Insolvency and Bankruptcy Board of India

This Board note is divided into two parts

A. Director's liabilities in respect of avoidance transactions
B. Treatment of live bank guarantees and letters of credit – legal examination

A. Director's liabilities in respect of avoidance transactions

The Governing Board in its 24th meeting held on 24th June, 2021 advised that a paper on dealing with directors associated with avoidance transactions, including international practices, and suggesting the amendments, if any, required in the Regulations and / or the Code be prepared. This part presents research on the kind of offences, liabilities on directors and potential defences available in relation to the running of business during solvency and insolvency situations.

2. A company being an artificial legal entity relies upon the wisdom and actions undertaken by the board of directors for its functioning. Accordingly, to protect the interests of the company, corporate laws generally envisage certain broad duties upon the board of directors. The nature of the duties envisaged *inter alia* include duty of care, avoiding conflict of interest, acting in good faith, promote the objectives of the company etc. Further, as the company doesn't operate in isolation and works within the macro and microenvironment, there are duties towards the various stakeholders of the company viz., shareholders, employees, workers, creditors and also society, and government.

Director's duties in different stages of financial situation of a company:

3. The issue of directors' duties and the relationships between the company and external stakeholders are of paramount importance, not only in the solvent state of the company, but also in the insolvent state. Thus, nature and expectation of the duties of the board of directors also varies with the changing financial status of a company. The table below shows three distinct phases and primary duties of directors in each, as a general understanding of legal positions across jurisdictions.

Sl. No	Financial situation	Primary duties towards	Relevant legislation
1	Solvent	Shareholders	Companies Act
2	Company is solvent but starts to face or foresee financial trouble ('twilight zone' or 'zone of insolvency' or borderline)	Different practices among different jurisdictions (Grey Area)	Different practices among different jurisdictions (Grey Area)

3	Insolvent and in formal insolvency proceeding	Creditors	Insolvency Laws

4. It is undisputed that the primary set of duties of the directors, in the stage of financial stability of the company, lies towards the shareholders, unless non-shareholders have specifically contracted for managerial protections. Since the shareholders contribute towards the business loss of the company by being primary risk bearers during solvency, the inherent nature of the director actions directly affects the stakes of the shareholders. Once in formal insolvency proceedings, their primary duties shift towards interests of creditors.

5. The most interesting divergences in the directors' duties are observed when a company starts to face financial trouble, and more so, when it is in bordering on insolvency. Duties of directors during this stage vary among jurisdictions. When a company becomes insolvent, but is not yet subject to a formal insolvency proceeding, the shareholders – or the directors acting on their behalf – may engage, even in good faith, in various forms of behaviour that can divert or destroy value at the expense of the creditors. However, there is some consensus among courts that during borderline insolvency, duties of directors are primarily owed towards creditors and secondarily, if afforded by statute, towards shareholders. There is a shift in duties of directors towards the creditors, who become residual risk-bearers and the best interest lies in conserving the remaining assets of the company towards either revival of the company or repayment of the obligated debt.

UNCITRAL: Legislative Guide on Insolvency Law on Directors' obligations in the period approaching insolvency

6. The Legislative Guide details underlying principles that should be adopted to regulate directors' obligations in the period approaching insolvency. The Guide identifies that 'it is essential that early action be taken' – in the form of causing a company to enter a 'relevant and effective insolvency process' – by directors when a company is facing an actual or imminent inability to meet its obligations as and when they fall due. The Guide notes that a number of jurisdictions have sought to incentivise directors to take early action by:

(i) imposing an obligation on a debtor to apply for commencement of formal insolvency proceedings within a specified period of time after insolvency occurs to avoid trading while insolvent; or
(ii) focusing on the obligations of directors in the period before the commencement of insolvency proceedings and imposing liability for the harm caused by continuing to trade when it ought to have been apparent that insolvency could not be avoided.

7. In doing so, the goal is to stop directors from *'externalising the costs'* of a company's adverse financial circumstances by placing all of the risks of continued trade on the company's creditors. The core disadvantage of this liability-based approach is that directors may become overly risk-averse, seeking to avoid any prospect of personal liability by prematurely closing a

viable (but distressed) business that otherwise could have survived. This in turn limits the development of a stronger rescue culture as part of local insolvency processes.

8. In the revised edition of the Principles for Effective Insolvency and Creditor/Debtor Regimes (April 2021), the World Bank identifies informal workouts as an important part of a best practice insolvency system because they provide a more timely, efficient and cost-effective alternative for viable businesses than formal insolvency options which are often cost-prohibitive and may spell the end of any prospect of an entity trading out of its difficulties.

9. While many jurisdictions have made progress in 'refocusing' insolvency laws with the stated aim of encouraging rescue and reorganisation through informal workouts. The Guide, also notes that there has been little focus on creating appropriate incentives for directors to use available options for informal workouts. Particularly where there is no carve-out for insolvent trading liability for directors when an informal workout is being pursued, the imposition of that liability may in fact limit resort to informal restructuring options for viable entities, and therefore the achievement of optimal insolvency outcomes as well as value creation; and economic and financial stability on a macroeconomic level.

10. The Guide also identifies another difficulty for directors when a company is operating in an insolvency context: reconciling the different interests of creditors and shareholders, with the latter tending to favour high-risk strategies to save a company in financial distress to increase shareholder value knowing that there is the protection of limited liability if a high-risk manoeuvre fails. It takes the view that the core objective in effectively regulating directors' conduct when a company is nearing insolvency is to seek to balance the often competing goals and interests of different stakeholders: **preserving the freedom of directors to discharge their obligations and exercise their judgment appropriately, encouraging responsible behaviour, discouraging wrongful conduct and excessive risk-taking, promoting entrepreneurial activity, and encouraging, at an early stage, the refinancing or reorganisation of enterprises facing financial distress or insolvency**. In implementing this balance, UNCITRAL recommends the following regulatory framework (recommendations 255 and 256):

(i) directors ought to have a duty to have due regard to the interests of 'creditors and other stakeholders' and to take 'reasonable steps' to avoid insolvency and, where insolvency is unavoidable, to minimise the extent of insolvency; and

(ii) 'reasonable steps' might include matters such as directors evaluating and being independently informed as to the current and ongoing financial situation of the company, seeking professional advice, holding discussions with auditors, protecting the assets of the company to maximise value, considering the structure and functions of the business to examine viability and reduce expenditure, continuing to trade in circumstances where it is appropriate to do so to maximise going concern value, and holding negotiations with creditors or commencing other informal procedures.

11. According to the Guide, it is also critical that the time when these duties arise to be clearly stated in enabling legislation because, without a clear reference point, directors cannot precisely predict when their personal duties, and potential liability, may crystallise. Again, that may deter responsible risk-taking, including the continuation of trade while an informal workout is pursued.

12. The Guide recommends that the duties owed by directors when the company is facing insolvency ought to arise 'at a point in time when a director knows, or ought reasonably to have known, that insolvency is imminent or unavoidable' (recommendation 257). It is also recommended that the 'directors' owing the duties ought to be specified as not only formally appointed directors but also 'any other person exercising factual control and performing the functions of a director' (recommendation 258). This is to reflect the practical reality that persons other than appointed directors may act in the same underlying capacity as appointed directors, exercising real control and influence over the affairs of the company, and those persons ought to be subject to the same duties to incentivise proper and responsible conduct towards creditors. In quantifying liability for any breach of these duties, itrecommends that local laws should provide that liability is limited to the extent to which the breach caused loss or damage to creditors (recommendations 259 and 260).

Practices in other jurisdictions

A. Director Liability Framework in US

13. The US Model Business Corporation Act, 2002, a federal law, which provides for minimum corporate governance norms for US companies, states that the director has a duty of good faith, care and loyalty. The extent of recognition of these duties were left upon the State legislations. The US courts have often held that the directors are vested with the duty of care and are liable towards shareholders though not ordinarily towards to bondholders or creditors.

14. Section 548 of US Bankruptcy Code provides for avoidance of fraudulent transfers made within the period of 2 years which involves intentionally fraudulent transfer or undervalued consideration outside the ordinary course of business. The creditors at this stage are entitled to very limited protection under the "implied covenant of good faith" found in commercial contracts and directors are constantly under the threat of legal action by the shareholders. The judicial interpretation in the US on creditor rights during insolvency and borderline insolvency underwent significant change due to multiplicity of lawsuits being filed by creditors against directors over disposal of corporate assets. Gradually, the US Courts accorded that during insolvency primacy must be given to creditor's expectations for preservation of value of the company. This resulted in creditors being allowed to pursue direct action claims against the board of directors for breach of fiduciary duties. The shifting of duties during borderline insolvency remained a legal and policy challenge, complicated by the varying interpretation given by courts until the Delaware Chancery Court's decision in Credit Lyonnais Bank, wherein Court held, *"where a corporation is operating in the vicinity of insolvency, board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate*

enterprise", and accordingly companies during borderline stage need to take into consideration interest of all categories of stakeholders, including shareholders, creditors, suppliers, customers etc.

15. The Delaware Supreme Court over ruled *Credit Lyonnaies* in *NACEP v. Gheewala matter* where the Court observed that, "*directors of solvent companies operating in borderline stage owe fiduciary duties to the corporation and its shareholders and should use their business judgment in the best interest of the corporation for the benefit of its shareholder owners*." Thus, *Gheewala* reverted to rationale of existing remedies available for creditors and merely allowed recourse to derivative actions claims in exceptional circumstances. This meant that the borderline stage was not to be considered as a triggering event for shifting of duties and the safe harbour of business judgment rule was applicable upon companies. In effect, in the US, as of now, directors owe no direct fiduciary duties to creditors simply by virtue of the company being in the borderline stage.

B. Director Liability Framework in UK

16. In the UK, Chapter II of the UK Companies Act, 2006 incorporates the general fiduciary duties on the directors, during solvency along with the business judgement rule. This includes the duty to promote success of the company, exercise independent judgement, reasonable care and due diligence, avoid conflict of interest and declare related party transactions.

17. Section 172(3) of UK Companies Act, 2006 shifts the director duties towards creditors during actual insolvency due to their risk-bearing capacity. Moreover, the courts in the UK have expansively interpreted the provision to cover fiduciary duties of directors even during the borderline stage.

18. Section 212 imposes liability for malfeasance where the directors are held accountable for misapplication or retention of corporate property in breach of fiduciary or other duties, including negligence. Where however, any payment is made for a proper corporate purpose and in the interests of the company's creditors, then liability is exempted.

19. Specifically with respect to borderline insolvency, section 213 and 214 of the UK Insolvency Act, 1986 imposes the fraudulent and wrongful trading standards liability upon the directors pursuant to which they are not to misapply or retain corporate assets and avoid insolvent liquidation of the company. These involve civil liability with discretion to Courts in ascertaining extent of personal liability of directors with the objective to compensate creditors for the loss caused by the director's conduct. The remedies available to aggrieved parties includes restoration of the property along with interest thereon. Further, section 214 clearly articulates that the directors must undertake every step to minimise the potential loss to creditors during borderline insolvency.

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

benefit of the company. Thus, the recourse to remedies under wrongful trading liability standard can be ordered during insolvent liquidation whereas those under the Companies Act, 2006 can be ordered even during solvency or borderline insolvency, thereby providing creditors with adequate safety net at all stages.

C. Director Liability Framework in Singapore

21. In Singapore, directors have a duty to act in the interests of the company. When a company is solvent and trading normally, this refers to the interests of the company as a separate commercial entity which is readily identified with the interests of its shareholders. However, when a company is insolvent, or even in a parlous financial position, directors have a fiduciary duty to take into account the interests of the company's creditors.

22. The courts have made clear that there is no bright line which, when crossed by the company, results in directors having to take into account the interests of the company's creditors. Instead, what constitutes the components of a company's interests has been framed as a continuum, where the greater the concern over the company's financial health, the more weight the directors must accord to the interests of creditors over those of the shareholders. In this context, the courts consider the general financial health and solvency of the company in order to ascertain if there was reason to doubt or to be concerned over the financial viability of the company.

23. It should be noted that provisions on insolvent/wrongful trading, fraudulent trading and misfeasance were migrated from the Singapore Companies Act to a new omnibus Insolvency, Restructuring and Dissolution Act with effect from 30th July, 2020. The offence of insolvent trading has been replaced with a prohibition against wrongful trading. The prohibition, which gives rise to both civil and criminal liability. Liability for a breach of fiduciary duty is both civil (redounding in liability for damages to the company) and also, under Singapore law, a criminal offence.

D. Director Liability Framework in Australia

24. Under section 181(1)(a) of the Corporations Act, 2001 it is the duty of directors and other officers to act in good faith in the best interests of the company. Although the interests of creditors are not expressly delineated, Australian courts have held that when a company is operating in an insolvency context, the identity of the company corresponds to the interests of the company's creditors. Further section 588G of the said Act imposes a duty for directors to avoid insolvent trading – specifically, the incursion of a debt by the company when it is either insolvent or otherwise becomes insolvent by incurring the debt and, at that time, there are reasonable grounds for suspecting the company is insolvent or would become insolvent as the case may be.

Offences and defences regarding directors' liabilities

25. Amongst the jurisdictions discussed earlier, few or all of the following offences and liabilities are posited in the company law or the insolvency law. Liabilities associated with

these offences apply to directors, officers, executive employees, privately appointed receivers and managers, and liquidators.

(i) **Insolvent trading:** The offence occurs if the director is knowingly a party to the contracting by the company of a particular debt, having at that time no reasonable or probable ground to expect the company to be able to pay. The test is generally objective and does not require fraud or dishonesty. Liability includes fine and/or conviction. Prosecution for the offence may be brought during any proceedings including in course of winding up.

(ii) **Wrongful trading:** Occurs if the company, when insolvent, incurs debts or other liabilities without reasonable prospect of meeting them in full. It also occurs if the company, when solvent, incurs debts or other liabilities that it has no reasonable prospect of meeting in full and that results in the company becoming insolvent. Reasonable prospect is generally not regarded as 50/50, but must be meaningful and held in good faith. Liability includes fine and/or conviction, with the determination generally based on the balance of probabilities.

(iii) **Fraudulent trading:** It applies if it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose. Liabilities include fines and/or conviction and also be without any limitation of liability. The element of dishonesty and other party being deceived is required. A subjective test and reasonability of actions against objective standards may also be used to establish the offence.

(iv) **Misfeasance:** Includes a breach of fiduciary duty /trust and the liability is usually civil with exceptions. Liabilities include the restoration/repayment of value or property lost by the company.

26. Another liability that is applicable on one or all of these offences is that of disqualification of the person from directorship. Such disqualification applies along with the fines and convictions and may extend for various lengths of time or be indefinite based on the severity of the offence. The burden of proof falls on the directors in the establishment of innocence.

Potential defences and safe harbours across jurisdictions:

27. Defences are drawn from the foundational basis for director duties - the business judgment rule and trust fund doctrine.

27.1 **Business judgment rule**: It is a presumptive and affirmative duty cast upon the board of directors, that all the actions and decision undertaken by them based on their commercial wisdom are necessarily in the best interest of the company. The legal effect of the rule is that it absolves the directors from corporate and personal liability for good faith and honest errors in making business judgment. The rule was essentially developed as a judicial creation by the US courts to protect company directors from imposition of civil liability for the decisions they make on behalf of the company and gradually adopted across the world to make debtor-friendly legislations.

27.2 The policy rationale outlining the rule is that in its absence, directors would often remain under the threat of legal action being at the helm of aggrieved stakeholder. However, there are certain circumstances under which safe harbour cannot be granted to directors under the rule such as fraud, undervaluation of corporate property, conflict of interest, non-arm's length related transactions, unfair contracts etc. Similarly, when directors deal in inter-corporate transactions or self-dealing not for the benefit of the company, then also the protection of the rule is not accorded.

27.3 **Trust fund doctrine**: It presupposes negative liability upon the directors to not utilise corporate assets in a manner prejudicial to company's interest or to the detriment of stakeholders. The essence of the doctrine is that the company assets are held in trust for distribution amongst creditors, imposing a fiduciary duty upon the directors to not dispose of those assets in contravention of rights of creditors. Thus, a legal duty is cast upon the directors to act for the benefit of creditors and not necessarily for in respect of shareholders. The doctrine being a judicial creation was incorporated for certain director obligation during insolvency; however, has been expanded to even cover instances of solvency and borderline insolvency. Similarly, the remedies also depend upon its application in the respective life cycle of the company and existing protection available to shareholder and non-shareholder constituencies.

Director responsibility framework in India

(a) When company is solvent:

28. The Companies Act, 2013 under section 2(60) includes the whole-time director, independent directors and executive directors as "officers-in-default", and these company representatives shall be liable for any penalty or punishment imposed by law enforcement authorities in accordance with the law time being in force. The imputation of liability can be both civil and criminal under the said Act depending upon the nature of offense.

29. The Companies Act, 2013 read with the SEBI (Listing Obligations & Disclosure Requirements) Regulations, 2015 largely governs director-specific corporate governance of companies during solvency. The director liability framework is governed by imputation of vicarious liability on directors responsible for conduct of business and on those who actually participated in commission of the offense.

(b) When company is in Insolvency:

30. The twilight zone is critical for survival of a company and preservation of its value, whatever it may worth. The Code provides for directors' liability not previously envisaged under any corporate legislation in India. Accordingly, it attempts to preserve commercial morality by incorporating provisions for avoidance of certain transactions, and penalising suspended directors' misconduct. It permits only the resolution professional (RP) or the Liquidator to file applications (or initiate proceedings) against avoidable transactions and improper trading (except under valued transactions in section 47, where an application can also be filed by a creditor or a member or a partner of the corporate debtor). Regulation 35A of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (CIRP Regulations) requires the RP to form an opinion

whether the corporate debtor has been subjected to any transaction covered under sections 43, 45, 50 or 66 on or before the 75th day of the insolvency commencement date (ICD). Where the RP is of the opinion that the CD has been subjected to any transactions covered under those sections, he shall make a determination, on or before the 115th day of the ICD, under intimation to the Board. Further, he shall apply to the AA for appropriate relief on or before the 135th day of the 1CD.

31. The Code provides civil remedies in respect of avoidance transactions. The AA may pass any or all of the following orders in the application dealing with avoidance transactions:

Nature of transaction and concerned section	**Possible orders by AA**
Preferential transaction u/s 44	i. Property transferred to be vested with the CD; ii. proceeds of the sale of property or the money so transferred to be so vested; iii. release or discharge of any security interest created by the CD; iv. pay any sum in respect of benefit received from the CD; v. financial debt or operational debt of a guarantor to be revived or to be a new debt, where any such debt was released or discharged; vi. providing security or charge on any property for the discharge of any financial or operational debt and also the same priority as a security or charge on the property, where security or charge released or discharged while giving priority; and vii. extend to which a person whose property is vested in the CD or on whom financial or operational debt is imposed by order of the AA, to be proved in the CIRP or liquidation process.
Application by creditors for undervalued transaction u/s 47	i. Restoring the position as it existed before such transactions and reversing the effects thereof in the manner as laid down in section 45 and section 48
undervalued transaction u/s 48	i. Property to be vested with the CD; ii. release or discharge of any security interest created by the CD; iii. pay any sum in respect of benefit received from the CD; and iv. payment of such consideration for the transaction as determined by an independent expert.

Nature of transaction and concerned section	Possible orders by AA
transaction defrauding creditors u/s 49	i. Restoration of the position as it existed before the undervalued transaction entered into by the CD under section 45(2); and ii. protecting the interests of persons who are victims of such undervalued transaction, where such transaction was entered into deliberately for keeping the assets of the CD beyond the reach of any persons entitled to make a claim against it or in order to adversely affect the interests of such persons.
extortionate credit transaction u/s 51	i. Restore the position as it existed prior to the transaction; ii. set aside the whole or part of the debt created on account of extortionate transaction; iii. modify the terms of such transaction; iv. payment of amount received by any person to be paid back to the CD; and v. relinquish any security interest created as part of the extortionate credit transaction.
fraudulent or wrongful trading u/s 66 and 67	i. Make liable such parties to contribute to assets of the CD; and ii. any debt of such person to CD shall rank in priority under section 53 after all other debts.

(c) When the company is in the twilight zone

32. The wrongful trading liability under section 66 of IBC can be imposed only *"when the director knew or ought to have known that the there was no reasonable prospect of avoiding the insolvency proceedings" or "didn't exercise due diligence in minimising the potential loss to the creditors"*. The wrongful trading standard doesn't envisage a look-back period to ensure that dishonest directors are subjected to the liability even in view of lapse of time. It covers broad spectrum of actions which directors can undertake to mitigate losses and they will be evaluated as being in capacity of "reasonable competent director", which could include not incurring further debts and making active efforts of rehabilitation of the company. In addition to civil liability, the directors are also subjected to criminal penalties for defrauding the creditors both during insolvency and borderline insolvency.

Potential defences

33. The Companies Act, 2013 for the first-time codified director fiduciary duties within the Indian director liability jurisprudence. Section 166(2)-(6) provides for the application of business judgement rule and civil obligations upon the directors who must act in good faith,

foster the mission and vision of the company, in the best interests of the company, employees, shareholders, community and environment. Similarly, section 166(7) incorporates the trust fund doctrine and imposition of penalty upon failure of fulfilment of duties as specified under section 166(2). However, unlike the US or UK, there has not been sufficient deliberation by Courts on the scope of section 166 fiduciary duties and remedies available for their consequent breach.

34. **It is evident form the discussions above that in terms of the availability of provisions in the Companies Act, 2013 and the Code on offences, associated liabilities and potential defences India is on par with the advanced jurisdictions. However, jurisprudence, practice and the applications of the defences is yet to develop in India.** There exist the following lacunae in the ecosystem:

Capacity of insolvency professionals

35. IPs conducting processes under the Code are challenged by lack of access to information on the company's dealings and lack of cooperation from the promoters/directors during insolvency. This impedes their task of determining the avoidable transactions. It is also observed that use of transaction auditors or forensic auditors, for determination of transactions, is fraught with challenges. There exist no standards or norms for the functioning and for the carrying out of these forensic audits.

Current status of pendency

36. There are around 700 applications involving over Rs. 2 lakh crore are pending for adjudication before the AA.

Limited enforcement of the director's liability provisions in the Companies Act, 2013

37. The civil consequences of the avoidable transactions regime under the IBC provides for claw back or imposition of fines upon the errant directors. Provisions for director's liability including disqualification of directors provided in the Companies Act, 2013 need to be better enforced in order to strengthen the ecosystem and culture of corporate governance. Sections 164 and 167 of the Companies Act, 2013 deal with disqualifications for appointment of director and vacation of office respectively on identified grounds. These provisions may be expanded to provide that a person shall not be eligible for appointment as a director of a company or shall vacate office as director, if he has been convicted of the offence dealing with avoidance transactions under the provisions of the Code. This is in line with the mechanism of director disqualification prescribed under section 6 of UK Company Directors Disqualification Act, 1986 wherein the conduct of the director is deemed to be unfit to be regarded as being in management, even in matters arising out of or related to insolvency. This will strengthen the director disqualification system and can result in causing reputational loss, career damage and act as deterrent.

Recent measures

38. The MCA had in January, 2022 released a discussion paper soliciting public comments on changes proposed to the Code. This included changes to streamline the framework for dealing with avoidance transactions in processes under the Code. Proposals included the parity in powers available to RP and Liquidator in matters related to avoidance transactions, allowing creditors, individually or collectively to file applications for avoidance of transactions where the RP has failed to do so, the look back period to start from the date of application bringing the period between filing and admission to be included in suspect period and to provide clarity on continuity of such applications after closure of CIRP including the aspects of distribution of proceeds, if any. Once these measures are in place, gaps in the avoidance application framework will be addressed.

Proposal:

39. Regulation 40B of the CIRP Regulations specifies that IRP or RP, as the case may be, needs to file event specific CIRP Form 6 within seven days of the occurrence of the relevant event. This form captures details in regard to filing of application in respect of avoidance transactions also. Further sub-regulation (1B) of regulation 40B was brought in through an amendment dated 14th July, 2021. It requires the RP to file CIRP Form 8 intimating details of his opinion and determination under regulation 35A, by 140th day of the ICD. It also specifically provides that the RP calculate the potential loss to creditors due to delay in commencement of the resolution process as per provisions of section 66(2) of the Code. This form also captures the details of the director/ promoter who were on the board of the company during the period when the suspect transactions took place and details of beneficiaries of such transactions.

40. **It is proposed that details of directors in respect of whom avoidance applications have been filed before the AA may be shared with MCA for information. Subsequently, orders received on such applications may also be shared with MCA for any action against the directors under the Companies Act, 2013 as may be deemed appropriate.**

Part B. Treatment of live bank guarantees and letters of credit

41. The Governing Board in its 24th meeting held on 24th June, 2021 discussed the issue of treatment of live bank guarantees and letters of credit (BG/LC) and advised that a discussion paper may include treatment and other contingent claims, including related market practice and international practice. Accordingly, the discussion paper dated 27th August, 2021 inter alia on included the treatment of LC/BG as claim and solicited public comments on the same. One of the issues in the discussion paper pertained to: *'Treatment of live bank guarantees and line of credit as claims in a CIRP'*. The Governing Board directed that, *"The treatment of live bank guarantees and letter of credit as claims in a CIRP may be brought for its consideration in the next meeting,* ***after detailed legal examination****."* The three possible scenarios for treatment of live bank guarantees and line of credit as claims in a CIRP, as presented in the discussion paper and the legal examination on each scenario is as under:

Scenario - 1: Where the LC/BG was invoked by the beneficiary before the insolvency commencement date (ICD) of the CD.

42. Since the creditor invoked its LC/BG and the bank has made the payment against such invocation, the banker has a right to be indemnified by the CD. Since the LC/BG has been invoked, it ceases to remain live and the right to payment being established even before the commencement of insolvency proceedings against the CD, by virtue of sec. 6(3) it becomes a "claim" against the CD as on the date of insolvency commencement.

43. Legal examination: By invocation of the LC/BG the right to payment being established even before the commencement of insolvency proceedings against the CD, hence by virtue of sec. 3(6) it becomes a "claim" against the CD as on the ICD. Hence, treatment provided in the discussion paper take into account the provisions of the Code and same is factually correct.

Scenario - 2: Where the LC/BG remains live and remains uninvoked during CIRP.

45. Since the beneficiary has not invoked the LC/BG, it remains live and uninvoked for its natural life. Since, the bank has not made any payment to the supplier, there is no question of the CD indemnifying the banker, as there is no right created for the banker. However, any live LC/BG has the possibility of being invoked at anytime and are hence reflected as a liability in the CDs balance sheet and the same may be considered as a contingent liability and acted upon accordingly.

46. **Legal examination of the proposal:** The following definitions in the Code are relevant for discussion:

46.1 Section 3(6) "claim" means –

> *(a) a right to payment, whether or not such right is reduced to judgment, fixed, disputed, undisputed, legal, equitable, secured, or unsecured;*
>
> *(b) right to remedy for breach of contract under any law for the time being in force, if such breach gives rise to a right to payment, whether or not such right is reduced to judgment, fixed, matured, unmatured, disputed, undisputed, secured or unsecured;*
>
> *Section 3(11) "debt" means a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt;*
>
> *Section 3(12) "default" means non-payment of debt when whole or any part or instalment of the amount of debt has become due and payable and is not [paid] by the debtor or the corporate debtor, as the case may be;*
>
> *Section 5(7) defines 'Financial Creditor', means a person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to.*

Section 5(8) defines 'Financial Debt', means a debt along with interest, if any, which is disbursed against the consideration for the time value of the money and includes the clauses (a) to (i). Clause (h) includes any counter-indemnity obligation in respect of-

(i) a guarantee,
(ii) indemnity,
(iii) bond,
(iv) documentary letter of credit and
(v) includes any other instrument issued by a bank or financial institution

46.2 From the aforesaid definitions it is clear that a right of payment whether secured or unsecured come within the meaning of claim. Further as per the provision of the Code a creditor is supposed to file the claim whether matured or unmatured. The question as to whether there is a default or not is to be seen. It is also clear that liability or obligation in respect of a claim which is due from any person includes both the 'Financial Debt' and 'Operational Debt'. It is clear that 'default' of debt is required to be noticed before initiation of CIRP and same has nothing to do with the claim of a person, whether secured or unsecured.

46.3 Duties of interim resolution professional (IRP) have been prescribed under section 18 and as per clause (b) and is required to receive and collate all the claims submitted by creditors to him pursuant to the public announcement made under section 13 and 15As per Section 25(2)(e), the RP is required to maintain an updated list of all the claims. Aforesaid fact also suggests that the maturity of a claim is not a guiding factor for collating or updating the claims.

Jurisprudence

47. The NCLAT vide order dated 13th July 2018, in the matter of **Andhra Bank v. M/s F.M. Hammerle Textiles Ltd.** clarified that a live (uninvoked or unmatured) guarantee is also a "claim" and a "financial debt" and needs to be admitted. It further held that,

> *"It is not necessary that all claims as are submitted by the Creditor should be a claim matured on the date of initiation of Resolution Process/admission, even in respect of debt, which is due in future on its maturity, the 'Financial Creditor' or 'Operational Creditor' or 'Secured Creditor' or 'Unsecured Creditor' can file such claim. Therefore, the definition of 'Claim' as defined under Section 3(6) is to be read along with Section 13 read with Section 15 of the 'I&B Code'."* It further observed that,*"…The Resolution Professional cannot reject one or other claim on the ground that only the person whose claim has been matured can be looked into and other claim not matured cannot be entertained."*
>
> *12. The only thing which is to be ascertained is whether the person who claimed to be 'Financial Creditor', whether his debt owed to him come within the meaning of 'Financial Debt' as defined under Section 5(8).."*

48. On another instances the Hon'ble NCLAT vide order dated 14th August, 2018 in the matter of **Axis Bank Limited v. Edu Smart Services Private Limited**, held that the commission of

a default had nothing to do with the claim. The contractual rights and obligations of a creditor in matters of contingent claims are admissible and the IRP is bound to acknowledge and accede to the claim. It further observed that

> *"Therefore, we hold that maturity of claim or default of claim or invocation of guarantee for claiming the amount has no nexus with filing of claim pursuant to public announcement made under Section 13(1)(b) r/w Section 15(1)(c) or for collating the claim under Section 18(1)(b) or for updating claim under Section 25(2)(e)".*

49. Thus, legal provisions and jurisprudence discussed above it is amply clear that the definition of the claim as provided u/s 3(6) is wide enough to cover unmatured claims, which the CD is liable to pay at a time in the future, as and when invoked by the creditor. Admission of such claim may not be taken as burdening the resolution applicant with unexpected liabilities as the same is made part of the information memorandum.

50. **The discussion paper had set out the option that any live LC/BG be treated as a contingent liability, as they are reflected as such in the CDs balance sheet and be acted upon accordingly. However, emerging jurisprudence has settled the issue stating that live LC/BG should be treated as claims even though unmatured.**

Scenario - 3: Where the LC/BG is invoked by the beneficiary during the CIRP.

51. Since the creditor invoked its LC/BG and the bank has made the payment against such invocation, the banker has a right to be indemnified by the CD and the right to payment is established and it qualifies as a claim. Market practice is that RPs have admitted such claims even when submitted after the 90-day period for claim submission has lapsed and in some cases claims have been admitted with approval of the AA.

52. **Legal examination: Any LC/BG which is live are part of information memorandum prepared by the RP and therefore, admission of claim under Scenario 2 and 3, may not be taken as burdening the resolution applicant with unexpected liabilities.**

Scenario - 4: Where the LC/BG is issued during the CIRP and same is invoked by the beneficiary during the CIRP.

55. The Governing Board indicated a possible fourth scenario, where the LC/BG is issued during the CIRP and the same is invoked before closure of the process. The issue of LC/BG is made as part of a running business and would have been done by the RP with the approval of the committee of creditors. It would hence be appropriate that the CoC, at the time of issue decide on dealing with the liability, if and when it arises during the CIRP. Possible options available for the CoC is to treat it as part of insolvency process resolution cost, interim finance or claims as that under scenario 2.

Observation:

56. Treatment provided in each of the scenarios in summarised below along with the analysis:

Scenario No.	Scenario	Analysis and need for intervention
1.	Where the LC/BG was invoked by the beneficiary before the insolvency ICD	To be admitted as claim as the right to payment being established even before the commencement of insolvency proceedings against the CD. It is the legal position and market practice also. **There seems to be no need for clarification.**
2.	Where the LC/BG remains live and remains uninvoked during CIRP	To be admitted as claims though the right to payment is not arisen i.e., unmatured claims. Though legal provision is not explicit, the issue has been settled by judicial pronouncements. **There seems to be no need for further clarification from the Board.**
3.	Where the LC/BG is invoked by the beneficiary during the CIRP	Market practice is to admit these as claims even if received after the 90-day period has lapsed or based on the directions of the AA. This is the established legal position and the market practice. **There seems to be no need for clarification.**
4.	Where the LC/BG is issued during the CIRP and same is invoked by the beneficiary during the CIRP	The Issue of LC/BG is made as part of a running business and would have been done by the RP with the approval of the committee of creditors. It would hence be appropriate that the CoC, at the time of issue decide on dealing with the liability, if and when it arises during the CIRP. **There may be few cases where this occurs and with no specific concern raised, there seems to be no need for clarification.**

57. In view of the fact that there is no need for clarification, no intervention is required. The note is submitted for information of the Governing Board.

58. **Proposal in para 40 on the issue of Director's liabilities in respect of avoidance transactions (Par A of this Note) may kindly be approved.**