the articles of association/shareholders' agreements. Several matters, including in relation to borrowing and repayment of loans, are reserved by the board of directors wherein the affirmative vote of such nominee directors is required for a resolution to be passed or an action to be undertaken. In such cases, it is imperative that such nominee directors be brought under the purview of the Master Circular. Further, the classification under the Companies Act, 2013 for determining "officer who is in default" under Section 2(60), which includes whole time directors, key managerial personnel, persons with whose advice the board of directors acts, etc could be considered as a guideline under the Master Circular.

Section 2(60) of the Companies Act includes "whole-time directors" and "every director, in respect of a contravention of any of the provisions of this Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the Board or participation in such proceedings without objecting to the same, or where such contravention had taken place with his consent or connivance”. Even independent and non-executive directors are covered within the purview of this definition subject to certain exceptions provided under Section 149(12).

It is submitted that RBI may consider revising the disqualification (Clause 2.5 (d) of the Master Circular) and reporting related requirements (Clause 5) as applicable to the directors on the lines of the Companies Act provisions discussed above. Such determination should be carried out by the banks at the time of assessing whether a wilful default has taken place.

4. Mechanisms under Company Law

As discussed above, while the Gujarat High Court in the case of *Ionic Metalliks v. Union of India* held that the issuance of the Master Circular was not an “impermissible delegation of legislative power”, there is a view that the banks, as non-state actors may not be most effective/appropriate authority to adjudicate on such matters. While default on loans is a violation of contract, from a rule of law perspective, the intent of the person violating such contract should not ideally be assessed by a non-judicial body. While the Master Circular does provide for a grievance redressal mechanism, the constitution of the committee comprising of GMs/DGMs of the Board of the financial institution may be in violation of principles of natural justice since fairness demands that an adjudicatory body ought not to be personally interested in the outcome of a decision/redressal mechanism. The present framework seems highly susceptible to legal challenges and may not be the most efficient way of achieving the desired outcomes. As is evident from certain recent instances, ‘wilful defaulters’ often dispute the finding of a bank by initiating legal challenges, delaying the final outcome. Wilful defaulters, who have the resources to litigate for many years may see more benefit in disputing such determination in courts than making efforts to repay.

In most other jurisdictions, situations analogous to at least some of the categories of ‘wilful defaults’ in the Master Circular are dealt with under the provisions relating to managerial liability and the avoidance of transactions in the company and insolvency laws of those countries. Such provisions kick-in in the run up to the insolvency. Given that ‘inability to pay debt’ on a formal demand is a ground for liquidating a company in India, the insolvency law provisions on managerial liability can be invoked in most cases of wilful default. Having said that, given the ineffectiveness of the Indian corporate insolvency regime, the importance of the present RBI regime on ‘wilful defaulters’ cannot be questioned. However, Indian corporate law in general and corporate insolvency law in particular contain several provisions, which if effectively invoked can go a long way in deterring wilful defaults and disciplining wilful defaulters.

A. Managerial liability and transaction avoidance provisions under Indian corporate insolvency laws

1. Law on the Books

The insolvency related provisions of the Companies Act, 1956 ("**CA 1956**") contain several provisions, which may be used to initiate criminal proceedings or impose personal liability to contribute to the company's assets against delinquent officers/controlling shareholders of the company in situations where they have acted against the interest of the creditors.

A significant provision strengthening creditor protection is Section 542, which imposes criminal sanctions against fraudulent trading. Section 542 provides that if in the course of winding up of a company, it appears that the business of the company has been carried on with an intent to defraud creditors or any other persons, or for any fraudulent purpose, **every person (even promoters get covered)** who was knowingly a party to the carrying on of the business in such fraudulent manner shall be personally responsible for any of the debts or liabilities of the company **(without any limitation of liability)** as may be directed by the court. Further, such person may also be liable to imprisonment for a term which may extend to 2 years or fine which may extend to Rs. 50,000, or with both. In order to be held liable under this section, it has to be proved that the person had carried on the business of the company with the intent to defraud creditors. Thus proof of dishonesty has been considered to be a vital element for the offence.

The CA 1956 also contains several other measures to safeguard the interest of the creditors. Thus under Section 540, officers of the Company being wound up may be prosecuted if they are found disposing off the property of the company or concealing at part of it thereof with the intent of defrauding the creditors of the Company. Section 543 provides that if in the course of winding up of a company, it is found that that **any person** who has taken part in the promotion or formation of the company, or any past or present director, manager, liquidator or officer of the company has misapplied, or retained, or become liable or accountable for any money or property of the company or has become guilty of misfeasance or breach of trust in relation to the company, then the Court can compel him to repay or restore the money or property with interest or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust as the case may be. Further provisions for the protection of creditor interests may be found in Section 538 , which makes certain fraudulent acts, omissions etc by officers of the company susceptible to criminal prosecution. Section 545 also provides for the prosecution of any past or present officer or **any member** of the company if it appears to the Court in the course of winding up of the company that such person has been guilty of an offence in relation to the company. The Court may choose to refer the matter to the Registrar of Companies instead of prosecution. Action under this section may be undertaken by the court either on an application by the person seeking the winding up of the company or *suo moto*.

With the object of furthering creditor interests, the CA 1956 contains numerous provisions, which prevent the corporation from making transfers, attachments or executions prior to and during the winding up process. Thus, Section 531A voids any transfer of property or delivery of goods made by a company within the period of one year before the presentation of a petition for winding up by the Court or the passing of a resolution for voluntary winding **up if it not made in the ordinary course of its business or in favour of a purchaser or encumbrancer in good faith and for valuable**

consideration. Such a provision has been included to prevent the siphoning away of corporate assets by company management having knowledge of the company's poor financial condition. There has been some indication from the courts that this provision strikes at undervalued transactions (similar to the provision avoiding transactions at undervalue contained in the British Insolvency Act 1986),[9] however, in practice it is not clear if the same sort of rigorous enquiry in the determination of undervalue transactions as done in the UK, is also followed in India.[10] Certainly the modern formulation of the undervalue transaction rule in the UK is different in its terms and scope to section 531A, despite their common heritage. Section 536, CA 1956 prohibits any transfer of shares of the company or the disposition of any property of the company including actionable claims and shares made after the commencement of the winding up process without the sanction of Company liquidator or the Court.[11] Similarly, under Section 537, attachment, execution or sale of Company property after the commencement of winding up without the leave of the Court is prohibited.[12] **These provisions are meant to prevent transactions that go against the *pari passu* principle of distribution of assets.**

The new company law legislation, the Companies Act 2013 ("**CA 2013**"), incorporates most of the provisions pertaining to managerial liability contained in the CA 1956 into its text. However, the relevant chapter has not been notified yet (as the National Company Law Tribunal, the adjudicating authority for insolvency matters under the new Act, has not been operationalized yet).The CA 2013 also contains a number of provisions which provide for the initiation of criminal proceedings against delinquent officers of the company or the imposition of personal liability on such officers to contribute to the company's assets. However, there are a number of issues which need to be resolved if the CA 2013 is to provide an effective regime for deterrence of managerial misconduct and punishment of offenders. For instance, the provisions under the CA 2013 do not recognise the existence of a duty on the directors to consider creditor interests when the company is in the zone of insolvency. Conventional corporate law jurisprudence says that the directors are primarily responsible to the company and its shareholders. However, given the societal losses associated with creditor losses and the risk of a creditor contagion, it has been argued that (as is the position in some other jurisdictions) that the duties owed by the directors to the company should be mediated by the interests of the creditors in insolvency or in the zone of insolvency. Additionally, insolvency law may make special provision for directors to be personally liable to the company in relation to their conduct in the lead up to insolvency proceedings. For example, the wrongful trading provision of the British Insolvency Act, 1986 subjects directors to personal liability if they fail to take reasonable steps to minimize the potential loss to the creditors after the point in time when they knew or ought to have known that there is no possibility of avoiding insolvent liquidation[13]. Such directors may be liable to

[9] See Section 238, Insolvency Act 1986

[10] See *Monark Enterprises v Kishan Tulpule* [1992] 74 CompCas 89 (Bombay); *Hawa Controls v Official Liquidator of Tirupati Foundry Private Ltd.* [2008]172 CompCas 528 (Gujarat).

[11] Section 536, CA 1956 (Section 334, CA 2013).

[12] Section 537, CA 1956 (Section 335, CA 2013).

[13] Section 214. 'Insolvent' liquidation means balance-sheet insolvency under this provision.

make contributions to the assets of the insolvent company, which could then be distributed to the creditors (Davies).

2. The Law in Practice

In a four year doctoral research project,[14] Kristin van Zwieten (now Clifford Chance Associate Professor of Law and Finance at the University of Oxford) conducted a comprehensive study of the development of corporate insolvency law in India, starting with the transplant of UK insolvency law during the colonial period to the operation of the law on liquidation and corporate rescue in the present day. Dr. van Zwieten's research findings reveal that courts in India have sometimes been inclined to view the non-payment of a single undisputed debt on demand as an insufficient basis to prove a company's 'inability to pay debts', notwithstanding that the CA provides for 'deemed' insolvency in these circumstances.[15] Some courts have required the evidence of such non-payment (even on formal demand) to be supplemented with additional evidence demonstrating the company's omission to pay without reasonable excuse and the existence of insolvency in the commercial sense.[16] The focus on the broader financial position of the company has also affected the judicial approach to winding up petitions said to be based on a 'disputed' debt. In dismissing petitions on the basis that the petitioner's debt is disputed, some courts appear to have been strongly led by evidence of the company's commercial solvency - rather than focusing on the veracity of the dispute alleged by the company. Thus, in India, courts seem to have combined the statutory demand test with a commercial insolvency test to determine when the company is unable to pay its debts. In contrast, in the UK, these tests constitute separate grounds for determining the company's 'inability to pay debts.'

More significantly, even where the petitioning creditor has proved the inability of the debtor company to pay debts, van Zwieten states that courts in India have recognised a wide discretion that enabled the courts to give time to the debtor to revive or make payment to the petitioner by later instalments, or even (albeit more exceptionally) dismiss the petition. The purpose of these practices was to avoid the making of a winding up order wherever possible. This is in stark contrast with the position in the UK where once the company's inability to pay debts has been proven, the petitioning creditor is ordinarily held to be entitled to a winding up order (although it should be noted that there is an alternative corporate rescue procedure, 'administration', which a debtor may be entitled to enter).

The cumulative effect of these developments appears to have been to render liquidation ineffective as a disciplinary mechanism against insolvent debtors. For the creditor to be able to use the threat of corporate insolvency procedures – with their attendant costs for debtors – to encourage repayment, there must also be a real possibility of the imminent commencement of liquidation proceedings, and attendant publicity. However, practices like requiring the non-payment of a single undisputed debt to be supplemented with evidence of the company's insolvency (in the commercial sense), or affording the debtor an opportunity to adjourn proceedings on the strength of their promise to later pay (perhaps by instalments) an already due debt, has meant that the threat of imminent liquidation

[14] van Zwieten, *The Demise of Corporate Insolvency Law in India* (2012, doctoral thesis in law, University of Oxford).

[15] See SS 433(e), 434(1), CA 1956.

[16] *e.g. Kanchanaganga Chemical Industries v Mysore Chipboards Ltd* [1998] 91 Comp Cas 646 (Karnataka), as cited in van Zwieten.

is not necessarily – at least in the present state of the law – a credible one[17]. Debtors are not compelled to negotiate with the creditors to restructure their debt or take other measures to resolve their financial distress. Therefore, it is necessary that the effect of these judicial practices be countered so that the creditor is ordinarily entitled to a winding up order upon proof of non-payment of a single undisputed debt after a formal statutory demand for payment has been made.[18]

An additional consequence of the apparent reluctance of courts to make winding-up orders (and associated costs of applying for such an order, given the likelihood of long delays, etc), is that few companies will likely go through formal liquidation proceedings. If the liquidation procedure is not used, then many of the statutory provisions identified above that can be used to constrain managerial behaviour in insolvent companies, are not available. Even where a winding up order *is* made, anecdotal evidence concerning the provisions relating to managerial liability under the CA 1956 suggests that those provisions have not succeeded in holding directors and other officers responsible for such violations. Interestingly, the evidence points to the existence of a practice whereby promoters resign from directorships and key managerial positions by the time the winding up order is made, installing employees (who act as proxies for such promoters) as directors in their place. Such 'employee-directors' then act as directors of the company which has already been stripped off valuable assets throughout the duration of insolvency proceedings. In such cases, it has been difficult to hold the promoters who are responsible for the company's failure accountable as they would have long ceased holding key managerial positions. While the managers can theoretically be held liable for transactions entered into while they were in office, prosecution in such cases has been found to be extremely difficult in practice.

The evidence also suggests that provisions relating to the prosecution of directors (and other persons) have been rendered ineffective due to funding constraints and lack of institutional capacity. The total number of Official Liquidators is grossly inadequate in comparison to the number of liquidations being initiated. As a consequence, Official Liquidators are currently overburdened, and are forced to give less priority to prosecutions under provisions imposing liability on directors. Further, Official Liquidators do not get adequate support in the form of legal assistance as the standing counsel

[17] Van Zwieten states how changes in practice and procedure in the early stages of the treatment of a creditor's petition to compulsorily wind-up a company significantly slowed the process of obtaining a winding-up order. She emphasised two such changes in particular:

- the development of the judicial practice of issuing a show-cause notice to a debtor company prior to the admission of a winding-up petition, leading to a hearing on the question of admission and attendant delays;
- the development of the judicial practice of affording a corporate debtor time to repay all or part of the debt owed to a petitioning creditor (including by instalments, over a potentially long period of time), prior to the admission of the petition or its advertisement.

She contrasted the position under English law, and suggested that the emergence of these practices in India was one plausible source of explanation for the difference in time required to obtain a winding-up order under English law (which remains similar to India's law on the books, but functions very differently in practice).

[18]The law may provide for exceptions if the petition has been filed for a collateral purpose to abuse the process of law and to allow the possibility of a corporate rescue in appropriate cases.

assigned to him/her prosecutes cases relating to 60-70 companies (even 200 companies in some cases). Therefore, they are often forced to seek multiple adjournments, delaying such prosecutions even further.

Anecdotal evidence also suggests that Official Liquidators face informational constraints in that the financial information relating to the company was often unreliable or incomplete. The Registrars of Companies, on whom the Official Liquidators have to rely for obtaining data relating to the company are often overburdened, and consequently not in a position to provide the required assistance efficiently. Therefore, a large number of cases seeking to impose liability on the directors of the insolvent company are dismissed on account of lack of sufficient supporting evidence in the form of financial data.

Recommendations:

a. Assuming improvements in the speed / cost of liquidation proceedings can be achieved (e.g. through the NCLT and/or by legislating against judicial practices which facilitate delay), RBI may consider recommending that the creditors should consider initiating winding-up proceedings in every case of a wilful default. <u>The creditors may also be advised to invoke provisions relating to managerial liability and avoidance of transactions in such cases (at the time of filing the petition).</u> Since these provisions may be used to impose personal (civil or criminal) liability on company directors or officers, this may become a very effective remedy for deterring wilful defaults (especially, after the NCLT is operationalized). **A provision similar to provision Clause 4.3 of the Master Circular may be incorporated to raise the profile of such company law provisions.**

b. The Bankruptcy Law Reform Committee is presently working on suggesting measures for improving the corporate insolvency regime in India. Given the importance of an efficient liquidation regime for deterring 'wilful defaults', the RBI may consider making the following recommendations to the Committee[19]:

    a. The debtor company's inability to pay debts may be established upon proof of non-payment of a single undisputed debt on statutory demand. The creditor should ordinarily be entitled to a winding up order on proof of such non-payment. Cash flow insolvency and balance sheet insolvency may be incorporated as alternate grounds on which a company can be held to be 'unable to pay its debts'.

    b. It is submitted that judicial practices (in liquidation) of deferring the hearing on admission or of the hearing on the petition where the debtor promises to pay by instalments at some later point in time, should be legislated against.

    c. It is important to note that most of the provisions relating to managerial accountability and avoidance of transactions can be invoked not only by the creditors, but also by the liquidators (official liquidators under CA 1956 and private or official liquidators under CA 2013). However, even in cases where a successful

[19] It may be noted that Vidhi is working as a legal consultant to the Committee on that project and will be independently suggesting such reforms..

action could swell the assets available for distribution to creditors, creditors are not happy to pursue such actions as they see it as throwing good money after bad. **Ultimately, these problems have had the effect of rendering the managerial accountability provisions under the CA 1956 nugatory.** All efforts must be made to ensure that the liquidators and their counsels are sufficiently equipped and have all necessary resources and funds to bring cases against the management for committing offences contemplated in the law. Actions which impose liability on directors, promoters and other officers of the company for misconduct may be funded by the state due to the public interest justification behind such actions.

d. The introduction of a civil remedy for wrongful trading similar to Section 214, of the British Insolvency Act, 1986 may be considered to be incorporated in Indian law.

B. Other relevant provisions in the Companies Act

1. Duty of auditors to report frauds

The CA 2013 contains stringent norms in relation to reporting by the auditor of frauds committed by officer(s) or employee(s) of the company. The law in this respect is enshrined in Section 143(12) of the CA 2013 according to which, if an auditor[20] in the course of performance of his duties as an auditor has reason to believe that an offence involving fraud (irrespective of its materiality) is being or has been committed against the company by officers or employees of the company[21,] he shall immediately report the matter to the central government (Secretary, Ministry of Corporate Affairs) but not later than sixty days of his knowledge of the fraud after following the procedure prescribed[22] in Rule 13 of

[20]Includes cost accountant conducting cost audit under Section 148 of the CA 2013 and the company secretary in practice conducting secretarial audit under Section 204 of the CA 2013. Also, as per the Rules, the provisions of Section 143(12) i.e. the duty to report the offence of fraud, are applicable to the branch auditor of the company's branch office, to the extent it relates to the concerned branch.

[21] As per Companies (Auditor's Report) Order (CARO) 2003 (which is applicable to certain classes of companies stated therein and was made under the Companies Act, 1956), the auditor's report should include a statement on whether any fraud on or by the company was noticed and if in the affirmative, it requires being reported along with its nature and amount. However, the CA 2013 and the Rules do not contain a similar order.

As per the present law it appears that the auditor does not have the duty under Section 143(12) of the CA 2013 to report to the central government directly the following categories of fraud - (i) frauds which are being or which have been committed by the company and (ii) frauds which involve the company and are being or have been committed by any third party other than the officers and employees (like vendors)

[22] As per Rule 13(1) of the Rules, the auditor is required to forward his report to the board or the audit committee immediately after the fraud comes within his knowledge, seeking their reply or observations within 45 days. After receiving their reply or observations, the auditor is required to forward the report containing the reply and observations of the board or the audit committee, as the case may be, along with his comments on the same to the central government within 15 days of

the Companies (Audit and Auditors) Rules, 2014 ("**Rules**"). Such report has to be on the letter head of the auditor along with his details which include inter alia his membership number. To provide adequate safeguards to auditors in such cases, Section 143(13) of the CA 2013 states that if the reporting by the auditor is done in good faith, no duty to which an auditor of a company may be subject to shall be regarded as having been contravened. Non-compliance of Section 143(12) results in a penal action against the concerned auditor by way of imposition of a fine not less than INR 1,00,000/- but which may extend to INR 25,00,000/-.[23]

As per Section 147(2) of the CA 2013, if an auditor contravenes inter alia any provision of Section 143 (which would include the duty of the auditor to report fraud) knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with fine not less than INR 1,00,000/- but which may extend to INR 25,00,000/- and imprisonment for a term which may extend to one year. Additionally, an auditor convicted under Section 147(2) of the CA 2013 shall be liable to (i) refund the remuneration received by him to the company; and (ii) pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.[24]

It is important to note here that the scope of the 'offences of fraud' which are required to be reported by the auditor under Section 143(12) of the CA 2013 is not specifically defined and no restrictions have been placed nor has any guidance been provided under the said <u>section or the Rules in terms of the kind or the nature of frauds that are required to be reported. Thus, the ambit of the said term being quite broad, it may inherently cover some or all instances of wilful default as defined in the Master Circular. Therefore it may be possible to argue that it is incumbent upon the auditor to report instances of wilful default to the central government as per the provisions of the CA 2013 and the</u>

receipt. In the event the auditor does not receive the reply and observations from the board or audit committee within the stipulated 45 days period, he is required to forward his report (along with a note containing the details of his report that was earlier forwarded to the board or the audit committee) directly to the central government. For other procedural details, a reference may be made to Rule 13 of the Rules.

[23] Section 143(15) of the CA 2013.

[24] As per Section 245(g)(ii), an auditor including an audit firm of the company may also be subject of a <u>class action suit</u> for any improper or misleading statement of particulars made in the audit report or for any fraudulent, unlawful or wrongful act or conduct.

Also, in the event the auditor of a company has directly or indirectly acted in a fraudulent manner or abetted or colluded in any fraud by or in relation to the company or its director or officers, such an auditor may be debarred by the NCLT from being appointed as an auditor for any company for a period of 5 years from the date of passing of the order and shall also be liable under Section 447 of the CA 2013(which relates to punishment for fraud, as per which any person who is found guilty of fraud shall be punishable with imprisonment for a term ranging from 6 months to 10 years and fine which shall not be less than the amount involved in the fraud but which may extend to three times the amount involved in the fraud).

In the event the auditor is an auditing firm, the liability shall be of the firm and that of every partner(s) who acted in a fraudulent manner or abetted or colluded in any fraud by or in relation to the company or its directors or officers. Rule 9 of the Rules further clarifies that – "In case of criminal liability of any audit firm, the liability other than fine, shall devolve only on the concerned partner or partners, who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud".

Rules as they currently stand. However, on the flipside, given that the provision does not specifically extend to frauds committed by the company it may also give rise to uncertainty in its interpretation and dilution of its effectiveness and enforcement due to ambiguity.

Recommendations:

a. The RBI may consider making a recommendation to the Ministry of Corporate Affairs ("**MCA**") that the reporting obligations of the auditors under Section 143 (12) of CA 2013 should be amended to specifically include at least some of the defined instances of 'wilful default'. Such reporting may initially be made to the bankers only, who should then follow the prescribed process for declaring the person as a 'wilful defaulter'.

b. To the extent some instances of fraudulent 'wilful default' may already be covered under the present wording of the Section 143 (12), the RBI may consider referring to this provision in the Master Circular to underscore its importance for timely identification and deterrence of 'wilful defaults'.

2. Providing a direct remedy for creditors to approach the NCLT for relief in cases of Wilful Defaulters

As per Section 73 of the CA 2013, a company accepting deposits is required to repay the same and the interest thereon, and on its failure to do so, the concerned depositor has a statutory right to apply to the NCLT (not yet operationalized) for an order *inter alia* directing the company to pay the amount due or for any loss or damage incurred by the depositors a result of such non-payment.

Section 74 of the CA 2013 creates a significant financial impact on the companies which accepted deposits before the commencement of the CA 2013, and which no longer meet the eligibility criteria to accept deposits under the CA 2013. It mandates such companies to pay the amounts due which remain unpaid, or which become due after the commencement of the CA 2013 to the depositors within one year of the commencement of the CA 2013 or from the date on which such payments are due, whichever is earlier. Any non-compliance of the above entails (as per Section 74(3) of the CA 2013) an imposition of fine on the company for an amount not less than INR 1 crore which may extend to INR 10 crore and with respect to every officer of the company in default, imprisonment up to seven years and fine not less than INR 25 lakh which may extend to INR 2 crore. Further, Section 75 of the CA 2013 provides that if a company fails to repay the deposit or part thereof or any interest thereon as per Section 74 of the CA 2013, and it is proved that the deposits had been accepted with the intent to defraud the depositors or for any fraudulent purpose, every officer who was responsible for the acceptance of the deposit shall without prejudice to the liability under Section 74(3) and under Section 447[25], be personally responsible for all or any of the losses or damages that may have been incurred by the depositors without any limitation of liability.

[25] Provision laying down the punishment for fraud under the CA 2013.

Section 164(2)(b) of the CA 2013 specifically provides for disqualification of directors of a company which has *inter alia* failed to repay the deposits accepted by it or pay interest thereon. Such directors are not eligible to be re-appointed as directors of that company or appointed as directors in any other company for a period of five years from the date on which the company fails to pay the deposits.

Recommendations:

a. We recommend that a provision similar to Sections 73 and 74 of the CA 2013 be introduced in CA 2013 in respect of 'wilful defaulters'. Under such a provision, the creditors may be given a clear statutory right to apply to the NCLT[26] (as and when it is operationalized) for an order (a) declare that a company is a 'wilful defaulter' and (b) that the company pay the amount due or for any loss or damage incurred by the creditor as a result of such non-payment. Although creditors can also (a) sue to enforce the debt (using the courts, or in the case of banks / FIs presumably the DRTs or where secured SARFAESI), (b) sue for any consequential losses in contract law where they flow from a breach, given that NCLT would be court specialised to deal with company and financial matters, it may useful to empower the NCLT to make orders that could be made in other courts/ tribunals to enforce payment of debts.It is also suggested that such a provision should also provide that in cases where the loan itself was fraudulently obtained or for a fraudulent purpose, every officer of the company who was responsible for acceptance of the loan and thereafter was responsible for 'wilful default' in respect of the payment / repayment of such loans shall be personally responsible for all or any of the losses or damages that may have been incurred by the creditors / lender without any limitation of liability (as is currently provided in relation to deposits under Section 74). Having said that, the scope of such a provision should only cover such directors who can be shown to have actively or passively participated in the fraud. **The RBI may consider making an appropriate recommendation to the MCA in this regard.**

b. Additionally, it is recommended that 'wilful defaults' should be added as an additional ground for disqualification of directors in the text of Section 164(2)(b) of the CA 2013. A disqualification related provision is already provided in paragraph 2.5(d) of the Master Circular – *"A covenant in the loan agreements, with the companies in which the banks / notified FIs have significant stake, should be incorporated by the banks / FIs to the effect that the borrowing company should not induct a person who is a promoter or director on the Board of a company which has been identified as a wilful defaulter as per the definition at paragraph 2.1 above and that in case, such a person is found to be on the Board of the borrower company, it would take expeditious and effective steps for removal of the person from its Board"*. **The RBI may consider making an appropriate recommendation to the MCA to provide for a specific statutory provision that provides**

[26] This should be in addition to the existing power of banks / FIs to declare (by adding to the list) wilful defaulters.

for automatic disqualification of directors on the ground of 'wilful default', after a determination has been made in accordance with the Master Circular (please see our recommendation in Section 3 above for identifying directors who should be covered for such disqualification).

c. Till such time as the NCLT is not operationalized, its powers may be exercised by the company courts under the aegis of the High Courts by bringing appropriate amendments to CA 2013. The RBI consider making an appropriate recommendation to the MCA in this regard.

3. Investigation into the affairs of the company for business being carried on for a fraudulent purpose and punishment for fraud

As per Section 206(4) of the CA 2013, the Registrar may, on the basis of the information available with him or furnished to him or on the basis of a representation made to him by **any person**, carry out an inquiry for determining whether the business of a company has been or is being carried on for a fraudulent purpose or unlawful purpose or not in compliance with the CA 2013 or if the grievances of the investors are not being addressed. The central government also has the power to direct the conducting of such an inquiry, if it is satisfied that the circumstances so warrant, by the Registrar or by an inspector appointed by it.

Similarly, under Section 213(b) of the CA 2013 (not yet notified), **any person (which may include creditors)** may make an application to the NCLT for the investigation into the affairs of a company and if the NCLT is satisfied that there are circumstances suggesting *inter alia* that (i) the business of the company is being conducted **with the intent to defraud its creditors**, members or any other persons or otherwise for a fraudulent or unlawful purpose, or in a manner oppressive to any of its members or that the company was formed for any fraudulent purpose; or (ii) the persons concerned in the formation of the company or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members, it may order an investigation into the affairs of the company by inspector(s) appointed by the central government. If such circumstances are proved to be in existence, every officer of the company who is in default and the person or persons concerned in the formation of the company or the management of its affairs shall be punishable for fraud under Section 447 of the CA 2013.

In the event it is concluded that the business of the company has been or is being carried on for a fraudulent or unlawful purpose, any person who commits such fraud shall be punishable for fraud under Section 447 of the CA 2013 which states that *"without any prejudice to any liability including repayment of debt under the CA 2013 or any other law for the time being in force, any person found guilty of fraud shall be punishable with imprisonment for a term which shall not be less than 6 months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud but which may extend to 3 times the amount so involved*". The definition of fraud given under this section in relation to the affairs of a company, "includes **any**

act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or **to injure the interests of**, the company or its shareholders or its **creditors** or any other person, whether or not there is any wrongful gain or wrongful loss."

It is important to note here that the central government has the power to assign the investigation into the affairs of a company to the Serious Fraud Investigation Office ("**SFIO**")[27]. The Director, Additional Director or Assistant Director of the SFIO authorized by the central government in this behalf, has the power to arrest a person who they have reason to believe on the basis of certain information, is guilty of any offence covered under *inter alia* Section 206(4) or Section 213 of the CA 2013.[28] Further, on receipt of the investigation report of the SFIO by the central government, the central government may after examination of the report and after taking such legal advice as it may think fit, direct the SFIO to initiate prosecution against the company and its officer or employees who are or have been in the employment of the company or any other person directly or indirectly connected with the affairs of the company.

Further, as per Section 224(1) of the CA 2013, on the basis of the inspector's report if it appears to the central government that any person has in relation to the company or in relation to any other body corporate or other person, whose affairs have been investigated, is guilty for an offence for which he is criminally liable, the central government may prosecute such person for the offence. Further, as per Section 224(5) of the CA 2013, in the event the inspector's report states that fraud has taken place in a company and due to such fraud any director, key managerial personnel[29], other officer of the company or any other person or entity, has taken undue advantage or benefit, whether in the form of any asset, property or cash or in any other manner, the central government may file an application with the NCLT for appropriate orders with regard to **(i) disgorgement of such asset, property or cash, as the case may be and also for (ii) holding such director, key managerial personnel, officer or other person personally liable without any limitation of liability.**

Recommendations:

a. Many of the provisions discussed in this section may not be useful in practice today as the NCLT has not been operationalized yet. Given that the operationalization of NCLT is entangled in litigation, as an interim measure, such provisions may be operationalized

[27] Such an assignment may be done on the basis of the grounds prescribed under Section 212(1) of the CA 2013.

[28] As per Section 212(6) and (8). Also, as per Section 212(6), no such person who has been arrested will be released on bail or on his own bond unless *inter alia* (i) the Public Prosecutor has been given an opportunity to oppose the application for such release; and (ii) where the Public Prosecutor opposes the application, the court is satisfied that there are reasonable grounds for believing that he is not guilty of such offence and that he is not likely to commit any offence while on bail.

[29] As defined under Section 2(51) of the CA 2013.

through company courts under the aegis of different High Courts. The RBI may consider making an appropriate recommendation to the MCA in this regard.

b. Further, 'wilful default' should be specifically added as a ground in Section 206(4) and Section 213(b) of the CA 2013. Therefore, under Section 206(4) of the CA 2013, an additional ground / circumstance on the basis of which the Registrar may conduct an inquiry for the purposes of investigation into the affairs of a company should be (some instances) of 'wilful default' by the company / its officers and on the determination that such an offence has been committed by the company, every person who is in default should be punishable for fraud under Section 447 of CA 2013. A similar amendment should be made to the provisions of Section 213(b) of the CA 2013. By virtue of such amendments to Section 206(4) and Section 213(b), officers of the SFIO (in case the investigation into the affairs of the company has been assigned to the SFIO by the central government) will be able to arrest persons who they have reason to believe are guilty of offences under Section 206(4) and Section 213(b) (which would specifically include the offence of wilful default, once amended), and such a provision would act a strong deterrent with respect to persons responsible for the repayment / proper utilization of the loans given to the company by lenders. The SFIO may also then institute prosecution against the company and the officers of the company or employees who are or have been in the employment of the company or any other person directly or indirectly connected with the affairs of the company, based on the recommendation of the central government. The punishment as mentioned in Section 224(5) above may also be imposed by the NCLT on the concerned persons on the basis of an application by the central government.

c. In relation to a fraud on creditors as defined Section 447, it may be noted that while the creditors can file a complaint before the NCLT under Section 213 (b), they cannot directly initiate a prosecution in a court. As per Section 439(2) of the CA 2013, a court can take cognizance of any offence under the CA 2013 which is alleged to have been committed by any company or any officer thereof, only on the basis of a written complaint made by **the Registrar, a shareholder of the company or of a person authorized by the central government in that behalf**. Therefore it appears that the court cannot take cognizance of any such offence on the basis of a creditor's complaint. **However, a creditor may intimate the Registrar or a person authorized by the central government in that behalf, who may then file a written complaint to the court**. Since Sections 206 (4), 224 (1) and 447 are already in force, the RBI may consider mentioning them in the Master Circular and make a recommendation that creditors should consider making references to the registrars of companies in appropriate cases of 'wilful default' to initiate investigations by the SFIO and/or prosecutions before courts.

4. Class action - suits

Section 245 of the CA 2013 provides for a requisite number of members or depositors (as prescribed therein) to file an application before the NCLT on behalf of the members or depositors if they are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company or its members or depositors. Such an order may be in respect of seeking orders *inter alia* to restrain the company from doing an act which is contrary to the provisions of this CA 2013 or any other law for the time being in force; to claim damages or compensation or demand any other suitable action from or against the company or its directors for any fraudulent, unlawful or wrongful act or omission or conduct or any likely act or omission or conduct on its or their part; to seek any other remedy as the NCLT may deem fit etc.

The Companies Bill, 2009 contained a provision in relation to class-action suits which permitted the members and the creditors to bring such suits. The said bill was examined by the Standing Committee on Finance ("**Committee**") in its 21st Report on the Companies Bill, 2009[30] wherein no change was proposed by the Committee in respect of the entities which could file a class action suit. A revised Companies Bill, 2011 was prepared by the MCA, which contained an amended provision relating to class action suits where only the members and the depositors could file class action suits. The said bill was also examined by the Standing Committee on Finance in its 57th report on Companies Bill, 2011[31] wherein the MCA had given the following reasoning for replacing creditors with depositors in the provision relating to class action suits – *"It has been felt that since creditors can enforce their claims through contracts/ agreements with borrower companies, they may not be given statutory right for class action. On the other hand since depositors do not have any contractual rights and are mainly of unsecured nature, they are being proposed to be empowered with right to file class action petitions before Tribunal."*

Recommendations:

a. Where a company is solvent it may not be appropriate to provide creditors with greater powers than those they have negotiated contractually to intrude into the ordinary governance of the corporation. Further, allowing creditors to so intrude may risk preventing the kind of entrepreneurial risk-taking that is promoted by acting in the interests of shareholders, and the associated broader welfare benefits. Having said that, it may be considered if creditors should be allowed to file class-action suits at least in some instances of wilful default as measure to deter such practices. Such a remedy could be provided by making an amendment to Section 245. The RBI may consider making an appropriate recommendation to the MCA in this regard.

[30] Available at http://164.100.47.134/lsscommittee/Finance/15_Finance_57.pdf

[31] Available at http://www.prsindia.org/uploads/media/Company/Companies_Bill_%20SC%20Report%202012.pdf

5. Piercing the Corporate Veil

A. The doctrine of limited liability

A company is treated as a separate legal entity, distinct from its promoters, shareholders, directors and employees. The CA 2013 recognises that upon incorporation, a company is a body corporate, capable of exercising all the functions of an incorporated company under the Act.[32] Its independent identity is confirmed through perpetual succession, a common seal, as well as the power to: (a) acquire, hold and dispose of property (b) enter into contracts in its own name (c) sue (and be sued) in its own name.[33]

The doctrine of limited liability, which is one of the foundational aspects of modern company law, is closely linked to the separate legal existence of a company. Ever since the House of Lords' judgment in *Salomon v Salomon*,[34] which has been cited on several occasions by Indian courts,[35] it has been recognised that the liability of the shareholders of a company is limited to the extent of their contribution, even if the business was 'precisely the same as it was' before incorporation, 'the same persons are managers' and the 'same hands receive the profits'.[36]

The doctrine has many economic benefits.[37] It reduces costs for shareholders by allowing them to spend fewer resources monitoring their agents who run the company. <u>It makes markets more liquid by delinking the value of a share from the personal finances of the owner.</u> By promoting free transfers of shares, it gives managers incentives to act efficiently.[38] Limited liability also enables investors to diversify their holdings more easily – with unlimited liability, this would be risky since the failure of one business could result in the depletion of personal assets.[39]

---

[32] CA 2013, section 9.

[33] ibid.

[34] [1897] AC 22.

[35] See, for eg, *T V Krishna v Andhra Prabha Ltd* AIR 1960 AP 123; *State Trading Corporation v CTO, Vishakhapatnam* AIR 1963 SC 1811; *Heavy Engineering Mazdoor Union v State of Bihar* AIR 1970 SC 82.

[36] [1897] AC 22, 51.

[37] Abhi Raghunathan, 'The Grand Trunk Road from *Saloman* to *Mehta*: Economic Development and Enterprise Liability in India' (2012) 100 Georgetown Law Journal 571, 576.

[38] Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1996) 236.

[39] Frank H Easterbrook and Daniel R Fischel, 'Limited Liability and the Corporation' (1985) 52 University of Chicago Law Review 89, 96.

B. Piercing the corporate veil – principles and case law

In certain situations, courts can go behind the independent personality of the company and 'lift' or 'pierce' the corporate veil to uncover the individual members or the larger economic entity of which the company is a part. This reflects the need to balance the separate legal entity and limited liability doctrines with notions of fairness. Indian courts have largely relied on English case law in determining whether and when the corporate veil can be pierced. The case law in India is unclear and to some extent, *ad hoc*.[40] Although there are no rigid categories of when courts consider it appropriate to pierce the corporate veil,[41] courts have expressed willingness to do so in the following situations.

(a) **Fraud or façade** – Where a company is being used as a device or cloak in order to commit fraudulent activities, the corporate veil may be pierced to hold members of the company liable. For instance, in *Saurabh Exports v Blaze Finlease & Credits*,[42] the defendant company was a family arrangement that was established in order to defraud its creditors. The court held that corporate entities were evolved to 'encourage and promote trade and commerce, but not to defraud people'[43] and therefore, it would be permissible to pierce the corporate veil to hold the members liable for the debts of the company. The Supreme Court accepted fraud as an appropriate ground for piercing the corporate veil in *Delhi Development Authority v Skiper Construction*.[44] In this case, the defendant company sought to defraud *bona fide* purchasers of property by establishing several corporate entities. Finding that the entities were cloaks behind which the members of the same family sought to defraud purchasers, the court pierced the corporate veil and held the family members liable. It observed[45]:

"…[when] the corporate character is employed for the purpose of committing illegality or for defrauding others, the court would ignore the corporate character and will look at the reality behind the corporate veil so as to enable it to pass appropriate orders to do justice between the parties concerned."

In another case, the corporate veil was pierced in order to unveil members of a partnership firm, that was disqualified from tendering, who had set up a company in order to achieve the same

[40] This may partly be because the English law itself is 'rich but confused' - David Kershaw, *Company Law in Context* (OUP 2012) 46.

[41] In *Tata Engineering & Locomotive Co v State of Bihar* AIR 1965 SC 40 [27], the Supreme Court held that it was not possible to 'evolve a rational, consistent and inflexible' approach to piercing the corporate veil.

[42] (2006) 133 Comp Cas 495 (Delhi).

[43] *Saurabh Exports v Blaze Finlease & Credits* (2006) 133 Comp Cas 495 (Delhi) [20].

[44] AIR 1996 SC 2005.

[45] *Delhi Development Authority v Skiper Construction* AIR 1996 SC 2005 [28].

purpose.[46] Similarly, courts have expressed willingness to pierce the corporate veil to investigate persons who operated fraudulent investment schemes through a company.[47]

(b) **Single economic unit** – The corporate veil may be pierced in some cases where groups of companies share an identity and community of interest, or comprise a single economic unit. In *Life Insurance Corporation v Escorts*, which involved investments made through wholly owned subsidiaries with the intention of circumventing certain conditions of an investment scheme, it was held that although the corporate veil could be pierced to determine the nationality of the shareholders, it could not be pierced to determine their individual identity and attribute liability.[48] This can be better described as 'peeping behind' the corporate veil to determine identity, rather than piercing it in order to impute liability.[49] Mere ownership and control of a company are not enough to justify piercing the corporate veil – there must be some impropriety or misuse of the company in question.[50]

(c) **Statutory piercing** – The Companies Act as well as other statutes provide for situations in which the shareholders may be held liable for acts of the company. For example, Section 339 of the CA 2013 (liability for fraudulent conduct of business) provides for personal liability of any person who was knowingly a party to the carrying on of the business who are knowingly parties to fraudulent conduct of business. This liability may extend to shareholders as well**. It may be noted that under this provision,** shareholders are not made liable because they are shareholders – they are made liable in their capacity as someone *knowingly party to* the carrying on of business. **It may also be noted that this provision has not been notified yet. However, as discussed above, its equivalent provision - Section 542 of CA 1956- is in force and may be invoked.**

(d) '**Self-piercing**' – There is some uncertainty about whether a company can itself ask the court to pierce the corporate veil.[51] In *State of UP v Renusagar Power*, the Supreme Court extended the benefit of concessional electricity duty under a statute on recognising that generation of

[46] *Yella Constructions v East Coast Railway* (2006) 6 ALD 460.

[47] *Ali Jawad Rizvi v Indo-French Biotech Enterprises* [1999] 95 Comp Cas 373 (Bom).

[48] AIR 1986 SC 1370 [93].

[49] Rishi Shroff and Shwetank Ginodia, 'A corporate governance perspective on lifting the veil in group companies in India and the United Kingdom' (2014) 25 International Company and Commercial Law Review 423, 430. In cases of peeping behind the corporate veil, the veil is only lifted to get information involving those who control the company, after which it is pulled down, and the company is once again treated as a separate legal entity – S Ottolenghi, 'From Peeping Behind the Corporate Veil, to Ignoring it Completely' (1990) 53 Modern Law Review 338, 340.

[50] *Ben Hashem* v. *Ali Shayif* (2008) EWHC 2380 (Fam) cited in *Balwant Rai Saluja v Air India Ltd* (2014) 9 SCALE 567.

[51] Rishi Shroff and Shwetank Ginodia, 'A corporate governance perspective on lifting the veil in group companies in India and the United Kingdom' (2014) 25 International Company and Commercial Law Review 423, 430.

power by a wholly owned subsidiary company, was to be regarded as generation of power by the parent company.[52] The corporate veil was pierced at the subsidiary company's request. In another case of self-piercing, the court allowed a company which did not have sufficient experience to qualify for a bid, to rely on the prior experience of its joint venture shareholders to qualify for the bid.[53] However, in *Singer India Ltd v Chander Mohan Chadha*, the Supreme Court held that it was not permissible for a company to ask for its own cloak to be unveiled in order to examine who its directors and shareholders are, and who in reality is controlling the affairs of the company.[54]

(e) **Economic offences** – Courts may be willing to pierce the corporate veil in cases involving certain economic offences. In a case before the Delhi High Court involving the evasion of excise duty, the Court observed that 'in certain exceptional cases the Court is entitled to lift the veil of corporate entity and to pay regard to the economic realities behind the legal façade'.[55]

(f) **Tax evasion** – Courts have frequently pierced the corporate veil where a company is used as a device for tax evasion or circumventing tax obligations.[56] This has been the case even in the absence of statutory authorisation permitting piercing of the corporate veil.[57] However, the Supreme Court has refused to pierce the corporate veil in the absence of evidence that the impugned transaction was a sham or a tax evasion scheme.[58]

(g) **Public Interest or interests of justice** – In some cases, courts have also pierced the corporate veil where, in the court's opinion, public interest or the interests justice required it. The Andhra Pradesh High Court, for instance, held that piercing the corporate veil 'is permissible if public interest requires… The important test is whether the method adopted for evasion of legal obligations would subvert public interest'.[59]

It is clear from the case law that context is critical when deciding whether to derogate from the separate legal entity and limited liability doctrines to pierce the corporate veil. Very often, it is not just one of the aforementioned factors, but two or more of them combined, that have prompted the court to pierce the corporate veil - for example, if tax evasion was being attempted by what was

[52] AIR 1988 SC 1737.

[53] *New Horizons Ltd v Union of India* (1995) 1 SCC 478.

[54] AIR 2004 SC 4368 [16].

[55] *Santanu Ray v Union of India* (1988) 18 ECC 51 [11].

[56] *CIT v Associates Clothiers Ltd* AIR 1963 Cal 629; *CIT v Sri Meenakshi Mills* AIR 1967 SC 819; *Juggi Lal Kamlapat v CIT* AIR 1969 SC 932.

[57] *Waste Energy Development v Govt of Delhi* (2003) 114 Com Cas 82 (Del).

[58] *Vodafone International Holdings v Union of India* (2012) 6 SCC 613.

[59] *Krishi Foundry Employees Union v Krishi Engines Ltd* (2003) 117 Comp Cas 340 (AP) [19]. See also *U K Mehra v Union of India* AIR 1994 Del 25[11]; *New Horizons Ltd v Union of India* (1995) 1 SCC 478 [30]; *Bijay Kumar Agarwal v Ratan Lal Bagaria* AIR 1999 Cal 106.

effectively a single economic unit, or if a company was being used to perpetuate fraud and there were strong public interest reasons favouring the piercing of the corporate veil.

Except where a statute provides otherwise, the corporate veil is pierced to hold liable (or identify) those who are in 'control' of the company in question. As the Supreme Court observed, '[t]he intent of piercing the veil must be such that would seek to remedy a wrong done *by the **persons controlling the company'***.[60] Control can be defined in many ways – for instance, with reference to shareholding, voting rights, right to appoint directors, management rights and veto rights.[61] Courts have not provided guidance about which indicia of control will be most significant in the context of piercing the corporate veil.

C. Application to cases of wilful default

Although the Gujarat High Court in *Ionik Metalliks* discusses the doctrine of 'piercing the corporate veil', its observations are only relevant in relation to the directors[62] and not the controlling shareholders. Presently, there seems to be no case law suggesting that wilful default of financial obligations of a company is, in and of itself, enough to enable courts to pierce the corporate veil to hold the controlling shareholders liable. However, it is quite possible for such cases to be recognised as an exception to the doctrines of separate legal personality and limited liability. Courts undoubtedly begin with the presumption that a company is a separate legal entity, distinct from its members, and that the liability of its members is limited. However, the range of cases in which courts have pierced the corporate veil has gradually expanded. The following observations of the Supreme Court are instructive[63]:

"…in the expanding of horizon of modern jurisprudence, lifting of corporate veil is permissible. Its frontiers are unlimited. It must, however, depend primarily on the realities of the situation…The

[60] *Balwant Rai Saluja v Air India Ltd* (2014) 9 SCALE 567 [71] (emphasis supplied). Empirical studies elsewhere have also shown that courts have generally been reluctant to pierce the corporate veil in cases where those sought to be held liable did not exert direct control or dominance over the company – see John H Matheson, 'Why Courts Pierce – An Empirical Study of Piercing the Corporate Veil' (2010) 7 Berkley Business Law Journal 1, 32-33.

[61] Definitions of control are also available in different statutory contexts. For example, the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations 2011, defines control as follows: '"control" includes the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner: Provided that a director or officer of a target company shall not be considered to be in control over such target company, merely by virtue of holding such position' (regulation 2(1)(e)). See also Companies Act 2013, section 2(27).

[62] Moreover the court is not really discussing directors being liable to pay the debts of the company, but rather suffering other sanctions as a result of being a director of a company that has defaulted in the proscribed circumstances.

[63] *State of UP v Renusagar Power* AIR 1988 SC 1737 [64, 66].

horizon of the doctrine of lifting of corporate veil is expanding… The veil on corporate personality even though not lifted sometimes, is becoming more and more transparent in modern company jurisprudence. The ghost of Salomon's case still visits frequently the hounds of Company Law but the veil has been pierced in many cases."

<u>Therefore, it is certainly conceivable for cases of wilful default to be recognized as a fresh ground for piercing the corporate veil in this 'expanding horizon' of jurisprudence.</u>

However, even if it is not recognised as a separate exception, it is quite possible that courts will pierce the corporate veil in some cases of wilful default by promoters of a company that fall within the *existing* broad categories. Based on established case law, courts may be willing to do so in the following situations:

- If the company is used as a mere façade to carry out the wilful default, or if the wilful default is considered a 'fraudulent activity' which the company was set up to promote.
- If the wilful default takes place through a vehicle forming part of a group of companies or a single economic unit.
- If the 'economic realities' of the wilful default are acknowledged as requiring the corporate veil to be pierced.
- If the court considers public interest or the interests of the financial institutions in question as requiring the corporate veil to be pierced.

Promoters engaging in wilful default are also likely, in many cases, to satisfy the 'control' threshold required for courts to pierce the corporate veil and establish personal liability.

Recommendations:

a. The RBI may consider making a recommendation to the Central Government (Ministry of Finance) to initiate the process for making a reference to the Supreme Court to determine if some cases of 'wilful default' as defined in the Master Circular can justify the piercing of corporate veil and hold the controlling shareholders personally liable. Such reference may also include the following questions (i) if such piercing can be allowed to assess the capacity of a borrower to repay in terms of Clause 2.1 (a) of the Master Circular and (ii) can such piercing be allowed even when the determination of the 'wilful default' has been made by a bank and not an official adjudicatory body or court?[64]

[64] Article 143 of the Constitution of India confers upon the President, the power to consult the Supreme Court on any question relating to law or fact. These questions have to be of such nature and of such public importance that it is expedient to obtain the opinion of the Supreme Court on the said matter. The scope of these questions does not necessarily only involve the interpretation of the Constitution, but covers a variety of other issues. Article 143 also makes it obligatory upon the Supreme Court to answer the referred questions, even though, in certain instances for 'good reasons'

Having said that, before making such a reference, the ramifications of a positive answer would also need to be closely considered. **Such a remedy may not be required if the liquidation regime can be made to work effectively**. For instance in the UK, if the company is in default and money has been siphoned off elsewhere, the proper course is to put the company into liquidation, and then sue the directors for breach of duty and/or counterparties to avoid transactions, with creditors then recovering through the proceeds of such actions in the liquidation (rather than becoming entitled to look to shareholders to pay the debts of the company).

b. The RBI may consider recommending the banks and financial institutions to file a winding up petition and invoke Sections 542 and 543 of the CA 1956 (or Sections 339 and 340 of the CA 2013, after they are notified) in every case where it can be shown that (a) the business of the company was being carried on with the intent to defraud the creditors and the directors/controlling shareholders/managers were knowingly parties to the carrying on of the business in such manner, or (b) where such persons are guilty of misapplication of company money or misfeasance or breach of trust in relation to the company. It may be noted that the winding up of companies can be initiated by the Registrar of Companies on the ground of inability to pay debts with the prior approval of the Central Government if certain conditions are satisfied – **the RBI may consider recommending that a 'wilful default' should be a specific ground for initiating a petition by the Registrar**.

6. International Approaches

A. Approaches for Disqualifying Directors

In the UK, the fundamental aspect of the regime with respect to directors in default is "*disqualification of the directors*" from being directors of a company and from being otherwise concerned with the company's affairs.[65] The underlying principle is that the errant directors are removed from the marketplace for the protection of the public, especially the future creditors, and

made in writing, such an obligation can be declined. Some cases in which such a reference has been made include *In Re Presidential Reference (Third Judges Case), AIR 1999 SC 1; Re Special Reference No.1 of 2012 (2G Case) ; Special Reference Case 1 of 2002 (powers of the election commission).*

[65]Purpose of the CDDA as stated therein

also, that it serves as a punitive action against the directors to deter them from undertaking such undesirable conduct in future.[66] Therefore a two pronged approach is taken through the remedy of director disqualification – (a) protective and (b) punitive. Once a director is disqualified, he cannot be a director of any company registered in the UK or an overseas company that has connections with the UK[67] or act as receiver of a company's property or directly or indirectly be concerned or take part in the promotion, formation or management of a company. They are also absolutely disqualified during the disqualification period from acting as an insolvency practitioner.

The consolidated law in this regard is enshrined in the Company Director Disqualification Act, 1986 ("**CDDA**") (read with the amendments brought about by the Enterprise Act, 2002 and the proposed amendments contained in the Small Business, Enterprise and Employment Bill ("**2014 Bill**")). The CDDA is a full-fledged legislation laying down the grounds for director disqualification, procedure for disqualification, consequences of contravention etc.

Under the CDDA, a director may be disqualified in four ways – (i) by the court; (ii) on the basis of an application made by the Secretary of State ("**SoS**") to the court; (iii) automatic disqualification; or (iv) disqualification by way of voluntary undertaking given by the concerned director. The grounds which may form the basis of the disqualification are briefly mentioned below -

(I) A court may pass a disqualification order against a director on the following grounds – (i) that he is convicted of an indictable offence in connection with the promotion, formation, management, liquidation or striking off of a company or with the receivership of a company's property or with his being an administrative receiver of a company[68]; (ii) that he is persistently in default in relation to certain provisions of the companies legislation requiring any return, account, document to be filed etc.[69]; (iii) <u>that it appears that he has been guilty of fraudulent trading or any fraud in relation to the company or breach of any duty, during the course of winding up of the company in the capacity of an officer, liquidator, receiver or administrative receiver[70]</u>. (iv) that he committed a breach of competition law.[71] It is important to note here that as per Section 9B of the CDDA (which relates to disqualification on the grounds of breach of competition law), the Office of Fair Trading ("**OFT**") or a specified regulator has the power to file an application for a disqualification order to the court on the basis of an investigation.

---

[66]Helen Anderson, *Directors' Liability for Fraudulent Phoenix Activity—A Comparison of the Australian and UK Approaches*, (2014) Journal of Corporate Law Studies Vol. 14 Part 1, 139.

[67]Company Director Disqualification, dated 12th November, 2014 available at https://www.gov.uk/company-director-disqualification

[68]Section 2, CDDA

[69]Section 3, CDDA

[70]Section 4, CDDA

[71] Section 9A, CDDA

(II) A disqualification order may be passed by the court on the basis of an application by the SoS to the court on the following grounds – if it appears to the SoS in public interest that (i) on the basis of investigative material[72], it appears that the conduct of the director in relation to the company (whether insolvent or not) makes him unfit to be concerned with the management of the company[73] (this is a catch-all provision present in the CDDA) ;(ii) that in respect of an insolvent company of which he is or has been a director, his conduct as a director (generally and in relation to any matter connected with or arising out of the insolvency of the company) makes him unfit to be concerned with the management of the company.[74] This ground appears to mandate the courts to pass a disqualification order.[75]The application may also be made by the official receiver, if so directed by the SoS, and the information required by the SoS or the official receiver, as the case may be, shall be provided by the responsible office holder and they will also be permitted to inspect the relevant documents. In certain cases, such office holders may also on their own report the matter to the SoS.

(III) There is also a provision for automatic disqualification of directors i.e. irrespective of an application being filed to the court by any person, the court in its discretion can pass a disqualification order in certain instances like where a court makes a declaration that the director is liable to make a contribution to a company's assets under the Insolvency Act, 2000[76] or where the director is an undischarged bankrupt[77].

(IV) In addition to the above, the CDDA was amended to introduce the concept of voluntary undertaking[78] by the directors, to bypass the (costly) involvement of the courts, whereunder the SoS may accept an undertaking from the concerned directors (that he will not function as a director for a specified period of time) if it is expedient in the public interest to do so instead of applying, or proceeding with an application for a disqualification.

1. Part – I: Grounds for disqualification orders under the CDDA

For the determination of 'unfitness' of a director to be involved in the management of the company under the CDDA, the matters to be taken into account (for all cases and for insolvent companies) are mentioned in Part 1 and Part 2 of Schedule I of the CDDA respectively ("**Schedule**"). Under Part 1 of the Schedule, the court should look into *inter alia*, (i) any *misfeasance or breach of any fiduciary*

---

[72] As defined in Section 8(1A), CDDA

[73] Section 8, CDDA

[74] Section 7, CDDA

[75] Section 6(1) of the CDDA read as "The court *shall* make a disqualification order against a person…"

[76] Section 10, CDDA

[77] Section 11, CDDA

[78] Section 1(A), CDDA

duty by the director in relation to the company; (ii) any *misapplication or retention* by the director of, or any conduct by the director giving rise to an obligation to account for, *any money or other property* of the company and (iii) how far the director has become involved in transactions aimed at *debt avoidance* (i.e. transactions defrauding creditors within the meaning of s 423 of the Insolvency Act 1986) or (iv) *failures to comply with specific sections of the companies legislation*.

On a broad overview of the Schedule, all matters of unfit conduct fall within one of the following more general categories-

- **Taking unwarranted risks with creditors'** or shareholders' **money**;
- Taking unfair advantage of the position of director;
- Serious failures to comply with statutory duties and company law.

The two categories of unfitness that emerge as per the jurisprudence in this regard are (i) breaches of commercial morality or probity and (ii) recklessness and incompetence. The former category include cases involving allegations of misfeasance/breach of duty, misapplication/retention of company money or property, and transactions defrauding creditors[79] whereas the latter includes gross negligence and incompetence of the directors.

As per the Master Circular, 'wilful default' broadly covers few instances.[80] On a plain reading of the abovementioned matters to be taken into account for the determination of unfitness of directors under the CDDA, it appears that activities which may be categorized as wilful default under the Master Circular, which include deliberate non-payment of loans, siphoning and diversion of funds for purposes other than for which such funds were given by the lenders, falsification of records, fraudulent transactions, disposal of securities without the lender's knowledge and misutilisation of funds for asset financing, would fall within the ambit of the Schedule I as they may amount to breach of fiduciary duty or misapplication of company's money or assets or failure in compliance of provisions of the companies legislation.

[79] Paragraph 4.1, The Guidance Notes for the Completion of Statutory Reports and Returns under the CDDA available at http://webarchive.nationalarchives.gov.uk/+/http://www.insolvency.gov.uk/pdfs/guidanceleafletspdf/dusguide.pdf

a) Deliberate non-payment of the dues despite adequate cashflow and good networth;
b) Diversion of funds for purposes other than for which they were taken from the lender;
c) Siphoning off of funds to the detriment of the defaulting unit;
d) Assets financed either not been purchased or been sold and proceeds have been misutilised;
e) Misrepresentation / falsification of records;
f) Disposal / removal of securities without bank's knowledge;
g) Fraudulent transactions by the borrower.

The Guidance Notes for the Completion of Statutory Reports and Returns under the CDDA published by the government of UK[81] ("**Guidance Note**") throws light on the kind of transactions which may be covered under the matters to be accounted for the determination of unfitness of directors (though they are not exhaustive). For the purposes of determining *misfeasance or breach of any fiduciary duty* by the director in relation to the company, the Guidance Note states that anything which is not in the proper interests of the company or generally to the detriment of the creditors, employees or members would fall under this head. Misfeasance has been defined to mean the misuse of a lawful authority in order to achieve a desired result and the fiduciary duties as captured in the companies legislation are listed as – (i) to act within powers (ii) to promote the success of the company (iii) to exercise independent judgment (iv) to exercise reasonable care, skill and diligence (v) to avoid conflict of interest (vi) not to accept benefits from third parties and (vii) to declare an interest in a proposed transaction or arrangement with a company. Additionally the director may also have duties specific to his particular company or role within the company arising from the articles of association, contract of employment or service agreement etc.

The Guidance Note also states that within the context of the disqualification regime, the most common types of allegation reporting a breach of fiduciary duty (although it might not be described as a breach of fiduciary duty in the allegation) include:

- Deliberate misapplication or misappropriation of company assets to the benefit of the director(s), their associates or group companies at the expense of creditors.
- Undue/ excessive remuneration.
- Loans (often unsecured) to the director, associates or group companies for no benefit to the company.
- Other payments/ transactions to the detriment of the company.
- Abrogation of duties (i.e. failed to act in the best interests of the company).

Secondly, in the event the director *removes or uses wrongly (or allow others to do so) any money or other property* of the company resulting in failure to fulfil an obligation or pay a debt or which results in a loss to the company, then also it is a matter rendering a director unfit. The next matter refers to debt avoidance and mainly covers *transactions defrauding creditors* which would include disposal of company's assets, property or undertaking by transfer, gift or at a significant undervalue for the purpose of placing such assets beyond the reach of the company, its members or creditors (Insolvency Act 1986 s 423). Lastly, the failure to comply with the provisions of the companies legislations in terms of keeping accounting records, making annual returns, signing of balance sheets etc. On a perusal of the explanations provided in the Guidance Note regarding the matters to be taken into

[81] Published by the Insolvency Service (an Executive Agency within the Department of Trade and Industry, Government of UK dated 2nd July, 2012) available on http://webarchive.nationalarchives.gov.uk/+/http://www.insolvency.gov.uk/pdfs/guidanceleafletspdf/dusguide.pdf

account for determining the unfitness of a director, they appear to be broad enough to capture instances of wilful default as enshrined in the Master Circular, and we can safely state that the remedy of director disqualification is being utilized for instances of wilful default (albeit by a different connotation) under the UK law. Hence it may be concluded that in the Indian context the remedy of director disqualification can be made applicable to instances of wilful default.

On a review of the database of the cases wherein disqualification orders have been passed as maintained by the government of UK[82], the grounds for disqualification mainly appear to be default in payment of tax / debt owed to the government, failure of preparation of adequate and accurate accounting records which led to the concerned entities not being able to decipher the financial status of the company in terms of the debt owed etc., siphoning off of company funds, abrogation of duties in terms of not being apprised of the affairs of the company, trading to the detriment of the creditors when the company is insolvent, fraudulent transactions relating to land wherein land was projected as a good investment opportunity but was not, collection of money from customers which was thereafter transferred to personal account, lack of commercial probity in terms of not purchasing goods for which the customers had paid money, for collecting membership fees from customers on the basis of false and misleading advertisements and also, for acting as directors when prohibited from doing so under the CDDA. Also, as per some case laws and newspaper reports, instances which have been considered as grounds for disqualification of the directors range from siphoning of funds owed to creditors[83], utilization of loans for purposes other than for which they were made by the lender[84], non-payment of debt[85]and failure to ensure the company kept proper books and records and complied with statutory obligations relating to filing of returns[86], which further corroborates the conclusion drawn above.

Furthermore, the 2014 Bill which proposes to the Schedule introduces the concept of passing disqualification orders against persons instructing unfit directors and hence it is proposed that the Schedule shall have two parts namely (i) matters to be taken in account for determining unfitness in all cases and (ii) additional matters to be taken into account where the person has been a director.

[82] Unfit conduct: our disqualification and restriction search facilities dated 21st July, 2014 published by the by the Insolvency Service (an Executive Agency within the Department of Trade and Industry, Government of UK) available at https://www.gov.uk/government/publications/unfit-conduct-our-disqualification-and-restrictions-search-facilities--2;

https://www.insolvencydirect.bis.gov.uk/IESdatabase/viewdirectorsummary-new-sub.asp

[83]*Leeds businessman jailed for siphoning 600k from firm*, available at http://www.yorkshireeveningpost.co.uk/news/latest-news/top-stories/leeds-businessman-jailed-for-siphoning-600k-from-firm-1-5902962 (in this case the director was disqualified for 5 years)

[84]*Secretary of State for Trade and Industry v Goldberg and McAvoy* , [2003] EWHC 2843 (Ch)

[85] Re Sevenoaks Stationers (Retail) Ltd, [1991] Ch 164(this was when the company was approaching insolvency)

[86]*Timber company director is disqualified for accounting record failings*, available at https://www.gov.uk/government/news/timber-company-director-is-disqualified-for-accounting-records-failings (in this case the director was disqualified for 8 years)

The matters mentioned therein are *inter alia* (i) the extent to which a person was responsible for causing any material contravention by a company of any applicable legislative or other requirement and the frequency of the same; (ii) the nature and extent of loss or harm or potential loss or harm caused by the person's conduct in relation to a company. The additional matters to be accounted for in respect of directors include *inter alia* (i) any misfeasance or breach of any fiduciary duty by the director in relation to a company and the frequency of the same; (ii) any material breach of any legislative or other obligation of the director which applies as a result of being a director of a company and frequency of the same. From the above, it appears that the matters to be accounted for the determination of unfitness of a director are proposed to be further generalized and broadened and such an amendment would definitely cover instances of wilful default as captured in the Master Circular, strengthening our viewpoint that the remedy of director disqualification can be used for instances of wilful default in the Indian scenario.

2. Part – II: Mechanisms for passing of disqualification order

In the context of a director committing a wilful default in the payment or repayment of loans, it appears that for a company (whether it is insolvent or not), the entity that would be responsible for the filing of the application for disqualification to the court is the SoS, who may do so in public interest, *on the basis of investigative material*. Thereafter, the court may pass a disqualification order after determination of the 'unfitness' of the director to be concerned with the management of the company on the basis of the Schedule (which lays down the matters to be taken into account for determining unfitness).

Further, in the event a company is insolvent and if a wilful default in the payment or repayment of loans has been committed by a director, then such an action may be classified as fraudulent and the court may pass a disqualification order on an application made to it or the SoS / official receiver may file an application to the court on the basis of information provided by the responsible office-holder and inspection of the relevant documents and the court may pass a disqualification order after determination of the 'unfitness' of the director to be concerned with the management of the company on the basis of the Schedule.

It is to be noted that in case of breach of competition law, a similar procedure is adopted i.e. either the court orders a disqualification of the concerned directors on a determination of the unfitness (however, in this case, the unfitness is not to be determined on the basis of the matters mentioned in the Schedule but on other factors as mentioned in Section 9A to Section 9D of the CDDA) or the OFT / specified regulator makes an application to the court on the basis of certain investigations for a disqualification order to be passed.

Therefore, the two procedural aspects in respect of the director disqualification regime in the UK jurisdiction which emerge on the abovementioned analysis are that firstly, in all cases, there is a necessary involvement of the court in the passing of a disqualification order and secondly, in matters where the SoS / Official receiver / OFT / specified regulator is involved in the filing of an application to the court, it is done on the basis of investigations, reports and detailed information thereafter, the courts pass the disqualification order. There seems to be no mechanism through which the involvement of the courts can be bypassed or in other words, where the regulator / state entity passes the disqualification order without the involvement of the courts (except through voluntary undertaking given by the director, which is dependent on the director's willingness to accept the default committed, and hence may not be of much significance for dealing with uncooperative and errant director).

It becomes relevant here to analyse the Australian regime in this respect to determine if it provides for a more effective mechanism for passing of disqualification orders. Part 2D.6 of the Corporations Act, 2001 ("**CA**") encapsulates the director disqualification regime for the jurisdiction of Australia. The regime in Australia is similar to the regime in UK in respect that prima facie the grounds for disqualification are wide enough to cover instances of wilful default, however it also differs from the regime in UK in various respects – (i) the CA states that any contravention of a disqualification order is an offence to which the ingredients of strict liability apply[87]; (ii) an additional ground for disqualification which is absent in the UK regime is that a person who has been disqualified from managing a corporation in specific foreign jurisdictions on or after 25 February 2009 will also be disqualified from managing a corporation in Australia.[88] This ground has the effect of closing a regulatory gap under which disqualified persons / directors could previously avoid disqualification simply by moving jurisdictions; (iii) one of the most important features of the regime under the CA is the regulator's (i.e. the Australian Securities and Investment Commission – akin to SEBI in India) power to disqualify a director (albeit in a specific instance of insolvency on the basis of the liquidator's report) without the involvement of the court (subject to a right to be heard)[89]. Thus the regulator itself can pass a disqualification order and the court does not have a role to play in the entire process.

On a comparative analysis of the mechanism for the passing of disqualification orders in the UK and Australia, it is evident that the public enforcement in the UK is necessarily dependent on the regulator i.e. SoS or the official receiver having both the required information on which to base the action and the required resources to make application to the court, and the director's disqualification can only be ordered once the matter reaches the court. These hurdles and delays necessarily limit the effectiveness of the regime.[90]

[87] Section 206A, Corporations Act, 2001

[88] Section 206B(6) and (7) and 206EAA, Corporations Act, 2001

[89]Section 206F, Corporations Act, 2001

[90]Helen Anderson, *Directors' Liability for Fraudulent Phoenix Activity—A Comparison of the Australian and UK Approaches*, JCLS Vol. 14 Part 1 (April, 2014)

3. Part – III: Other relevant features of the director disqualification regime in the UK

Compensation orders under the CDDA[91]

The 2014 Bill (which proposes to bring out certain amendments in the CDDA) proposes to bring out the concept of compensation orders / compensation undertakings[92] against a person who is subject to a disqualification order / disqualification undertaking and the conduct of the person for which he is subject to the a disqualification order / disqualification undertaking has caused loss to one or more creditors of an insolvent company of which the person has at any time been a director. A compensation order / undertaking requires the person to pay a specific amount to the SoS (i) for the benefit of the creditors specified in the order and/or (ii) as a contribution to the assets of the company so specified.

Consequences of contravention of the orders passed under the CDDA

In the event a person acts in contravention of a disqualification order / disqualification undertaking, he incurs a criminal liability of imprisonment for not more than 2 years or fine or both.[93] Additionally, if at any time of a contravention, a person is involved in the management of the company, he shall be personally responsible for such debts and other liabilities of the company as are incurred at a time when that person was involved in the management of the company of the company.[94] A director who is disqualified from acting so or enters into a disqualification undertaking may subsequently seek leave from the court under section 17 of the CDDA to act as a director.

Period of disqualification

The CDDA stipulates a minimum disqualification of 2 years and a maximum disqualification of 15 years. The legislation does not provide guidance in terms of the criteria for the determination of the length of the disqualification, however the UK courts follow the guiding principle given below which has been laid down in *In Re Sevenoaks Stationery (Retail) Limited*[95] *by* the Court of Appeal , which divides the possible periods of disqualification under the CDDA into three brackets -

a) A top bracket of 10-15 years for serious cases.

b) A middle bracket of 6–10 years reserved for serious cases but not top bracket cases.

c) A bottom bracket of 2-6 years where the conduct complained of was not relatively serious.

[91] This is currently the subject of a law reform proposal in the UK: Small Business, Enterprise and Employment Bill 2014.

[92]Section 15A and Section 15B, Small Business, Enterprise and Employment Bill 2014.

[93]Section 13, CDDA

[94]Section 15, CDDA

[95][1991] Ch 164

B. Whistle-blowers' protection

The protection provided to whistle blowers in the UK is captured in the specific legislation of Employment Rights Act, 1996 and more specifically in the Public Interest Disclosure Act, 1998. The law is that it is unlawful for an employer to subject a worker to a detriment because they have made a protected disclosure which includes disclosures made in public interest and the following categories of wrongdoing has occurred, is occurring or is likely to occur – criminal offence, breach of a legal obligation, miscarriage of justice, danger to health and safety of any individual, damage to the environment, deliberate concealment of information in relation to the aforementioned factors. Thus these provisions cover the possibility of a whistle blower making a disclosure in relation to a director who has committed a wilful default. As regards the whistle-blower protection regime in Australia, there is no single piece of legislation which prevents employers dismissing or taking other detrimental action against whistle-blowers, however the CA itself has certain provisions which protect company officers, employees and contractors who make good faith disclosures about breaches of corporations legislation by the company itself or by one of its officers or employees. In India, the law in this respect is at a very nascent stage and is currently applicable only to a limited class of companies, which is enshrined in Section 177(9) and (10) of the Companies Act, 2013 whereby listed companies are mandated to <u>establish a vigil mechanism for directors and employees to report genuine concerns which shall provide for adequate safeguards against victimisation of persons who use such mechanism and disclose the same on their website or the board's report</u>. Such requirement has also been extended to companies accepting deposits from the public and t**<u>hose which have 'borrowed money from banks and public financial institutions in excess of fifty crore rupees'.</u>** Clause 49 of the Listing Agreement between listed companies and the Indian Stock Exchanges has been recently amended which, inter alia, provides *"the company may establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. <u>This mechanism could also provide for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the Chairman of the Audit committee in exceptional cases</u>. Once established, the existence of the mechanism may be appropriately communicated within the organization."*

Recommendations:

a. It is submitted that law on director liability in India is extremely fragmented and suffers from several inconsistencies. The regime provides several arbitrage opportunities for the erring directors. We recommend that the Government should develop a separate law on liability of directors on lines of the director disqualification regimes discussed in this section.[96] Such a law can include 'wilful default' (or at least some kinds of wilful default)

[96] If this is explored other options, such as the veil piercing idea, may not be necessary.

as a specific ground for disqualification and imposition of penalties, subject to appropriate safeguards.

b. It is submitted that the whistle-blower protection regime, as envisaged in the Companies Act 2013 (read with the relevant rules) does not provide specific guidance on measures for protecting the interests of the whistle-blowers. Given that such a mechanism can be very useful for early identification of wilful defaults and protecting the creditors' interest, the Government should develop detailed rules for effective operationalization of the provision. The RBI may consider making an appropriate recommendation to the MCA in this regard. The RBI may consider making a specific reference to the provision in the Master Circular to the extent it is applicable for listed companies and companies which have 'borrowed money from banks and public financial institutions in excess of fifty crore rupees'.

7. SUMMARY OF RECOMMENDATIONS

a. **Strengthen the Existing Regime**: We understand that the government is working on a separate law on the subject of 'wilful defaulters'. It is submitted that instead of developing a draconian law which may have a chilling effect on lending, efforts must be made to strengthen the existing legal provisions, which if implemented effectively, can go a long way in deterring wilful defaults. The investigation and adjudication mechanisms envisaged in the new Companies Act, 2013, along with provisions relating to the managerial accountability and transaction avoidance under insolvency laws, if invoked efficiently (with proper backing of the State in terms of funding and resources) can be very effective measures to deter wilful defaults.

b. **Separate Law and Regulator**: Having said that, if wilful defaults are widespread among non-corporates as well, the company law provisions may not help in mitigating the situation and a separate legislation will be required. Such legislation should also consider the possibility of developing a separate investigation and enforcement authority for dealing with all cases managerial misconduct (including 'wilful default'). The proposed regulator may be modelled like the Securities and Exchange Board of India for investigation and adjudicatory purposes and should be manned by representatives from all the financial sector regulators.

c. **Director Identification and Reporting (implication of the decision in *Ionic Metalliks*)**: The RBI may consider revising the director identification and reporting obligations in the Master Circular along the lines of the 'officers in default' concept in Section 2(60) of CA 2013 to the extent it applies to directors, subject to the exemptions specified in Section 149 (12) of the CA 2013. Such determination should be carried out by the banks at the time of assessing whether a wilful default has taken place.

d. **Managerial Liability and Transaction Avoidance under Insolvency Laws:** The RBI may consider recommending the banks and financial institutions to file a winding up petition and invoke the provisions relating to managerial liability (and transaction avoidance) in all cases of wilful default (especially where the default falls under Clauses 2.1 (b), (c) and (d) of the Master Circular) Sections 542 and 543 of the CA 1956 (or Sections 339 and 340 of the CA 2013, after they are notified) in every case where it can be shown that (a) the business of the company was being carried on with the intent to defraud the creditors and the directors/controlling shareholders/managers were knowingly parties to the carrying on of the business in such manner, or (b) where such persons are guilty of misapplication of company money or misfeasance or breach of trust in relation to the company. It may be noted that the winding up of companies can be initiated by the Registrar of Companies on the ground of inability to pay debts with the prior approval of the Central Government <u>if certain conditions are satisfied – the RBI may consider recommending that a 'wilful default' should be a specific ground for initiating a petition by the Registrar</u>. **The RBI may consider mentioning this in the Master Circular.**

c. Auditor's Reporting Obligation: The RBI may consider making a recommendation to the Ministry of Corporate Affairs ("**MCA**") that the reporting obligations of the auditors under Section 143 (12) of CA 2013 should be amended to specifically include some instances of 'wilful default'. Such reporting may initially be made to the bankers only, who should then follow the prescribed process for declaring the person as a 'wilful defaulter'. To the extent some instances of fraudulent 'wilful default' may already be covered under the present wording of the Section 143 (12), **the RBI may consider referring to this provision in the Master Circular to underscore its importance for timely identification and deterrence of 'wilful defaults'.**

d. **Re-instating the debt-enforcement function of liquidation law:** The debtor company's inability to pay debts may be established upon proof of non-payment of a single undisputed debt on statutory demand. Contrary to the language of the statutory provision and its purported intent, courts require the evidence of such non-payment (even on formal demand) to be supplemented with additional evidence demonstrating the company's omission to pay without reasonable excuse and the existence of insolvency in the commercial sense. <u>The creditor should ordinarily be entitled to a winding up order on proof of such non-payment.</u> Cash flow insolvency and balance sheet insolvency may be incorporated as alternate grounds on which a company can be held to be 'unable to pay its debts'. Judicial practices of deferring the hearing on admission or of the hearing on the petition where the debtor promises to pay by instalments at some later point in time, should also be legislated against. **The RBI may be consider making an appropriate recommendation to the BLRC in this regard.**

e. **Other Provisions under Companies Act, 2013:**

   i. **Provisions which may be invoked:** Since Sections 206 (4), 212[97],224 (1) and 447 are already in force, the **RBI may consider mentioning them in the Master Circular and make a recommendation that creditors should consider making references to the registrars of companies in appropriate cases of 'wilful default'** to initiate investigations into the affairs of the company by the SFIO and prosecutions before courts.

   ii. **Operationalisation of Existing Provisions:** If the NCLT is operationalized, there are several provisions in the CA 2013, which can be invoked in some instances of 'wilful default'. These provisions include Section 213 (b) (i) & (ii), Section 224 (5). Given that the operationalization of the NCLT is entangled in litigation, it is submitted that the power of the NCLT under those provisions may be given to the Company Courts as an interim measure. **The RBI may consider making an appropriate recommendation to the MCA in this regard.**

   iii. **Amendments for Creditor Protection:** As mentioned in Section 4 of the Report (Mechanisms under Company law), there is significant scope to amend some of the existing provisions of the CA 2013 to cover 'wilful default' as a specific ground for triggering those provisions. These provisions include Section 143 (12) (auditor's reporting obligations), Section 164 (disqualification for appointment of directors), Sections 206 (4) and 213 (b) (investigation into the affairs of the company), and Section 245 (class-action suits). Further, the possibility of developing a separate creditor protection provision (on the lines of Sections 73 and 74) to approach the NCLT in the event of a 'wilful default' may also be considered (as along as such a measure does not provide creditors greater powers than those they have negotiated contractually).**The RBI may consider making an appropriate recommendation to the MCA in this regard.**

f. **Piercing the Corporate Veil: The RBI may consider making a recommendation to the Central Government (Ministry of Finance) to initiate the process for making a reference to the Supreme Court** to determine if all (or at least some) cases of 'wilful default' as defined in the Master Circular can justify the piercing of corporate veil and hold the controlling shareholders personally liable for the debts of the company. Such reference may also include the following questions (i) if such piercing can be allowed to determine the capacity of a borrower to repay in terms of Clause 2.1 (a) of the Master Circular and (ii) can

[97] Other than Clauses (8) to (10).

such piercing be allowed even when the determination of the 'wilful default' has been made by a bank and not an official adjudicatory body or court? Even if a reference cannot be made, the government may argue in an appropriate case before the Supreme Court that 'wilful default' can be considered as a separate ground for piercing the corporate veil.

c. **Developing a separate director liability regime:** It is submitted that law on director liability in India is extremely fragmented and suffers from several inconsistencies. The regime provides several arbitrage opportunities for the erring directors. We recommend that the Government should develop a separate law on liability of directors on lines of the director disqualification regimes discussed in this section. Such a law can include 'wilful default' as a specific ground for disqualification and imposition of penalties.

g. **Whistle-blower protection:** It is submitted that the present whistle-blower protection regime is not robust enough. Given that such a mechanism can be very useful for early identification of wilful defaults and protecting the creditors' interest, the Government should develop detailed rules for effective operationalization of the provision. The RBI may consider making an appropriate recommendation to the MCA in this regard. **The RBI may also consider making a specific reference to the provision in the Master Circular to the extent it is applicable for listed companies and companies which have 'borrowed money from banks and public financial institutions in excess of fifty crore rupees'.**

h. **Striking a balance**: if some of the above recommendations are implemented, others may become redundant. For instance, in the presence of an effective liquidation regime complemented by a separate director disqualification regime, a ruling from the Supreme Court that allows piercing of the corporate veil may not be required. A balance should be struck between 'upholding lending agreements/deterring fraud' and 'promoting entrepreneurial activity and investment'.