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Securing the Creditors within Company Law and Judicial Precedents

SOUMYADIP PANDA[1]

ABSTRACT

Creditors, in common parlance, can be termed as any legal entity who extends credit by giving the permission to another entity to borrow money with an intention to repay the same in the future. They play a crucial role in keeping the company in a good condition. They are the sole functionaries of the company who give them the credits to maintain their business. By the righteousness of loaning cash by the creditors to the company, the company becomes indebted to them and subsequently is under a commitment to take legitimate consideration of the creditors' enthusiasm.

Earlier there were no such establishments that give alleviation to the creditors whose cash is being associated with the company that falls flat. Many times it was also seen that the company, in the wake of taking cash from the creditors, disappeared without restoring the due cash to the creditors. Such acts on part of the companies render misfortune to the creditors.

Hence, to regulate such acts and secure the creditors, there are numerous enactments that have been authorized by the Indian Government. These enactmentshave made it feasible for the creditors to guarantee their cash once more from the company. Consequently, in today's time, a company which cannot reimburse the due sum to the creditors can't take the reason of being wiped out.

In this paper, the Author tries to explore the eclectic ways by which security is stood to the creditors of a company and furthermore view the different arrangements that assist the creditors in understanding their credit. The Author further aims to highlight a few judicial remedies and precedents at their aid among which the Swiss Ribbon Case of 2019 is held as a Landmark Citation in the field of company law and insolvency code respectively.

For this paper, the Author will be adopting the doctrinal method to proceed with his research work. Primary resources the Author will be referring to in the course of his research work will include books, journals, law reports and cases. Other sources like articles published in online journal and the similar will be accessed online through the use of online databases.

Keywords: *Creditors, Companies, Liquidator, Winding Up, Insolvency.*

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I. Introduction

The need for protecting the creditors comes up at the time when the company is going through winding up procedure. This concept has grabbed significant importance during the procedure of winding up for protecting the creditor's interest, which had lent their hard earned money to the company. It is the credit creation which invokes the debtor-creditor relationship and also makes the process of insolvency possible.

Insolvency can be defined as a state wherein the company is not able to pay its debts. It is the prima facie reason for the court to allow the winding up of a company but is cannot be said to be the sole reason for initiation of the process of winding up. A company in the state of insolvency leads to its liquidation. This insolvency state takes place when the company is not able to pay the amount due which has been taken by it from some sources outside the company, which is also known as creditors to raise the capital required. This creates the creditor-debtor relationship. The creditor's interests are considered while the company is undergoing the process of winding up, so that some portion out of their due amount is given to them from the assets which has been realised during the process of winding up.

Credit can be raised from a wide variety of individuals and institutions. A creditor may be anyone who is not a member of the company. He may be an individual or any financial institution or anyone willing to lend money to the company. They may be institutional lender like banks that plays an important role in offering loans to the companies; trade creditor who supplies goods or services to the company; any wealthy individual; government agencies; employees etc.

Credit can be obtained by a company in many different ways. They may be as under:

By offering security-borrowing companies offer security to lenders which may prove attractive to the latter because it their loan risks are reduced by giving them such privilege which are claimed for the repayment in case of the company's insolvency. Such securities may include the building, the machinery and plants of the company etc.

By seeking unsecured loan-a company can seek such a loan without offering the security. However, in cases of such arrangements, the risk is borne by the lender that if the company becomes insolvent their debts will be satisfied only after the payments have been made to the secured creditors.

By resorting to third party guarantee-a loan from a creditor such as a bank will be guaranteed by a third party which may be an individual director of the debtor company. The guarantor

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further undertakes to answer for all the default of the principal debtor.

II. WHO IS A CREDITOR?

Creditor includes any person other than the member of a company. The term "creditor" includes any person to whom a debt is owed, whether through a loan of money, sale of goods or otherwise and who, by virtue of the creditor debtor relationship, is in a position to exert control over the business affairs of a borrower. A creditor is generally regarded as an outside source from that of the company. However, a member can also become a creditor, if any money that has lend by the member to the company is due.

Creditor includes secured and unsecured creditor which is determined according to the creation of security by them over the loan. Secured creditor may be regarded as one having created a security over the assets of the company. Whereas, unsecured creditors are those that does not create any security on the assets of the company while granting loans to the company. Secured creditors enjoy the right to repayment of money prior to that of the unsecured creditor. They have a preferential payment over that of the unsecured creditors.

Creditor's rights deal not only with the rights of creditors against the debtor, but also with the rights of creditors against one another. Where multiple creditors claim a right to levy against a particular piece of property or against the debtor's accounts in general, the rules governing creditor's rights determine which creditor has the strongest right to any particular relief. In other words, the claim of the creditor should not only be determined on a pari passu basis but should also be determined according to pro-rata basis. The creditor that has granted an amount which is more in value than that of another creditor, then the amount to that creditor shall be repaid according to the percentage of contribution he has made in the company.

(A) Secured Creditor

A ‘secured creditor’ means a person who holds a mortgage, charge or lien on any of the company’s property or any part of it as security for any debt due to him from the company.[2]

It is not necessary for a secured creditor to prove his debt in the winding up. He may rely on his security and proceed to realise his debts standing wholly outside the winding up proceedings. After exhausting the security, if anything more remains due to him, he has to prove the same. A secured creditor, after, realizing such amounts by proceeding against the security, it is open to him to prove for the balance due as an ordinary creditor in the winding up proceedings. He will be entitled to payment of interest only if there is a surplus available

[2] Defined under Presidency Towns Act and Provincial Insolvency Act

after all the creditors have been paid off. However, a secured creditor cannot be compelled by the liquidator to prove his debt.

The term secured creditor has not been defined under the Companies Act of 1956. “Secured creditor" under section 2(zd) of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, means any bank or financial institution or any group of banks or financial institutions and includes—

i. debenture trustee appointed by any bank or financial institution; or

ii. securitisation company or reconstruction company, whether acting as such or managing a trust set up by such securitisation company or reconstruction company for the securitisation or reconstruction, as the case may be; or

iii. any other trustee holding securities on behalf of a bank or financial institution, in whose favour security interest is created for due repayment by any borrower of any financial assistance.

A secured creditor can be asked to contribute to the expenses incurred by the liquidator in maintaining the secured assets before realization. The liability to contribute towards expenses of maintaining security would cease only when the option to surrender the security is exercised.[3] It has been held in the case of Board of Industrial and Financial Reconstruction v. Swadeshi Mills Ltd.[4] that the secured creditor holding the first charge on the property to be responsible for paying the guards, and for protecting the property. It was further directed to the official liquidator not to appoint security guards from private agencies but to send his requisitions to Security Guards Board constituted under the Act.

Thus, the position of the secured creditor has been considered in the case of Norman Holding Company Ltd.[5] where the court has held that, although a creditor who proves in the liquidation of an insolvent company for an unsecured debt is required by Rule 490 of the Insolvency Rules of 1986 to set off money owed by him to the company against that debt, he is not required to set off the amount owed against any secured debt unless he elects to prove that debt in the liquidation, since Rule 490 requiring an account to be taken of mutual debts only applies to debts proved in the liquidation and a secured debt does not need to be proved in the liquidation.

(B) Unsecured Creditor

An unsecured creditor is one other than the preferential creditor that does not have the benefit

[3] section 529(2) of Companies Act, 1956
[4] (2002) 112 Com Cases 698 (Bom)
[5] 1991 BCLC 1, 6 (Ch D)

of any security interests in the assets of the company.

The effect of the application of insolvency rules is that all unsecured creditors must provide proof of their debts and all such debts are to be paid pari passu. However, it has to be noted that the unsecured creditors, unlike the secured creditors, have to prove their debts before the liquidator and only to the satisfaction of the liquidator can claim their due amount. The pari passu rule of the even distribution of the property of a company between unsecured creditors on its winding up applies equally to winding up by the court and voluntary winding up.

Claims have to be filed before the liquidator and not before any court or anywhere else. In the case of Bhagwan Das Gopal Prasad v. Ashoka Oil Products P. ltd[6] the applicant has a lodged a complaint against Rajasthan Rajya Vidhyul Prasaran Nigam Ltd. that the later has a claim against the respondent company which is frivolous. The court held that if the applicant has any objection against the claim of the Nigam, he may send his objection to Official Liquidator. But the action of the applicant to approach the court in this application is wholly unreasonable and untenable. Any person who has a claim against the company, which is ordered to be wound up by the court, has a right to lodge the claim before the Official Liquidator. It is the duty of the liquidator to decide and adjudicate upon the claim lodged by Nigam is whether frivolous, baseless or fraudulent or dishonest.

As regards interest, in the case of an insolvent company, creditors whose debts carry interest are entitled to add the same for purposes of dividend only up to the date of winding up and only in the event of a surplus they can claim subsequent interest.[7] In the case of a solvent company where a debt carries interest, the creditor will be entitled to interest, subsequent to the winding up and until payment is made.

In case of any debt, the liquidator has to satisfy himself that the amount claimed by a creditor is really due to him, even though the entries in the books of account may establish the indebtedness. Since the properties of a company are vested in to the hands of the liquidator, he shall be very prudent and cautious while granting the application of any creditor with regard to claim of money due from the company. In Menastar Finance Ltd. v. Simon[8] the applicant, Menastar Finance Ltd applied to the court to set aside the decision of the liquidator to satisfy the claim of B. M. Samuels Finance group to whom Menastar owed a certain sum of money. BMS filed a suit against Menastar for the recovery of the debt amount and also for winding up of the company to which Menastar could not attend and the decision of the court went in favour

[6] (2003) 41 SCL 364 (Raj)
[7] Quartermaines case (1872) 1 Ch 639
[8] (2003) 1 BCLC 338

of BMS. Hence, Menastar presented the application to reverse the decision of the liquidator to accept the claim of BMS. It was held by the court that the liquidator's power is no different from that of the court in deciding whether to accept or reject a creditor's proof. It is the duty of the liquidator to ensure that the assets of the company are distributed among those who are justly, legally and properly creditors. The rationale was based on the liquidator's duty to ensure the assets of the insolvent company were distributed amongst those who were justly, legally and properly creditors and hence the liquidator was considered to be in correct position to determine the claim of the creditor.

III. Preference in payment

In the process of winding up of a company, debts due to the workmen and secured creditors shall be paid in priority to all the other debts.[9] The debts payable shall be paid in full, unless the assets are insufficient to meet them. The main purpose for insertion of such a provision is for ensuring that the workmen are not deprived of the claims which are made by them and are legitimate in the event of the company's liquidation. The workmen of the company is treated as secured creditors in respect of their claims against the company and the company's remains charged for the worker's payment which includes dues and such charges are to be pari passu with the charge of the creditors who are secured. Under section 529A the dues to the secured creditors are supposed to be treated pari passu, and needs to be treated prior to all the other dues.

The effect on the position of the secured creditor was examined by the Madras High Court in Indian Bank v. V.S.Perumal Raja[10]. In this case the applicant sought for leave from the court to continue the suit against the respondent company that has been ordered for winding up by the court for a certain substantial amount of money. The court granted leave subject to the condition that since the applicant chose to ignore the process of liquidation and relied on the security, so in case of any deficiency by the sale of such securities, the applicant shall not be included in all the shares in any dividend which may be declared in the liquidation by the official liquidator except and also to the extent which has been provided under section 529A of the Companies Act, 1956, to which the applicant got aggrieved and appealed before the court. The court held that section 529A of the Act makes the secured creditor suffering in payment of the workmen's dues from the realisation of his security, for recovering what he has suffered from the assets in the hands of the official liquidator, preferentially. To say, the said

[9] [section 529-A]

[10] (1993) 76 comp cases 787 (Mad)

amount which he suffers must be paid in priority to all other debts. But, this doesn't mean that he can never recover at all or any other unrealised portion of the debt which is due to him. Thus, section 529A enables the secured creditor suffering in payment of the workmen's dues from the realisation of his security, to recover what he has suffered from the other assets in the liquidator's hands and that amount shall be paid in priority to all other debts.

The principle underlined under section 530 is that the debts and liabilities, other than those mentioned in section 529-A, should be treated as preferential debts. However, after coming into force of section 529-A, debts and claims enumerated under that section will have priority even over the preferential claims enumerated under this section. Therefore, only if there is any balance left after satisfying the claims under section 529A will the State or other creditors get any share.

The question with regard to the priority of payment shall be decided by the court. No other State legislations have the jurisdiction to decide upon matter with regard to the priority of payment of the claim amount. It has been decided in the case of Official Liquidator v. State of U.P. [11] the court held that the adjudication of claims against a company in liquidation, the determination of priority of debts, etc., are all matters within the purview of winding up proceedings and there are specific provisions in the Companies Act in these respects which is a complete and exhaustive code and thereby shall not be decided or override the same by other State Legislations.

However, there is provision for any transfer of property, movable or immovable, delivery of goods, payment or any other act which is similar or related to property, made or taken, by or against the company within a period of six months before the commencement of the winding up of the company, be deemed a fraudulent preference of its creditors and be invalid accordingly.[12] In order to constitute a fraudulent preference, there need not necessarily be a transfer of property nor there should be any cash payment. To find a case of fraudulent preference, the dominant motive in the mind of the company as represented by the directors or the general body of shareholders, as the case may be, must be to prefer the creditor. Where the directors of a company make payment or do any other act in favour of a creditor solely with a view to avoid civil or criminal proceedings cannot be referred to as a fraudulent preference.[13] Further it has been held in the case of Monark Enterprises v. Kishan Tulpule[14] it was held by

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[11] [1981 All LJ 541

[12] section 531 of the Companies Act, 1956

[13] As held in the case of Re, Hamilton v. Blackpool Motorcar Company Ltd. (1901) 1 Ch 77.

[14] (1992)74 com cases 89 (Bom)

the court that to establish fraudulent preference, it is not enough to show that preference has been shown to a particular creditor, it must also be shown that it was done with a view to give him favoured treatment. The dominant motive attending the transaction has to be ascertained, and if it is tainted with an element of dishonesty, questions of fraud arise. Payment made under moral obligations is invalid as fraudulent preference.

According to Llyod, J. the proper test to see whether there was an overriding intention to prefer one particular creditor or creditors or whether a creditor of an insolvent company has received a preference, the court has to consider the state of mind of the directors at the time the alleged preference was given and to see whether the company was influenced by a desire to give a preference. It is not enough for showing that there was preference, it has also to be shown that the preference must be a fraudulent one. Fraud cannot be inferred from mere suspicion. It should be based on legal evidence which must show that there was a real intention to prefer one creditor over another.[15] The burden to prove that the transaction is fraudulent preference is on the party who impugns it.[16] The onus lies on those who claim that they will avoid the transaction for establishing what the debtor has really intended and what the real intention was to prefer.

IV. Right in making company decisions affecting creditor interests

The company has to convene a meeting, under the provisions of the Act, of the creditors to take place immediately or the next day of the general meeting held at which the resolution for the process of voluntary winding up is supposed to be proposed and shall cause notices of the meeting to the creditors.[17]

However, non-compliance with the provisions of the section renders the directors liable to fine but does not make the proceeding of the meeting invalid. In the case of E. V. Saxton and Sons Ltd. v. R. Miles (Confectionaries) Ltd.[18] a creditors' voluntary winding up meeting was convened without giving notice. However, the resolution passed for winding up was still held valid.

The creditors also enjoys a preferential right to appoint a person to be liquidator with the power of the court to vary the appointment on application made within seven days by a director, member or a creditor[19] for the purpose of affairs related to winding up and distributing the

[15] Wills v. Corfe Joinery Ltd. (1998) 2 BCLC 75 (Ch D)
[16] As held in the case of Re, Washington Diamond Mining Co. (1893) 3 Ch 95.
[17] section 500 of the Companies Act, 1956
[18] (1984) 1 Comp LJ 118: (1983) BCLC 70 (Ch D)
[19] section 502 of the Companies act, 1956.

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assets of the company and if there is any difference in the nomination of liquidators by the company and the creditor, the nomination made by the creditor shall prevail.

It is the liquidator's duty to call for a meeting of the creditors' and lay a statement of the assets and liabilities of the company before them if the liquidator thinks that the company is not in a condition to be able to pay its full debts.[20] It is further, the duty of the liquidator to call for a meeting of the company and the creditors at the end of the first year from the commencement of winding up as well as at the time of fully wound up for the purpose of laying down his accounts of act in the meeting.[21] The liquidator is also under obligation to show the accounts of the company along with the other affairs of the company in the process of winding up at the meeting to be called by him of the members and the creditors of the company.[22] These responsibilities of the liquidator have to be followed in both a winding up by the court as well as in voluntary winding up. The main reason for inserting such provisions is mainly to make the creditors of the company aware of the affairs of the company to make any decisions in relating to the affairs of the company which has direct interest with that of the creditors. Inorder to protect the interests of the creditors, the Companies Act, has make provisions for the creditors to know the affairs of the company during winding up and thus, making the entire process transparent to the creditors.

V. RIGHT TO NOMINATE DIRECTORS

The court has the power under section 543, in the course of winding up, to examine the conduct of any director, who has been guilty of any misfeasance or breach of trust, on the application of the creditor. However, the court has no power to make an order against the directors for all acts of misfeasance without any specific finding as to whether the director is actually responsible for such acts of misfeasance.

The nominee directors representing the secured creditors should act for the interests of the creditors. The responsibility that is vested to him by the creditors should be done with an impartial manner. It was held in the case of *Stock & Co. v. Dilip chakraborty*[23] that the director is under double responsibility i.e. as a director and as a nominee of the creditors to watch and control the affairs of the company. Misfeasance proceedings may be taken against a nominee director of a company in relation to a breach of his duty to consider the interest of creditors when the company was insolvent. It should be emphasized that the directors of a company in

[20] section 495 of the Companies act, 1956
[21] section 496 of the Companies act, 1956.
[22] section 497 of the Companies act, 1956.
[23] (1996) 87 com cases 139

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discharging the duties they have towards the company must also take into account the interest of its creditors.

The duty of the director towards the creditors originated from the famous case of *Walker v. Wimborne*[24] where it was held by the court that while discharging their duty towards the company, the directors are also required to take into consideration the interests of its creditors and the shareholders. Any failure in taking the creditors' interests into consideration will cause adverse consequences for the company. In the Great Britain, the first signal of recognition of this duty appeared in the case of *Lonrho Ltd. v. Shell Petroleum Co. Ltd*[25], wherein Lord Diplock stated that the company's best interests, as per which the directors were supposed to act, were not primarily those of its shareholders but it can also include those of its creditors".

Perhaps the most significant area of uncertainty can be said to be the question of whether the above mentioned duty is an independent duty which is owed directly to the creditors, with the result that any or all such creditors can take such steps for enforcing it against the directors, or whether it is an indirect duty owed towards the company for take into account the interests of the creditors', with such results that it can only be enforced by the company. The preponderance of the authority has always favored the second interpretation. In *Walker v. Wimborne*, it was held that the duty was expressed to be the one which is owed towards the company, and this approach may be reflected either impliedly or expressly in all but one of the case of the Great Britain. The exception is *Winkworth v. Edward Baron Development Co. Ltd*.[26], wherein Lord Templeman observed that the duty is owed to the company by the directors as well as to the creditors of the company for ensuring proper administration of the company's affairs and also that the property of the company is not dissipated or exploited for the advantage of the directors impairing those of the creditors. This can also be interpreted that there is a specific and separate duty towards the creditors. As has already been indicated, however, this is not in consistence with such approach which has been taken in other British cases. Indeed, the concept of a direct duty towards the creditors was rejected specifically in the later case of *Yukong Lines of Korea v. Rendsberg Investment Corp. of Liberia*[27] where Toulson J. opined that a director never owes a direct fiduciary duty towards an individual creditor, nor an individual creditor is entitled to sue for the breach of such fiduciary duty which is owed by the director towards the company.

A nominee director cannot be relieved of the proceedings just for the reason that he was

[24] (1976) 137 CLR
[25] [1980] 1 W.L.R. 627 (H.L.(E.)) (Eng.).
[26] [1987] 1 All E.R. 114 (H.L.)
[27] [1998] B.C.C. 870 (Q.B.D. (Comm.)

nominated by the creditor. They too would be subjected to the usual procedure for trial on merits for finding out whether as directors they performed their statutory duties in good faith. In the case of Official liquidator v. Ram Swarup[28] the directors who were nominated by the creditors were guilty of withdrawing heavy amounts free of interest and thus starving the company of funds and putting the company into heavy losses showed a fraudulent state of mind and this fact was itself sufficient to dispel their argument that they were only nominal directors and not in charge of the company affairs.

Proceedings against a director who has been found guilty of such acts that affects the interests of the creditors or acts against the interests of the creditors of the company must be dealt with by the court having jurisdiction under the Act.

Any act of misfeasance or misconduct, breach of trust or gross negligence by the directors shall be brought to the court's notice within a period of five years either from the date of passing of the order of winding up or the first appointment of the liquidator or the date of the act complained of.

VI. CONTROL OVER CORPORATE SPENDING

A creditor who, by virtue of loan agreements or the acquiescence of its debtor, exercises substantial influence and authority over the business affairs of the debtor risks potential liability for all the debtor's debts. When a debtor defaults on a loan agreement or when it owes money to a creditor beyond the agreed payment period, concern about repayment often will lead its creditors to demand drastic concessions as the price of forbearance. Without another source of financing, the debtor may accede to a number of creditor demands and grant a right of consultation and veto power over expenditure of funds. The debtor may also give the creditor significant authority over decisions such as which creditors will be paid and when payments will be made, the manner in which the debtor will conduct its business, whom the debtor will retain and hire which assets will be held and which sold, and which contracts will be accepted.

An early case considering the extent of control necessary to impose liability on lenders is Harris Trust & Savings Bank v. Keig (In re Prima Co.)[29]. In this case certain banks that lend a large sum of money to the company became dissatisfied with its management when the company was incurring losses. One of the banks suggested that the debtor employ an outsider as manager of the company which the company reluctantly employed and executed a contract granting him complete control over the business. It was held that the company had reasonable grounds to

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[28] (1997) 88 com cases 569

[29] 305 U.S. 658 (1939).

believe that the banks would call their loans if the company did not employ the manager and hence the court found that the bank had exercised undue influence and took advantage of the debtor's situation.

Again in the case of Ford v. CE.Wilson & Co.[30] the court approved strong measures taken by the creditor to protect its loan. Here Ford, the borrower have an outstanding loan secured by a mortgage and requested an additional loan from its bank on the condition that the debtor shall pledged his personal properties and thereby agreed to deposit all proceeds of its account in a special account. The counter signature of the bank's agent was required on all checks drawn against this account. Sometime later the business failed. A trade creditor brought suit against the bank for the unpaid purchase of goods it sold to the debtor as it contended that the bank was liable for the debtor's contracts because it assumed such control of the debtor's business as to become a partner. However, it was decided by the court that the bank's actions were necessary to protect the security for repayment of its loans.

Another case to cite the control of creditor over the business of the debtor is the case of Chicago Mill & Lumber Co. v. Boatmen's Bank[31]. There the bank lent a sum of money to the debtor which was secured by a pledge of all the company's stock. After making an additional loan to the company, the bank arranged to have its assistant cashier elected president of the company in order to protect its interests as a creditor. The cashier was given one-third of the company's stock by its sole shareholder, subject to the pledge to the bank, and the evidence showed that the general manager of the debtor company received his directions from the cashier. The court recognized that when one corporation owns or controls the entire property of another, and operates its plant and conducts its business as a department of its own business, or as its alter ego, it is responsible for its obligations incurred in so doing. However, the court held that the bank's conduct was the product of a legitimate and customary practice of a substantial creditor in overseeing the business of a debtor which was in financial trouble and it did not constitute sufficient control to render the bank liable for the debts of the company to a trade creditor.

Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.[32] provides an excellent history of the law in this area and demonstrates the example of creditors who exercise control over their debtor in seeking to protect repayment of their debt. The plaintiffs were ten creditors of an insolvent corporation who sued National Distillers to recovery money owed them from the debtor, Brad's Machine Products, Inc. Brad's previously was awarded a contract to supply

[30] 129 F.2d 614
[31] 234 F. 41 (8th Cir. 1916)
[32] 483 F.2d 1098

fuses to the government. Brass was a principal component of the fuses. Bridgeport Brass Company, a subsidiary of National Distillers, was the principal supplier of brass to Brad's. By March 1969, Brad's owed Bridgeport approximately one million dollars. At the request of Brad's, Bridgeport converted this obligation to a promissory note secured by a real estate mortgage. The parties also entered into an agreement whereby Brad's would continue to receive brass as long as it paid promptly for new shipments. Notwithstanding this agreement, by July 1969, Brad's owed another $600,000 to Bridgeport for its brass purchases. By then the government had threatened to cancel Brad's contract due to its deteriorating financial condition. Not surprisingly, a meeting was called and it was agreed that National Distillers would provide Brad's with internal financial management assistance; lend it another $600,000; defer payment on $630,000 of accounts receivable; assist Brad's in liquidating unprofitable assets in order to provide working capital; and intervene with the government. Shortly thereafter, Brad's executed notes for the amounts due and secured them with a real estate mortgage and a security interest in certain of its assets. Brad's also assigned other assets to National which could be sold to increase the liquidity in the working capital fund. Leon Rudd, an internal auditor employed by National, was sent to Brad's plant to oversee its finances and establish control procedures. Rudd remained with Brad's for fifteen months and during this time National loaned Brad's another $169,000 and deferred another $667,000 in accounts payable. Despite Rudd's efforts and National's largess, Brad's ceased doing business. The Court of Appeals for the Fifth Circuit began its analysis with a discussion of the instrumentality rule cases where the controlling creditor was generally an owner of the dominated corporation or had formed the corporation to advance its own interests. Reviewing the cases, the court noted that ownership of a dominated company was not the determinative factor when imposing liability. Rather, the court extracted a broader principle of control liability: If a lender becomes so involved with its debtor that it is in fact actively managing the debtor's affairs, then the quantum of control necessary to support liability may be achieved.

Thus, from the above cited case laws it appears from the decisions that courts recognize the practical necessities that arise when creditors are confronted with debtors in financial distress. Moreover, a value judgment appears to have been made by the courts that it is worthwhile to permit creditors to take relatively strong measures, when working with a debtor's business, to protect the creditor's debt rather than adopt a rule which would have the effect of forcing creditors to seek premature liquidation or bankruptcy proceedings. To summarize, under the instrumentality rule courts permit a creditor to place itself in a position to obtain all necessary information, to request a negative veto power over a debtor's financial transactions and to

provide assistance or counselling to a debtor. The creditor-debtor relationship demonstrates that require a strong showing that the creditor assumed actual, participatory, total control of the debtor. Merely taking an active part in the management of the debtor corporation does not automatically constitute control by the creditor corporation.

Protection of creditors' under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

Apart from the Companies Act of 1956, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act of 2002 also provides for the protection of the creditors. This is an Act enacted to regulate securitisation and reconstruction of financial assets and enforcement of security interest and for matters connected therewith or incidental thereto. This Act has created provision for protection of the creditors' interest and thereby has provided immense opportunities for the creditor to claim back their money from the debtor in a hassle free manner.

Any security interest created in favour of any secured creditor may be enforced, without the intervention of court or tribunal, by such creditor under this Act.[33]

Where any borrower, who is under a liability to a secured creditor under a security agreement, makes any default in repayment of secured debt or any instalment thereof then, the secured creditor may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor shall be entitled to exercise all or any of the following rights under this Act:[34]

- take possession of the secured assets of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset;
- take over the management of the business of the borrower of the borrower including the right to transfer by way of lease, assignment or sale for realising the secured asset. Provided that the right to transfer by way of lease, assignment or sale shall be exercised only where the substantial part of the business of the borrower is held as security for the debt;
- Appoint any person to manage the secured assets the possession of which has been taken over by the secured creditor;

[33] section 13(1) of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
[34] section 13(4) of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

- Require at any time by notice in writing, any person who has acquired any of the secured asset from the borrower and from whom any money is due to the borrower to pay the secured creditor.
- Where any action has been taken against a borrower under the provisions of this Act, all costs, charges and expenses which, in the opinion of the secured creditor, have been properly incurred by him or any expenses incidental thereto, shall be recoverable from the borrower.
- Where dues of the secured creditor are not fully satisfied with the sale proceeds of the secured assets, the secured creditor may file an application in the form and manner as may be prescribed to the Debts Recovery Tribunal having jurisdiction or a competent court, as the case may be, for recovery of the balance amount from the borrower.

In the case of financing of a financial asset by more than one secured creditors or joint financing of a financial asset by secured creditors, no secured creditor shall be entitled to exercise any or all of the rights conferred on him under the provisions of this Act, unless exercise of such right is agreed upon by the secured creditors representing not less than three fourth in value of the amount and such action shall be binding on all the secured creditors. Provided that in the case of a company in liquidation, the amount realised from the sale of secured assets shall be distributed in accordance with the provisions of section 529A of the Companies Act, 1956.

The Chief Metropolitan Magistrate or District Magistrate shall at the request of the secured creditor may assist him in taking possession of any secured asset or has to sell or transfer the same under this Act.[35]

VII. Conclusion

Thus, from the discussion carried on above, it may be concluded that the necessary protection are given to the creditors now by the introduction of the new provisions in the existing laws and also by the introduction of the new legislations by the Indian Government. Unlike in earlier days where the creditors' rights were not considered and protected as such, the present existing legislation has given exclusive rights to the creditors for claiming their amount back if the company fails to repay the said amount. The creditors' rights are given a lot of importance as they are considered as the person in the company who provides the finance for helping the company in the smooth and successful running of their business. As a result of the role the

[35] section 14 of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002

creditors play, their rights were considered and therefore, effective legislations have been enacted for looking into their rights. Thus, we can say that the creditors are ensured with proper protection by granting them their legitimate rights for claiming their interest.

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