Hiving a business with high debts – risk(s) posed by third party intervention

Introduction

Often times in the course of due diligence exercises, quite fascinating facts and questions emerge whereby asset deals may come under the scanner for the most unexpected reasons. Assume an investor wants to buy a target's business and the sale is planned to be structured in such a manner that values are assigned to individual assets and liabilities and not as a going concern. In such situations, it would also be common that the seller owes money to third parties (*including government agencies*) which, often times, it cannot afford to pay. The parties decide to hive-off the relevant business to a new company as part of the restructuring which will impact business volumes in the seller's primary company with correspondingly low revenues. The third party gets to know of the transaction prior to closing and raises a demand to seek payment from the seller. The latter refuses to pay and raises a plea of insolvency. The question which emerges is can the third party somehow prevent that transfer of assets and/or, in effect, reach the buyer?

This newsletter examines this and related issues.

1. Law and jurisprudence on insolvency and liquidation

Under Indian company law, the term "insolvency" is undefined but the Companies Act, 1956 (**"Act"**) describes liquidation which can be either voluntary (initiated by either the shareholders or creditors of a company) pursuant to a court order. Section 433 of the Act describes certain circumstances when the jurisdiction of the tribunal can be invoked. Section 433 (e) covers a company, which is "unable to pay its debts" which constitutes a ground for its liquidation. Different people can initiate the winding-up process: these include the company itself, its creditors, contributories[1] or the Registrar of Companies (**"ROC"**) or any person authorized by the central or the state government. Therefore, should an unsatisfied creditor (a tax authority, any third party) raise a demand, that creditor can seek dissolution. But, it is worthwhile to remember that dissolution of an Indian company is a fairly long-drawn process. In a dissolution caused by insolvency the endeavor is to focus on the 2 possibilities for the debtor: **(a)** as far as feasible, restoration to profitable trading; or **(b)** maximize the return to the creditors where the company cannot be saved. In order to accomplish these dual objectives, the law provides for a fair system for distribution of assets among creditors.

Indian jurisprudence has held that debt as mentioned in Section 433(e) of the Act is a definite sum and excludes contingent or conditional liability unless the contingency or the condition has already occurred. Inability to pay debts usually occurs where a company's entire capital is lost in heavy losses (unless it is willful non-payment), a company undergoes financial crisis, it is not economically or commercially viable to run the business and a company or its creditors consider dissolution.

[1] Under section 428 of the Act contributory is a person who is under an obligation to contribute to the assets of a company in the event of its winding-up.

The courts have also held that a winding-up petition cannot be used as an alternative for realizing the debt by a creditor as such a tactic will tantamount to blackmailing or stigmatizing a company. The idea behind a petition on this ground is that a company is in a genuine financial crisis and, as a result, unable to settle the dues of its creditors. The tribunal first ascertains the reasons why a company is unable to pay the outstanding debts. In the course of its inquiry, it will go into the merits of the case and evaluate whether the financial crisis is caused due to deliberate actions of the shareholders/officers or by market conditions. There is discretionary power of the tribunal in ordering winding-up, and to establish that dissolution is not simple.

2. Consequences on prior transactions

Part 5 of the Act spanning 35 sections covers various provisions that apply to winding-up. In this part, a series of sections discuss the effect of dissolution on certain antecedent transactions. Three are important: **(a)** Section 531 deals with fraudulent preferences, **(b)** Section 531A under which transfers within a period of one year before the presentation of the petition for winding-up or the passing of a resolution for voluntary winding-up are deemed void against the liquidator, and **(c)** Section 532 deals with another category of transfers and is not pertinent as it addresses transfer by a company of all its property to trustees for the benefit of its creditors; it is provided that such transfers shall be void.

Section 531 provides for a "fraudulent preference" on the eve of winding-up with a view to favor some creditors over others. Basically, this means that during the course of investigations if it emerges that "any transfer of both movable and immovable property, delivery of goods, payment, execution or other act relating to the property made, taken or done by or against a company within 6 months before the commencement of winding up…….. shall in the event of the company being wound up have deemed to be a fraudulent preference of its creditors and be invalid accordingly." Pursuant to Section 533, any person preferred is subject to same liabilities as persons in management, who have given a fraudulent preference. This is the sole provision where the buyer may have a cause for concern and the triggering factor is that it must occur in a winding-up proceeding. Another pertinent section is 531A which discusses "Avoidance of voluntary transfer" and stipulates that *"any transfer of property, movable or immovable, or any delivery of goods, made by a company, not being a transfer or delivery made in the ordinary course of its business or in favour of a purchaser or encumbrancer in good faith and for valuable consideration, if made within a period of one year before the presentation of a petition for winding up by or subject to the supervision of the court or the passing of a resolution for voluntary winding up of the company, shall be void against the liquidator."*

Thus, while section 531 treats certain transactions as invalid and section 532 treats another category of transfers as void, section 531A stands in between treating the transfers covered thereby as void against the liquidator, but are not rendered totally void.

The judicial precedents, in the context of tax disputes, hold that they are declared void only as against the liquidator. In other words, they are valid amongst the parties and against the rest of the world, except the liquidator. It is open to the liquidator to treat them as void and of no effect, and, accordingly, seek to recover the property covered thereby ignoring the transfers. He need not seek to have the transfers set aside or cancelled. The transfers are voidable at his

option so that it will be equally open to the liquidator to honor the transfers and deal with them as such. All that section 531 implies is that the transfers will not bind the liquidator, and it will be open to him either to treat them as void, or to affirm them. Since the option is with the liquidator, if he does not choose to disown them, they will continue to be valid and operative.

3. Penal implications

Further, Section 538 of the Act covers offences by officers of an Indian company in liquidation for offences against the company or creditors regarding:

- fraudulent removal or concealing of property,
- non-maintenance or non-delivery of books of accounts to the liquidator,
- non-delivery of the custody of movable and immovable property to the liquidator,
- suppressed value sales,
- omissions in relation to the statement of affairs of the company,
- false claims of debts,
- destruction or mutilation of records,
- making fictitious losses or claims, false representation etc,

Sections 539 and 540 provide penalties for falsification of books and frauds by officers which may extend to imprisonment up to seven years. For certain acts, there are both monetary and penal sanctions. The court can assess personal damages against the past or present directors, managers, liquidators or officers of the company for engaging in prohibited acts. This damages claim is in addition to the criminal liability incurred, and the court has power to direct prosecution under Section 545. The trigger for these penalties is **(a)** an ongoing winding-up proceeding due to insolvency; **(b)** investigations reveal malpractices leading to bankruptcy.

In summation, briefly, the corporate and insolvency law does not provide chasing the new owners, or reversal of the transaction outside the special situation covered under Section 531.

Authored by:
Priti Suri