

Session 6

Insolvency and Corporate Governance – The Role of the Board in the Twilight Zone

Opening remarks by Chairman:

Justice A. K. Sikri, Judge, Delhi High Court & Senior Vice President of INSOL India

We have been talking in the last two days on the theme of this seminar, which is 'Policy Dialogue on Corporate Governance in India'. It is indeed a very important topic in our corporate regime and as you know it fully well, it is the main theme, this is the central theme running through the concept paper also, which has been prepared by the Ministry of Company Affairs.

The main thrust of the concept paper and the aim is, as it is highly and repeatedly projected, discipline, accountability and transparency and all three words signify good corporate governance and therefore that is, if I may say so, after reading the concept paper, the main thrust of the Ministry of Company Affairs and the main concern that somehow, we have adequate provisions in the Company's Act, which is in the offing to ensure good governance.

Need for good governance, I need not even highlight and infact, as I said earlier, you must have discussed it in first five sessions. I would only say that, this good governance assumes all the more importance in this twilight zone. This is the period when a particular company is in doldrums. It may have become sick company and therefore may have gone to BIFR and reference is registered or it may be a company against which a winding up petition is filed, say on the ground that the company is unable to pay the debts, so in both the cases, we are visualizing a situation where the company is facing financial crunch.

Now at that stage, certain very crucial issues arise. Mr. Gupta would speak in detail when the matter goes to BIFR; the important thing is, first, how to ensure that the creditors are paid, the protection of creditor's interest. At the same time, it is the endeavor that somehow the company is rehabilitated, revived because on the one hand whereas the interest of the creditors is to be secured, financial institution is to be secured for the healthy economy because only when the creditor knows that he will get his money back and that too with interest, all these financial institutions would lend the money. On the other hand, revival of the company is equally important for economy in general, for the employment, production etc and somehow inspite of all possible efforts made, the revival efforts fail then it is to be ensured that the liquidation process is fast, quick and whatever can be retrieved of the assets available so that the creditors are paid off whatever maximum can be paid to them. So these three competing interests, recovery, restructuring and liquidation, how to balance during this phase, which is very delicate phase and is termed as by Insol International, also Twilight zone, on which this topic is based.

Now during this period, the role of directors becomes all the more important and it is here that we have to have adequate provisions to ensure that the directors are not able to indulge into mal-practices and there is an honest effort to revive the

company. The company may become sick or its credibility or net worth may erode due to various reasons, I mean, reasons can be broadly categorized into two. One could be that it may be due to some market forces beyond the control inspite of best efforts, best management practices, the company goes bankrupt or goes into financial difficulties or it may be attributed to mis-management on the part of the directors. I am reminded of one joke at this stage and I think, I will be able to make my point more clear. There were two persons who were vacationing at a very expensive and luxurious resort. One was a lawyer and the other was an engineer so after two or three days, they were meeting occasionally, they asked each other, yes, how come you are here and able to afford. So the Lawyer says, thanks to insurance company, my house got fire and I got hefty amount in the insurance claim so that is how I am here. He asked the engineer, how come you are here. He says, look here, reason is same, I also got the amount from the insurance company but my house was destroyed in floods. He says, how could you cause floods. I could trigger fire but how could you cause floods.

So first is the example of mis-management, second is the example where things beyond control although the result is the same.

So at this stage, the entire approach is to preserve the assets, protect interest of the stakeholders and minimize the future risk and how to ensure this and what are the various provisions. Actually, our existing Company's Act has various provisions, I need not say in detail. Section 540 dealing with defrauding creditors, 541, maintenance of when there are improper accounts etc. 538, falsification of company's book, 542, fraudulent conduct of company's business, 543, delinquency and malfeasants etc. where the directors can be held personally liable but this becomes all the more important when we are in this twilight zone.

At this stage, what can be and how the system can be strengthened. All the speakers, who are very eminent speakers in their field, we have the Chairman of the BIFR, we have Mr. Neil Cooper who is associated with Insol International and was the President of the Insol International for a number of years. I had the occasion to see him performing in various international seminars and you will find him to be an outstanding speaker.

We have Mr. Shardul Shroff, who was not only associated with this concept paper, the expert committee which was constituted thereafter and I think, every economic legislation in this country, he is the person who can be banked upon.

We have Mr. Lalit Bhasin

I will say, some of the experiences that I have had, when I was the Company Judge for almost in two years in Delhi High Court and how to tackle such problems, while dealing with the problem of good governance or dealing with these directors, which I came across.

First, I will give you an example of a case. It was an interesting case and an innocuous case. I dealt with this case during liquidation, it was an application by the official liquidator under Section 531(a) on the ground that some of the assets which were transferred by the company before its winding up should be retrieved but when

we go a little deep into the facts, astounding facts were found. Here, this company, which had gone into liquidation, few days before filing up the petition, when the winding up petition was filed, this company was having a substantial portion on lease, on rent in Connaught Place area and a few days before, tenancy was surrendered in favor of the landlord. It was given back, it was on a rental of five hundred something only, you know, in Connaught Place area, all these tenancies which were created in 1920's, 1930's, the rent is 200, 300, 500 rupees but the market value today would be much substantial. So when it is surrendered, one can understand what deal must have taken place but a few days before it is surrendered and immediately on surrender, a new lease deed is entered into with company B, so company B becomes the tenant. Company B files 'company winding' up petition after 20 or 25 days, on the ground that it had given a sum of thirty or forty thousand as loan to company A and company A is not paying the amount.

Now, notice was served. Company A, against which the winding up order was passed doesn't even come to the Court and contest so winding up orders were passed. The facts which were revealed afterwards were this. Both the companies were related, connected with each other, the management was almost same, so what company A did that it was having much liabilities, many creditors to whom it had to pay, many financial institutions so two things they achieved. Its prime asset transferred in this manner and the plea, which was taken was that because of financial difficulties, we were not in a position to pay the rent so we surrendered the tenancy and so the tenancy is transferred to the sister concern, that is B and showing some loan from B at the instance of B, winding up orders so that all other creditors go to dock. So this is one thing, although in that case, I passed the order of canceling the tenancy etc., I could get some material for that and it should come back to the official liquidator etc. but that's the history. This is one example, how the directors can play such tricks.

There is one more thing, which I will state, because all these provisions under the Company's Act, which I have stated just now, they all operate post-liquidation proceedings and it's a matter of common knowledge that in our country, these liquidation proceedings go on for years together. It has its fillip side also, silver lining, which I will narrate later and very interesting phenomena but what happens when for fifteen years, twenty years, liquidation proceedings go on. Why so much time takes place? Although when winding order is passed and official liquidator is appointed, within three weeks, statement of affairs is to be filed by the directors, giving the details of all assets, liabilities, creditors, debtors but I need not go into the reasons here, in detail. That itself can be a subject matter for lengthy discussion but fact remains, this statement of affairs does not come forward. So it is a non-starter, for official liquidator also, for the company court as far as liquidation proceedings are concerned.

Now, some attempt can be made. Last balance sheet, this company must be filing annual return with the Registrar of companies but experience shows that Registrar of Companies does not have its record updated. You will not find, for last five years, ten years, the record there so nobody knows, where the assets are or what the assets are and many times it is seen, when the notice goes, the petition is filed because non-filing of the statement of affairs is a criminal offence also and an application is filed by the official liquidator, these people are not even traceable.

Those very persons, if there are Section 138 proceeding under negotiable Instruments Act, some cheques are dishonored or if the bank, financial institution has filed recovery proceedings where their personal assets are mortgaged, they are appearing before that recovery tribunal also, they are appearing before the criminal court also. I mean, that's the experience so how to tackle these situations and what can be the provisions so one has to take into account these.

Presentation:

Mr. Ravindra Gupta, Chairman, BIFR, Ministry of Finance, Government of India

Let me at the outset compliment the Ministry of Company Affairs, the CII, the Institute of Chartered Accountants and the Institute of Company Secretaries for having set up this National Foundation for Corporate Governance because in today's global markets and its dynamics, it's a cut-throat competition and unless you are very efficient, state of the art technology and machines and practices, you cannot survive.

I can recall, in 1994 when the WTO agreement was signed an air of gloom had descended on the country and the apprehension was that Indian industry will be swarmed by multinationals but if you look, after ten years or twelve years, there is a lot to cheer. I am so happy that every year, more and more Indian companies are becoming globally competitive and a country where manufacturing was supposed to have gone is re-establishing and I think, for the first time, the country is getting advantage of its wage differential. However, this is happening at the top of the lawyer and it has to percolate down and it is also nice to see that Indian companies are also joining the body of multinationals, it is a good trend.

I must also regrettably mention that there was no premium on corporate governance in this country. The industrial policy framework that we put in place after India became independent functioned within a plethora of controls, high tariff barriers, fears of monopoly or exploitation and therefore we licensed our economic capacities based on domestic demand and we pushed them to Godforsaken places. But everyone wanted licenses because in an economy of shortages, there were premiums to be had and therefore, you were under no pressure to be efficient or to produce better quality of goods or newer goods or adopt better technology. This is rather unfortunate but I am happy that WTO, which was seen as a dragon has been a blessing in disguise and the country's economy is moving faster, the corporate results are fine and they are improving year by year. The Board of Industrial and Financial reconstruction (BIFR), which was created along with the appellate authority under the Sick Industrial Company's Act of 1985 had two major concerns.

One, the protection of employment and two, gainful use of country's resources and the idea was that the scheme that was put in place will identify sickness quickly and be able to put in place remedial measures so that the resources will again become productive and the company will come out of the red.

However, in the scheme of things, the companies are required to come to the Board and register when their net worth has been fully eroded although Section 23 of the Act also envisages that company shall inform the Board when 50% of its net worth has been eroded and Section 23(a) was added so that some action could also be taken but I find that hardly any company gives information to BIFR after 50% of its net worth has been eroded. All the registrations that I have seen are only when the net worth has been fully eroded.

Then I also found, during my experience with the hearings. For some reason, the Board of Directors are not keen to accept that the company has become sick or is going to be sick. There are many cases, where we find that company's liabilities, quiet often, the interest payable to secure creditors is hidden, it is not reflected in the

balance sheet. Then for some reason, after several years, possibly because cohesive action has been initiated by secured creditors, they come to Board and register and they bring all the accrued interest and other liabilities, they also write off debts, quiet often, they change the method of depreciation, quiet often, they also change the accounting year so that the net worth can be shown to have been fully eroded. Now, you can see that by whatever the reasons, by delaying this acknowledgment of sickness, a couple of years earlier, you are putting the company at a great disadvantage because as more time passes, the more difficult it becomes for company to revive but this tendency is there and I think, one of the issues of corporate governance would be that sickness must be recognized and accepted as soon as it is detected and I think, there must be much greater use of Section 23 where you report to the Board that 50% of the net worth has been eroded.

In this regard, I would also like to request the Institute of Chartered Accountants of India and the Institute of Company Secretaries of India that they should also professionally apply themselves and not be persuaded to hide liabilities and sickness. The auditor is required to record a certificate in the balance sheet. If the net worth has been fully eroded and the company has become sick, I think, they should use the forum of the Institute to push this across to its members that they should help in this national task, I should say.

I am sorry to mention that a very large number of companies register because registration offers them protection so no proceedings, cohesive action for recovery etc. can be taken by any creditors, secured or otherwise and they try and delay the process so that they can keep enjoying this protection and they use or mis-use the system in the country to do so. I am sorry to report to you that there are, with the BIFR became operational in 1987, then there were a very number of companies registered in 1987 who continue to be sick and be with BIFR, they just keep on coming back. Somehow or the other, they will go to the appellate authority, then to the High Court and so on and so forth, so they just prolong so that they continue with the protection that they get.

As you must be aware that the Government had passed two Bills whereby a national company law tribunal would have been created but that process is on hold because of legal problems so BIFR is still functional.

I would also regrettably inform you that somehow the Government has never put in place the number of benches, which were envisaged under the law and today only one bench is functioning and there is a huge backlog. You will be sorry to know that we have not finished the first hearing in cases which were registered as far back as 2002. Because of this creation, National Company Law Tribunal, for the past couple of years, the Government's interest had flagged and they were giving some extension to existing members but it is only last year that they put a bench fully in place, so I would also request this forum to request the Government that they should put a couple of more benches, otherwise the purpose will not be solved.

I must also say that, in the past, the role of banks had also come for a lot of criticism because they had not extended adequate credit limit in time or they had not pursued rehabilitation process very actively but now I find that banks are quiet proactive and they are helping the process, I would say, vigilantly as well as expeditiously. We

have been trying to push the process but I will again request this forum that they should request the Government to put a couple of more benches in place.

Thank you.

Presentation by Mr. Neil Cooper, Partner of Kroll Corporation Advisory & Restructuring Group, UK
(not to be done – as requested)

Presentation:

Mr. Shardul Shroff, Managing Partners, Amarchand Mangaldas

Chairman Sir, thank you for this opportunity and the organizers, thank you for this opportunity for expressing some of the issues in the context of this theme of 'Directors in the Twilight Zone'.

I think, there is a need in the Indian context, first to explain, what the law has touched upon and what the law has yet to get into. In England, the English law clearly has a schedule of general principles by which directors are bound and some of these principles are the abeyance of the Constitution and taking lawful decisions, promotion of the Company's objectives, delegation and independence of judgment, care and skill and diligence and transactions involving conflict of interest. We don't have such a statement of duties embedded in our law. One of the issues, which has triggered this dialogue is the concept in many jurisdictions where the context of insolvency law, where the company has gone into liquidation, the Court on the application of the liquidator, seeks to declare that the director should make a contribution to its assets. Once, there was no reasonable prospect of avoiding insolvency and the director failed to take every step with a view to minimizing the potential loss to company's creditors. So what the twilight zone really focuses on is, when there is a shift from the shareholder duty take place and move over to the creditor duty because it is in this question that embeds the change in the policy.

If a director has a duty to promote the success of the company, when does the duty stop for the shareholder and when does it start for the creditor to preserve the assets, which the creditor ultimately can get out of those assets whether they are secured creditors or whether they are unsecured creditors. It is in this context that Mr. Cooper's statement that it is not only about the captain, it is also about the crew and therefore the question of what is the reasonable care, skill and diligence that you have to exercise in the twilight zone. Is your skill and care to do more and I am going to pose a very interesting question immediately or is it do less. This is the debate in most international jurisdictions that does the first sign of insolvency create chilling effect on the directors and should they freeze in their steps or should they do more to create an environment where the accelerated business can actually bring the company out of a potential sickness. Do you need a turnaround specialist? Is a turnaround specialist secure or is he going to be villain, if the company is not saved. Where does the skill lie? Was it a reasonable exercise of skill or was it an excessive burden that was put on the company, a reckless burden put on the company so the duty of the Court in analyzing whether the director had such a duty, whether it was reasonably exercised, whether it was recklessly exercised is a function, which at least in the Indian jurisdiction has not come up for consideration.

The question of avoiding conflicts of interest is a general duty and I remember, way back in 1980, when I started my career in the High Court at Delhi, the question was asked in a very interesting case known as Electronics and Computers Limited, which is incidentally still going on in the Delhi High Court, where the question was, if there are creditors directors on the board of a company and there are shareholder directors, what is the fiduciary duty. Is the creditor's duty to resign from the board, should he recall the directors because there is an obvious conflict and the creditor's directors may not support a revival scheme under 391, 394, should they step off the

board or should they stay on the board to preserve the creditor's rights and the creditors' assets, if there are secured creditors outside winding up. This was one of the most tricky questions raised and it is still unresolved because there is no judgment on this particular subject.

The duty, not to accept benefits from third parties in the Twilight zone, it's a common duty whether it exists prior to winding up or prior to the first signs of insolvency or a duty in insolvency or in the Twilight zone as was being talked about and the duty to declare one's interest in the proposed transaction, the example that the learned judge gave in the context of tenancy could never have happened if there was a duty to declare one's interest in the proposed transaction and a clear announcement of the law that such a contract could never be entered into, that if it is a related party contract, if it's an 'interested party' contract in an insolvency, if it results in avoidance or fraudulent preference in favor of some shareholders or some stakeholders and it jettisons the interest of other stakeholders, that is a bad transaction in law.

Let me pose me this question in the context of infrastructure companies and companies where the law permits an incredibly high debt equity ratio, where the gearing, which is permissible because of the very nature of the industry and telecom is one such case or you take ports, you take roads, you take any of the new breed of infrastructure companies where the recovery rate is a prospective ten years process and the very act of getting into the business is in the red.

Today, if you ask for the balance sheet of any telecom company, out of ten companies, nine will be in the red. Are they in the twilight zone or are they in the flourishing zone because every day you hear of packages where people reduce their tariffs to even one rupee, even for a long distance call. Is that reckless behavior or is that behavior for enhancing the business potential of the company.

Now, these are the kind of questions, which will arise when you consider the duty in the twilight zone. If for example, it is found that, that company did not have the money to pay its creditors and yet embarked upon ambitious schemes of giving one rupee tariff rates for doing telecom business across the country. Would it be reckless or would it be in the nature of enhancing the business as is expected of a reasonable, prudential director in the circumstances of other companies. That's the kind of issue, which the Judge will face when this question of 'duties of directors' in the twilight zone will come up for consideration.

It is not so much the fraudulent representation. It is not so much the tracing of assets. Those are the regimes in insolvency. Those are the questions, which arise when you are in the thick of the process of trying to trace the assets or trying to recover the maximum due. The twilight zone is that zone where you have to actually make the judgment, should I do this and is it in the interest of the company and the creditors, not only the creditors, not only the shareholders but both and can I progress the business of the company to pull it out of insolvency and that's why Mr. Cooper mentioned that it is a very specialist function. It should not result in preventing rehabilitation processes. It should not prevent creation of future processes whereby the company actually benefits from risk taking. You can't enunciate a duty for a director, which makes the director risk averse and at the same time, the direction should not be reckless enough so as to be completely in the risk

zone and dragging the company deeper into the risk morass. I think, this is the issue around twilight zone, this is what the Irani committee has actually stated in the context of Paragraph 14.1 of the report where the issue, when should the reporting happen, what should be the duty in such circumstances, how should they be dealt with by an impartial and independent.

What is the ground reality, however? If you see the provisions of Section 15 of the Sick Industrial Company's Act, there is already a duty. This is not new law for us. There is already a duty upon companies where if, after their duly audited accounts, they find that the company is rendered or is likely to be rendered a sick industrial company, to refer the matter to the shareholders. There is a duty to report the potential sickness and there is a duty to bring out a fair plan as to how the process will come out of the insolvency so it is something, which is already there. The provisions of Section 17(2) contemplate getting a company out of sickness of its own. There are procedures, which the Board has whereby it can appoint a special director to protect the interest of the petitioning creditor or whoever has petitioned the sickness application.

So there are, on the ground, circumstances and law, which does envisage how the twilight issues should be dealt with. It is a very major area in the debate, which is happening internationally. I don't think, the debate has fully come to India because this question and let me sort of illustrate it.

Take the issue of what has happened in Section 286 of the Company's Act. The moment you have not paid debentures or bond holders, you are disqualified for five years, so you can never have good directors in a situation where there is the depositors and the debenture holders are in arrears. You are actually doing a dis-service or you need to create a separate sub-board or a shadow director concept where you actually bring good people whom you pay more to really bring the company out of sickness. For example, in the infrastructure company's, they are probably the best paid executives, those are companies all in the red and the kind of growth that has happened, 150 million telecom users in the last six years. Its incredible but that's not happened because these are insolvent companies. In truth, they are but they are still doing great business, they have great enterprise value, they are not insolvent, they are paying their debts but on the break-up value basis, they are minus, they are all in the red.

So it's a question, which needs to be qualitatively addressed in the kind of company that you are, there is no absolute formula. What applies to an infrastructure company may not apply to a trading company, may not apply to a manufacturing company, the norms become different and therefore, there is lot of intelligent interpretation of the principles applicable to directors in the Twilight zone.

Presentation

Mr. Lalit Bhasin, President, Indian Bar Association

Hon'ble Justice Sikri, my worthy panelists, distinguished participants. My special thanks to Mr. Shardul Shroff.

I will just touch upon the subject because there are four aspects of the subject. First is insolvency, second is corporate governance, third is the twilight zone and fourth is the role of the directors.

Insolvency has been dealt with in detail as to what constitutes insolvency, whether it is the provision of SICA or it is the Company's Act or even the amendment, second company's law amendment, which has not been brought into force as yet. So far as corporate governance is concerned, we have had elaborate discussions in the last two days but speaking for myself, I do not like the word 'governance'. As a professional, we never like to be governed by any authority. As lawyers, we appear before the Courts but we have our own ethics and etiquettes of the profession but we are not governed by anyone, so I don't know why and how this philosophy of corporate governance has emerged. What is required is evolving right practices, conventions in the business world and India is fully aware of these. We had the best corporate practices followed by the business houses of India, even before the word 'corporate governance' was known, examples are the Tata's, Birla's, Mafatlal's, for ages and they even had the Gandhian values in their corporate transactions but somehow, corporate governance has come to stay. The independence of directors may be diluted, may be jeopardized and those who are not so independent may join the Boards where as the real independent directors may not like to be on the Boards.

It is in this context that we have to see as to what is the twilight zone and here my friend, Mr. Sumant Batra, has very elaborately in this book, there is a chapter on India and this is a book 'Directors in the Twilight Zone'. He has very elaborately dealt with what constitutes a twilight zone under the SICA, under the Company's Act and under the Company's Law Amendment.

My submission to you here is that, there is no special responsibility or obligation on the Board of Directors only in the twilight zone, I think, it is an ongoing responsibility, ongoing obligation, right from the time when a person joins the Board of Directors. You cannot relax your vigil, when the company is supposed to be doing well because that may lead to a situation as Mr. Neil Cooper had said that, what is the crew supposed to do when you spot the Iceberg. With great respect, I may say, it is the responsibility of the Board of Directors of a company to ensure that there is no occasion to spot an iceberg, you have to steer clear before that situation emerges that you are facing with a crisis and for that, there are abundant provisions in the Company's Act, in the listing requirements, which are, if complied with, would never lead to a situation that you are suddenly faced with a crisis that the financial strength, financial health of a company has gone down.

I think, the role of the audit committee has not been adequately highlighted. This is a phenomena, which has emerged and very effectively, the role of a audit committee as also the latest accounting standards and audit standards, which have emerged over a period of time have made the task of the directors, no doubt, more onerous but at the same time, easier also because there is a requirement of quarterly

statements, half yearly statements and of course the yearly statement and of course, the role of the audit committee is virtually to sit upon the auditors and upon the managers of the company to ensure that there are proper systems of control, proper methodology, proper accounting practices, audit committee's report then comes to the Board of Directors. When audit committees, they meet, they have the internal auditors there, the statutory auditors are invited, therefore, the Board of Directors of a company, at all points of time, do have a clear picture about the financial health of a company and it is at that point of time, if they feel that, yes, the profits are going, the net worth is going down, so what remedial steps should be taken. I look upon the role of directors in twilight zone, not in a negative perspective that they will commit frauds and they will do all sorts of illegal things, which they are not supposed to do.

I look at it, the role of the directors in a very positive manner as to what steps they should take to revive the health of the company, if according to them, the health is not so good. What sort of medication is required? What remedial steps are required. Some steps may be required, for instance, if you have taken loans, go for rescheduling of loans. If you do not have the proper type of personnel, go into a financial audit of your human resources requirements, undertake all those exercises and if your profit has gone down due to some adverse taxation, which has emerged, even go for lobbying with the Government, this taxation is counter-productive, this levy is counter-productive, take all those remedial steps to revive the health of the company. I think, this is the way we have to look at, the role of the directors in the twilight zone.

Thank you.

Presentation:

Mr. Sumant Batra, Senior Partner Kesar Dass B & Associates, Advocates & Solicitors

Thank you Mr. Chairman. I have no presentation to make, I have no speech to make. I would have preferred to continue to sit on that table and make my notes. The only reason, I got tempted to sit on the dais and get a time slot was because I was quiet unsure whether it being the last session, running overtime, I would have the opportunity to ask four questions, which I have, which I wanted to make sure that I ask and I know, I can take the liberty of using this time to ask those questions and that's what I am going to do because very rare to get such a privileged set of brains at one point of time under one roof but before I raise my questions, I just wanted to emphasize on the need on this subject.

We all know the obligations which we have talked them universally and there is a lot of work, which has been done on what are these special obligations, which are cast on the Board at the time when the company goes into insolvency or the insolvency is in imminent. The area where there seems to be a lack of clarity to some extent is the area or at the time when there is a first indication to those who are running the company, who are in the management, who are dealing with accounts or who are associated with the affairs of the company. At that particular time, what are the special obligations that come into being, if at all, there have to be any and that is what the twilight zone is and a lot of expressions have been narrated attributed to this period and all of them are, perhaps as appropriate as the expression 'Twilight Zone'.

As Mr. Bhasin said, why should there be any specific liability or obligation during this period because that obligation is a continuing obligation and it is implied that the Board would continue to perform its obligations as it is obliged and which is sacrosanct. So why should there be any particular attempt to define a special overall supreme responsibility in such a period.

I don't think, there is any such requirement and that is what probably the message which we got from Neil, Shardul and of course from Mr. Bhasin himself, which is that, there is no need to provide special legal provisions perhaps but definitely the underlying message is, there is a requirement, there is a need to change the mindset. There has to be a very different line of thinking, which must trigger, the moment you come to know that an insolvency is imminent or likely or may occur or may be avoidable as Shardul used one of the expressions 'freezing in their steps', should you do that or should you become more proactive or should you start getting into a panic action as to so many tick boxes, which you must do, either on a regulatory basis or a legal compliance basis or perhaps from the point of rescuing the company.

All that is still a matter of debate and that is why we are here because there is some further clarity, which we consider is required in the Indian context and that it is a need is something which is perhaps not a debate. We certainly do need to address this issue as Shardul emphasized as also Dr. J. J. Irani committee did clearly mention in paragraph 14.1 because we did extensively and Irani committee debated

this and we concluded that there needs to be a message, which must go out of the J. J. Irani committed where after the policy makers would evolve.

So the issues of a silver line, which must run through the twilight period, which is the mindset of the management must work in a particular fashion.

Questions and Answers:

Sumant Batra: There were lots of ideas on the slides of Neil. Shardul mentioned a few specifically but the question is, how do we take them forward, how do we implement them and my first question therefore is to Neil. I have three questions, one of them is to Neil and two to Shroff.

The first question is to Neil. Should there be a legal obligation on the Board to call a meeting of the creditors and the shareholders to be able to inform of the financial difficulty or a likely insolvency.

My questions to Shardul are, what additional disclosures do you consider can the Board be obliged to make whenever they get a first indication of a financial difficulty coming towards them.

The second question is, the auditors who perhaps get the first smell of the difficulty and of course in turn, inform the audit committee or perhaps the Board or the Executive in what ever way, what obligations should the auditors have, if at all any to take any particular steps or action in this area.

Response by Mr. Neil Cooper:

Starting with the question, what is their legal obligation. I think, the legal obligation when they enter the twilight zone, that period of uncertainty is not to convene a meeting of creditors. Their legal obligation is to take every step to avoid increases the losses to creditors. Now that might mean that they have to stem losses, it might mean, they have to cease loss making activities, they should start to recognize the contingent liabilities that fall in, they have to take particular care with customer deposits, if they are receiving deposits from people who may be creditors in future, they have to avoid incurring liabilities that will not be paid but overall, I believe, they should take advice. Now at the point where, either that advice or their conclusion is that the company is insolvent and it needs to be wound up, then they should have a duty at that stage to convene a meeting of creditors but I don't believe that simply, that period of uncertainty triggers that responsibility.

It should only be when the company is going into insolvency, that at that stage only and I think, there may be quiet a good rationale behind it as if that stage when even the attempt can be made to revive the company and as such a meeting is called then it may have knee jerk reaction and may rather be a step or the reaction from the others, creditors, shareholders may be such that it may have negative impact on the entire process.

Response by Mr. Shardul Shroff:

I think, there is a very interesting statement in the book, which has been spelt out and I thought, I will just read four lines out of it that in England in a 1960 report that unreported case, they have conceptualized a silver lining or sunshine or light at the end of the tunnel test and therefore the question of whether you need to disclose that this is the perception of the persons in management, this is their view and that is the reason why trade is going on and therefore trade is not fraudulent has been one of the test enunciated in England. I think, the same kind of test is there in Section 15 of SICA because when you do get a sign that there is an imminent sickness or erosion

of the capital and the net worth of the company, you do have a duty in our law to call a meeting of the shareholders. Now, whether that is prudent, whether that is good law, whether it will scare away creditors, whether it will create a run on the company, these are questions, which management always debate. As a commercial practitioner, I have seen that the moment Section 15 kind of situation arises, there is a huge flurry of activity because managements look upon it as invitation for trouble because when you declare that yes, your potential is sick, you are not within the zone of protection of SICA, you run a greater risk of people making a run on you but you are therefore, also in a situation where you declare, how you are going to deal with it.

So that is one answer in some sense to the two questions that Sumant put to me that what additional disclosure should be expected from the Board in the twilight zone.

I think the answer lies in the kind of resolution, Section 15 of the Sick Industrial Companies. I am not sure whether it is the best of solutions because as I myself explained a few minutes ago, it can lead to a run on the company without the protection of the Sick Industrial Company's Act being available but it is nevertheless a savior for the management from being charged with the theory that you are fraudulently trading, that you are mis-managing the company because the reasons for your sickness would have been enunciated in the explanatory statement and the plan that you have as management would have also been brought to the shareholders so if they do feel that you are not on the right track, they could have a different plan but you will be saved of the odium of a charge of fraudulent trading, which could survive in insolvency. I think, that is one of the lessons, which English law and Indian law has for us.

In terms of what are the obligations of the auditors who are among the first to come to know, I think, the principle is the same in CARO, which is our reporting order in India that if you do sense industrial sickness. Here the zone of reporting is essentially in industrial sickness but I don't see a reason why this should not stretch to major trading companies or any major company, which has a public impact, where there is a huge public employment or a huge public funds being raised, in a sense, that there is a large debt or there is a large credit, which has been availed or large number of depositors, which are there. Where ever, there is going to be a large public impact, I think, the duty to disclose and it has been very well said, 'sunlight is the best disinfectant', so you bring it to the fore. Yes, it has consequences, there will be a lot of pain attached to the disclosure but the pain which can result from non-disclosure is far greater than the pain which arises from disclosure.

Observation:

In the meeting that you convey, you tell the shareholder, what do you propose to revive the company also so that, that can avoid the panic, if any, which can spread to the creditors and that is the way you could achieve both, information as also avoidance of panic.

Observation:

To my mind, overnight companies won't reach the stage of sickness. It may start, well in advance rather, the decline in finance and health and wealth of any particular company, in terms of erosion of financial resources will stop much earlier. By

consistently going through the financial statements, with the help of some financial tools and we can identify, the company is having some decline in terms of profitability, efficiency and effectiveness, there actually, this corporate governance will work rather. If they are meticulous to go through all areas, maybe, in the area of finance and other related aspects, that will give alarming signal, from the beginning itself. They can awaken and take measures and improve their efficiency, then this situation won't come overnight rather, so therefore, it requires lot of measures, mainly difference of accounts, skill, ability of executives who is responsible to take all the financial decisions, so thereby, if at all, if the companies are very serious about following all corporate governance practices and such other things, this problem can be mitigated.

Sum up:

As rightly pointed out by Mr. Lalit Bhasin that corporate governance is an on-going responsibility of the directors. It assumes more importance during twilight zone, that was the message of the addresses of both Mr. Neil Cooper and Mr. Shardul Shroff. We have sufficient provisions in law, the question is of their enforcement and at that stage, what should be the responsibility, what is the duty or what are the rights of these directors, everything is to be seen as Mr. Shroff used the expression, we have to see whether it's in the manner in which they acted, was it a reckless manner or it was a bold decision, taken in order to see that the company comes out of wood.

So ultimately, when ever such actions of the Board of Directors or the other members of the crew, as the expression used by Mr. Neil is to be judged, ultimately the test is, whether it was a bonafide honest move or a fraudulent move, that I think, was the message and on that basis, we will have to judge and depending upon the nature of the industry where these considerations, we may have to apply different consideration depending on the situation prevailing there.

Thank you.