

INSOLVENCY RELATED LIABILITY OF DIRECTORS UNDER THE COMPANIES ACT, 1956

A company is legally separate and distinct from its members. It is ultimately an artificial creation and it acts through its servants or agents. The decisions of a majority of its members in general meetings are regarded as the acts of the corporation. The majority acts through the Board of Directors. Board of Directors, as a whole, is generally delegated all powers of the management and it may sub-delegate any of these powers to individuals directors or other servants and managers. There is a relationship akin to agency between the corporation and its board as well as the servants or agents that are delegated with specific responsibilities. These Corporate executives are assigned with immense power which must be regulated not only for public good but also for the protection of those whose investments are involved. A director must however exercise his expert skill and knowledge for the company. He should exercise skill and care in carrying out their managerial functions. In addition to fiduciary duties there are some statutory duties also that have been provided under the Companies Act, 1956. A director has to perform his functions with reasonable care. If the directors unable to perform their duties they can be held to be liable under the provisions of this Act. At the time of winding up of a company the liquidator has a vital role to play. But since the directors are the key officers of the company they are also having some liabilities which are as under:

Misconduct By Officers of Companies in Liquidation:

Section 538 of the companies act, 1956 provides that a past or present officer of a company commits an offence:

- a) does not, to the best of his knowledge and belief, fully and truly discover to the liquidator all the property, movable and immovable, of the company, and how and to whom and for what consideration and when the company disposed of any part thereof, except such part as has been disposed of in the ordinary course of the business of the company;

- b) does not deliver up to the liquidator, or as he directs, all such parts of the movable and immovable property of the company as is in his custody or under his control, and which he is required by law to deliver up;
- c) does not deliver up to the liquidator, or as he directs, all such books and papers of the company as are in his custody or under his control and which he is required by law to deliver up;
- d) within the twelve months next before the commencement of the winding up or at any time thereafter, conceals any part of the property of the company to the value of one hundred rupees or upwards, or conceals any debt due to or from the company;
- e) within the twelve months next before the commencement of the winding up or at any time thereafter, fraudulently removes any part of the property of the company to the value of one hundred rupees or upwards;
- f) makes any material omission in any statement relating to the affairs of the company;
- g) knowing or believing that a false debt has been proved by any person under the winding up, fails for a period of one month to inform the liquidator thereof;
- h) after the commencement of the winding up, prevents the production of any book or paper affecting or relating to the property or affairs of the company;
- i) within the twelve months next before the commencement of the winding up or at any time thereafter, conceals, destroys, mutilates or falsifies, or is privy to the concealment, destruction, mutilation or falsification of, any book or paper affecting or relating to, the property or affairs of the company;
- j) within the twelve months next before the commencement of the winding up or at any time thereafter makes, or is privy to the making of, any false entry in any book or paper affecting or relating to, the property or affairs of the company;

- k) within the twelve months next before the commencement of the winding up or at any time thereafter, fraudulently parts with, alters or makes any omission in, or is privy to the fraudulent parting with, altering or making of any omission in, any book or paper affecting or relating to the property or affairs of the company;
- l) after the commencement of the winding up or at any meeting of the creditors of the company within the twelve months next before the commencement of the winding up attempts to account for any part of the property of the company by fictitious losses or expenses;
- m) within the twelve months next before the commencement of the winding up or at any time thereafter, by any false representation or other fraud, obtains on credit, for or on behalf of the company, any property which the company does not subsequently pay for;
- n) within the twelve months next before the commencement of the winding up or at any time thereafter, under the false pretence that the company is carrying on its business, obtains on credit, for or on behalf of the company, any property which the company does not subsequently pay for;
- o) within the twelve months next before the commencement of the winding up or at any time thereafter, pawns, pledges or disposes of any property of the company which has been obtained on credit and has not been paid for, unless such pawning, pledging or disposing is in the ordinary course of the business of the company; or
- p) is guilty of any false representation or other fraud for the purpose of obtaining the consent of the creditors of the company or any of them, to an agreement with reference to the affairs of the company or to the winding up,

If any of the above conditions are satisfied:

- a) Liability under this provision is criminal
- b) A person guilty of this offence is liable to imprisonment or fine or with both.

- c) the offences mentioned in clauses (m), (n) and (o), with imprisonment for a term which may extend to five years, or with fine, or with both/ and, in the case of any other offence, with imprisonment for a term which may extend to two years, or with fine, or with both:
- d) The act in question must have occurred in most of the above cases either:
 - i. After the commencement of the winding up
 - ii. Within the 12 months preceding the commencement of the winding up

Defrauding Creditors: [Section 540]

An offence committed by an officer of the company which is subsequently wound up by the court or which subsequently passes a resolution for voluntary winding up if he:

- a) Has, by false pretense or other fraud, induce any person to give credit to the company; or
- b) Has made or caused to be made any gift or transfer of or charge on or has caused or connived at levying execution against the property of the company with intent to defraud creditors of the company; or
- c) Has, with intent to defraud creditors of the company, concealed or removed any part of the property of the company since the date of any unsatisfied judgment or order for payment of money obtained against the company, or within two months prior to that date.

Liability under this provision is criminal and punishable with imprisonment for a term up to two years and with fine. There is no set time period. It all depends on whether it was within the knowledge of the officer that the company was bound or likely to go into liquidation. But absence of mens rea (Intention to defraud) may be a defense available to the officers of the company.

Maintenance of Proper Accounts: [Section 541]

In the course of winding up of a company, if it is shown that proper books of accounts were not kept by the company, every officer in default shall be guilty of

the offence under this provision. The offence must have been committed throughout two years immediately preceding the commencement of the winding up or the period between the incorporation of the company and the commencement of the winding up whichever is shorter. Liability under this provision is criminal.

Falsification of Company's books: [Section 539]

If with intent to defraud or deceive any person, any officer or contributory of a company which is being wound up destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of, any books, papers or securities; or makes, or is privy to the making of, any false or fraudulent entry in any register, book of account or document belonging to the company; he shall be punishable with imprisonment for a term which may extend to seven years, and shall also be liable to fine. Liability under this section is criminal and this offence applies when the company is being wound up.

Fraudulent Conduct of Company's Business: [Section 542]

Officers of the company is are guilty of fraudulent conduct of business if, in the course of winding up of a company, it is found that any business of the company has been carried on with intent to defraud the creditors of the company or any other person, or for any other fraudulent purpose. Persons engaged in the conduct of the business shall be personally liable, with unlimited liability, for all or any of the debts or other liabilities of the company. Thus the conditions which have to be satisfied for application of this section are:

- There has to be an insolvent liquidation in progress
- There has to have been dishonesty in the running of the business
- The standard of proof is that of beyond reasonable doubt even in a case of civil liability
- It applies to persons who are knowingly parties to fraudulent trading

Liability under this section may be civil or criminal. The court has wide discretion to compensate for the loss of caused to the company by the director's conduct but

it may also include a punitive element in the award of damages made. The main defense under this section is that the party concerned was not dishonest.

Delinquency, Breach of Trust and Misfeasance: [Section 543]

During the course of winding up if it is found that any person who has taken part in the promotion or formation of the company, or any past or present director, manager, liquidator or officer of the company shall be guilty of delinquency, if he has misapplied, or retained, or become liable or accountable for, any money or property of the company; or has been guilty of any misfeasance or breach of trust in relation to the company. Liability under this section is civil and the accused person can be compelled by the court to repay or restore the money or property or any part thereof, with interest at such a rate as the court thinks just

Misfeasance Proceedings: [Section 24 of Sick Industrial Companies Act, 1985]

Any offence is made out, if, in the course of scrutiny or implementation of any rehabilitation scheme or proposal it appears to the BIFR (Board for Industrial and Financial Reconstruction) that any person who has taken part in the promotion, formation or management of sick industrial company or its undertaking, including any past or present director, manager or officer or employee of the sick industrial company has misapplied or retained, or become liable or accountable for, any money or property of the sick industrial company; or has been guilty of any misfeasance, malfeasance or non-feasance or breach of trust in relation to the sick industrial company, the Board may, by order, direct him to repay or restore the money or property or any part thereof, with or without interest, as it thinks just, or to contribute such sum to the assets of the sick industrial company or the other person entitled thereto by way of compensation in respect of the misapplication, retainer, misfeasance or breach of trust, as the Board thinks just, and also report the matter to the Central Government for any other action which that government may deem fit. Liability under this section is civil. Honesty and reasonability may be defense for the directors under this section.

Directors and Managers with Unlimited Liability: [Section 427]

If the liability of any director is unlimited under the companies act, then such director is liable to contribute the additional sum as an ordinary member during the winding up of the company if so required and in such a case they shall be treated as a member of an unlimited company.

Offences under Sick Industrial Companies Act, 1985: [Section 33 of SICA]

If any person violates the any scheme, or any order of the Board, or the appellate authority and or makes a false statement or gives false evidence to the Board or the appellate authority, shall be punishable with simple imprisonment for a term which may extend to three years and shall also be liable to fine.

Offences under Part VIA of the Companies Act: [Section 424L]

Any person who violates the provisions of part VIA of the companies act, 1956 or any scheme or order of NCLT or Appellate Tribunal or produces the wrong evidence or attempts to tamper the records submitted under this act is liable to be punished for imprisonment for a term of to three years and fine. The liability under this section is criminal.

The motive behind imposing personal liability upon the directors is to protect the creditors, controlling and disciplining the management. The personal liability of directors seeks to protect and promote the full and free exercise of the directors while managing the assets of the company.