Private Equity Corner

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SAFEGUARDING NOMINEE DIRECTOR'S INTEREST IN PRIVATE EQUITY INVESTMENTS - AVOIDABLE TRANSACTIONS UNDER THE INSOLVENCY CODE

INTRODUCTION

In the Indian market, there is an increasing trend for private equity investors to get a nominee director on the board seat of the company they are investing in, along with another set of negotiated control and voting rights. While this safeguards their investment, it also increases the risk incurred by the private equity investor if the company gets admitted to the corporate insolvency resolution process ("CIRP") under the Indian bankruptcy regime. This is a recent phenomenon due to the evolving jurisprudence relating to avoidable transactions under the Insolvency and Bankruptcy Code, 2016 ("**Code**"), hence going forward these investors need to exercise caution while exercising the control rights in the investee company.

The Delhi High Court in the case of "Tata Steel BSL Limited vs. Venus Recruiter Private Limited and Ors"[1] ("**Judgement**") has held that an application for avoidance of a preferential transaction can be heard and adjudicated by the National Company Law Tribunal ("**Tribunal**") even after the approval of a resolution plan. This Judgement overrules the erstwhile understanding that the CIRP ends with the approval of a resolution plan.

The impact of the Judgment may be far more adverse for investors, not just because it expands the already broad scope of the creditor beneficial legislation, but also puts at risk their investment corpus and assets in case of personal liability that may be imposed on them by virtue of actions/ inactions of their nominee directors.

This article aims to highlight the risks to the investors due to the wide scope of section 66 of the Code, and point out possible safeguards that may be taken to counter this.

TYPES OF AVOIDABLE TRANSACTIONS

Given it is possible that the management of a corporate debtor ("**Debtor**") before initiation of the CIRP undertakes transactions which could have adversely impacted the financial interest of its stakeholders (particularly the creditors), the Code encapsulates a regime which provides a method to nullify such transactions and render them ineffective (along with any asset transfer that may have been done pursuant to such transaction) in the larger interest of the creditors[2]. There are four such types of avoidable transactions, namely: (i) preferential[3]; (ii) undervalued[4]; (iii) fraudulent[5]; and (iv) extortionate[6] (collectively, "**PUFE Transactions**").

The Supreme Court in the case of Anuj Jain Interim Resolution Professional for Jaypee Infratech Ltd. v Axis Bank Limited Etc[7] laid out conditions to be satisfied in order for a transaction to classify as PUFE - for a detailed analysis on this case please click here. The focus of this article however shall be on fraudulent and wrongful trading transactions, as these pose a higher degree of risk to the investor nominee directors upon initiation of CIRP or liquidation proceedings due to:

(i) the wide scope of Section 66 of the Code;

(ii) the personal liability it imposes on non-executive directors;

(iii) the lack of a lookback period[8] for detecting fraud;

(iv) the retrospective imposition of liability on a nominee director (even after the investor has exited); and

(v) the impact of the Judgement, which means that the management of a Debtor would continue to be liable for fraudulent transactions even after creditors have received payments under a resolution plan and acquisition of the Debtor.

BROAD SCOPE OF THE PROVISION OF LAW

- **STANDARD OF "FRAUD"**

The first part of Section 66 apportions liability on "any person" to make contributions to the assets of the Debtor if he carried on the business knowingly for a fraudulent purpose[9].

Any Persons - The definition of "person" within the Code is extremely broad and the scope of this phrase is not just restricted to insiders such as the promoters, employees or executive directors[10] but also extends to any persons, including other companies, creditors or individuals, who were knowingly parties to that fraudulent trading[11].

It covers not just individuals but also corporates and accordingly there is a possibility that the adjudicating authority

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("**Authority**") may hold that a corporate investor is liable in certain circumstances, for example, if there is a fraud and if the Authority is able to establish intention on the part of the investor to the effect that the nominee director is just a representative and is not acting on his own volition, then the authority may pierce the corporate veil and hold the corporate investor liable. While there is no existing jurisprudence where the Authority has held the corporate entity behind the nominee director liable, this is a possible interpretation in view of the broad definition.

Knowingly - Since the Code does not define the term "knowingly", mere knowledge could be deemed sufficient for the purpose without requiring any active participation in the act.

Dishonest Intention - The requirement of establishing intention presents the problem of evidence. In the case of Grantham Vs. R[12] it was held that it is not necessary that the person accused must believe that there is no reasonable prospect of ever paying the creditor, but it is sufficient to show that he believed that the debt could not be paid when it became due or shortly thereafter.

No Lookback Period – While directors have been held liable in the past for their actions which fell within the 'look-back period', there is a conspicuous lack of a look back period with respect to fraudulent transactions, which means that a resolution professional can go back any number of years to check for fraudulent transactions and hold a director liable even after his resignation for his actions[13].

- **"WRONGFUL TRADING"**

Section 66 (2) imposes liability only on the director or partner of a company, when he falls short of the specific fiduciary duty that he owes towards the company and the duty of care he owes towards the stakeholders, including the creditors. There is no requirement to establish wrongful intention so long as it is proven that a director has acted negligently or recklessly thereby exposing the company to risk. The impugned directors in such cases cannot even plead ignorance or lack of knowledge[14].

Standard under Section 66 (2)- The standard for deeming an action as "wrongful trading" has to be established by the Authority on a case by case basis using the yardstick of whether the director had exercised general knowledge, skill and experience to be expected of a person carrying out the same functions[15]. The courts have ruled that if the director "shuts his eyes" to what must be obvious to someone even superfluously, he could be held liable for dereliction of duties and be compelled to make good the losses caused to the company due to his neglect, even if he has not been held guilty for the commission of fraud.[16].

Twilight Zone- The directors have an additional duty to take active steps in terms of conducting due diligence during the period when they ought to have known that the commencement of CIRP was imminent for the company[17], till the time the company enters into such resolution ("Twilight Zone"). Upon entering this Twilight Zone, the intentions and actions of the directors need to shift from maximising the interest of the shareholders to protecting the interests of the creditors in order for the directors to avoid liability.

In view of the above, it is pertinent to note that the Tribunal has given inter alia the following indicative examples of 'Wrongful Trading'[18]:

(i) repaying a loan received from a director while other creditors were not paid;

(ii) a director paying his own salary whilst the salary for the employees was not paid;

(iii) buying goods on credit when there is no means to pay for them;

(iv) using customer deposits for cash-flow purposes with no means of supplying goods;

(v) not keeping proper accounting records; or

(vi) any transfer or sale of assets at anything less than a fair and reasonable commercial value.

WHETHER NOMINEE DIRECTORS WILL FALL WITHIN THIS BROAD SCOPE?

The people responsible for the management of a company have always been held liable for any fraudulent actions perpetrated by the corporate entity. However, it has been open for directors to seek exemptions from liabilities by stating that they are non-executive or independent directors who are not responsible for the day to day affairs of the company. Further, a claimant would have to provide strong evidence of mala fide intention and establish a causal nexus between the fraud and involvement of director, in order to pierce the corporate veil and make a director personally liable for fraudulent transactions. The development of jurisprudence around Section 66 of the Code substantiates a lower threshold to pierce the corporate veil and the unlimited liability that ensues on nominee directors. Section 66 is a radical extension in civil liability for directors whose fraudulent, reckless and negligent actions during financial distress affect the interest of creditors, made all the more potent because of its broad scope and low thresholds (as detailed in the section above).

Private equity investors, often choose to have a nominee director on the board of directors of the investee company. If the investee company has conducted a transaction post the investment, for e.g. transferring a business vertical to a group entity at a subdued valuation prior to initiation of CIRP, then the resolution professional might flag off such a transaction as fraudulent subject to adjudication by the Authority. The rights given to investors under investment documents, inter alia the right to a board seat and observer, quorum rights, affirmative voting rights, information and inspection rights are intended to ensure that the nominee director, and by extension the investor, had knowledge of the affairs of the company. If intention is proved, by virtue of the scope of "any person", the investor may also be held liable. If not, with the mere possession of information and exercise of control (as granted to the investor under the investment documents), the nominee director may be held liable for 'not exercising' sufficient due diligence as expected from one in his position.

SAFEGUARDS AVAILABLE FOR THE INVESTORS

Directors and Officers Insurance- The first thing the investor should ensure is to have a robust D&O insurance policy in place. This will ensure if the nominee director is held liable because of a fault of the Debtor (except in cases

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of fraud), he will be covered by the insurance paid by the Debtor.

Indemnity- Most investment documents have a clause distinguishing between the nominee directors and executive directors of the company, thus specifically insulating the nominee directors from any liability that may arise out of the day to day functioning of the company. Investors should consider incorporating a specific provision to the effect that if an order is passed under the Code against the nominee director, the losses incurred as a result of this order should by indemnified by the Debtor to the investor.

Caution while drafting transaction documents- The investors will need to carefully balance the potential risk that could arise out of Section 66 with the kind of operational control they are seeking to achieve in the company. The more robust the set of investor rights in relation to information, inspection, affirmative voting items, the more risk they incur. These clauses need to be carefully drafted keeping in mind minimum level of intervention at the operational level by the investor. For example, if the information rights are very exhaustive and also include a catch all clause of providing all information required by the investor, it is very easy for the Authority to establish presence of knowledge on the part of the investor and hence attract liability under Section 66.

CONCLUSION

Over the course of the last six years we have seen multiple examples where huge corporate entities have been sent for insolvency resolution without there being much realizable value for the creditors. We have also witnessed mega corporate financial scandals involving the board of directors, for example, the scandals involving DHFL, HDIL, Yes Bank, Videocon, ICICI Bank, to name a few. The broad scope of the provisions of law pertaining to fraudulent transactions and wrongful trading as well as the adjudication of standards by the authority on a case by case basis has led to a perilous pit for the non-executive nominee directors (and in turn the investors), who need to tread carefully on the track.

– Sach Chabria, Arjun Gupta & Harshita Srivastava

You can direct your queries or comments to the authors.

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[1]Tata Steel BSL Limited Vs. Venus Recruiter Private Limited and Ors 2023/DHC/000257.

[2]The UNCITRAL Legislative Guide on Law of Insolvency, Page 4, available at: https:// uncitral .un.org /sites/ uncitral.un.or g/files /media- documen ts/unci tral/en /05-807 22_ebo ok.pdf.

[3]Section 43 of The Insolvency and Bankruptcy Code, 2016.

[4]Section 45 of The Insolvency and Bankruptcy Code, 2016.

[5]Section 66 of The Insolvency and Bankruptcy Code, 2016.

[6]Section 50 of The Insolvency and Bankruptcy Code, 2016.

[7]Civil Appeal Nos. 8512 – 2019.

[8]Look back period is the relevant time up to which a resolution professional or a liquidator can go back to scrutinize an expected avoidable transaction- The report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, 2015 (May 2020) 101, available at: https:/ /ibbi.g ov.in/B LRCRep ortVol1 _04112 015.pdf).

[9]Ashish Rathi v. Rajiv Rathi and Others, 2022 SCC Online NCLT 21.

[10]Mr. Nandkishor Vishnupant Deshpande Vs. Worldwide Online Services Pvt. Ltd. and others.

[11]Morris v. Bank of India [2004] 2 BCLC 236- UK Jurisprudence

[12]R v Grantham [1984] QB 675.

[13]Amardeep Singh Bhatia Vs. Abhishek Nagori Liquidator for Asian Natural Resources (India) Ltd. – NCLAT New Delhi, Mr. Nitin Bharal Ex-Director/Promoter Vs. Stockflow Express Pvt. Ltd. Through Liquidator, Mr. Sanjay Gupta.

[14]Mr. Nandkishor Vishnupant Deshpande Vs. Worldwide Online Services Pvt. Ltd. and others.

[15]Mr. K. N. Narayanan Namboodiripad Vs. K. Parameswaran Nair, Erstwhile RP – NCLAT Chennai.

[16]Official Liquidator, Supreme Bank Ltd. v/s. P A. Tendolkar [1973] 1 SCC 602.

[17]based on a reasonable man standard

[18]Mr. K. N. Narayanan Namboodiripad Vs. K. Parameswaran Nair, Erstwhile RP – NCLAT Chennai.
