

Avoidable Transactions under the Insolvency and Bankruptcy Code: Key Considerations

For the success of any insolvency regime, it is critical that distressed companies are prevented from taking measures which could hamper recovery to creditors in the event insolvency proceedings were to commence. Such protective provisions assume particular importance in the Indian context, where companies are often closely held by promoter groups who may seek to transfer value from assets through opaque structures to other group companies for their own benefit. Accordingly, the National Company Law Tribunal (the “**NCLT**”) is empowered to undo any such transaction to protect the interests of creditors and other stakeholders under the Insolvency and Bankruptcy Code, 2016 (the “**IBC**”).

Recently, in the matter of *Anuj Jain Interim Resolution Professional for Jaypee Infratech Limited v. Axis Bank Limited and others* (“**Jaypee Infratech**”),¹ the Supreme Court of India clarified certain key aspects in respect of preferential transactions under Section 43 of the IBC. Such preferential transactions are one of the four categories of “avoidable” transactions (i.e., those which may be annulled or disregarded) under the IBC, the others being undervalued, extortionate and/or fraudulent transactions.

This note briefly discusses the different types of avoidable transactions under the IBC, the guidance issued by the Supreme Court on certain aspects of such transactions in *Jaypee Infratech* and a few key considerations for parties to mitigate the risk of their transactions falling within the ambit of such avoidable transactions.

PREFERENTIAL TRANSACTIONS

Under Section 43 of the IBC, a transaction is said to be a ‘preferential transaction’ if: (a) the transaction relates to transfer of the property or interest of the corporate debtor for the benefit of a creditor, surety or guarantor in relation to an antecedent / past

¹ Judgment of the Supreme Court of India dated February 26, 2020 in Civil Appeals 8512-8527 of 2019.

liability; and (b) the transaction has the effect of giving such creditor, surety or guarantor a beneficial position in the distribution of assets in the event of liquidation under Section 53 of the IBC.

Further, for any such preferential transaction to be avoidable, it ought to have occurred: (a) in case of a transaction with a related party, within a “look back” period of two years immediately preceding admission of the corporate debtor into insolvency; and (b) in any other case, within a “look back” period of one year immediately preceding admission of the corporate debtor into insolvency. Transactions in the ordinary course of the business or financial affairs of the corporate debtor or the transferee which result in the creation of new value for the corporate debtor are exempted even if such transactions fall within the aforesaid look back periods.

In *Jaypee Infratech*, the key issue before the Supreme Court was whether certain mortgages created by Jaypee Infratech Limited (the company under insolvency) for loans availed by its parent company Jaiprakash Associates Limited (“**JAL**”) amounted to preferential transactions avoidable under Sections 43 and 44 of the IBC. The JAL and its promoters argued that the beneficiaries of the mortgage were the creditors in whose favour such mortgages had been created, and accordingly, the “look-back” period should be one year (applicable in case of transactions with unrelated parties). However, the court found such transactions to be for the benefit of a related party (subject to the “look-back” period of two years) as they allowed JAL to avail a significantly higher amount of lending from a larger number of creditors.

The Supreme Court also issued a key clarification in respect of the exclusion of transactions conducted in the ordinary course of business from the ambit of preferential transactions liable to be set aside – According to the terms of Section 43(2) of the IBC, transfers made in the ordinary course of the business or financial affairs of the corporate debtor or the transferee company would not fall within the ambit of preferential transactions. However, the Supreme Court held that the term “or” in such provision must be read as “and”. The court, relying on the scheme and objective of the IBC, observed that the relevant consideration for the purpose of Section 43 is the conduct and affairs of the *corporate debtor* and to disregard such transactions which appear to minimize the potential loss to other stakeholders in the affairs of the corporate debtor, particularly its creditors. Accordingly, even if a preferential transaction is undertaken in the ordinary course of the business of the transferee company, it would be included within the purview of a preferential transaction as long as it is not in the ordinary course of the business of the corporate debtor.

In relation to the term “ordinary course of business”, the Supreme Court held that a transaction could be classified as such only if it was part of an “*undistinguished*

common flow of business done” and did not arise out of “*any special or particular situation*”. Accordingly, even though furnishing a security would be a normal business practice for a company, it would not amount to a transaction in the “ordinary course of business”.

UNDERVALUED TRANSACTIONS

Under Section 45(2) of the IBC, a transaction is considered to be undervalued if the corporate debtor: (a) makes a gift to a person; or (b) enters into a transaction with a person which involves the transfer of one or more assets by the corporate debtor for a consideration the value of which is significantly less than the value of the consideration provided by the corporate debtor, and such transaction has not taken place in the ordinary course of business of the corporate debtor.

The plain language of the above provision would suggest that the relevant reference point to determine whether a transaction is undervalued would be the cost of acquisition of the asset by the corporate debtor. However, an interpretation discounting depreciation and the actual value of the asset at the time of the transfer would be evidently unreasonable. While we have not come across any decision by Indian courts / tribunals under the IBC setting out the relevant parameters to determine when consideration may be seen as inadequate or undervalued, the fair market value of the transferred asset may be a relevant reference point for such determination. This appears to be the position under the UK Insolvency Act as well².

Similar to the position in respect of preferential transactions, any transaction in the ordinary course of business of the corporate debtor would not amount to an undervalued transaction. The “look-back” period for undervalued and preferential transactions is also the same. Accordingly, the guidance issued by the Supreme Court in *Jaypee Infratech* on these aspects would apply in the context of undervalued transactions as well.

TRANSACTIONS DEFRAUDING CREDITORS

Section 49 of the IBC deals with “transactions defrauding creditors”. Such transactions are undervalued transactions which are “deliberately” entered into by the corporate debtor either (a) for keeping assets of the corporate debtor beyond the reach of any person who is entitled to make a claim against the corporate debtor; or (b) in order to

² See, for instance, *Perpetual Trustee Company Limited and another v. BNY Corporate Trustee Services Ltd and others*, [2009] EWCA Civ 1160; *Phillips and another v. Brewin Dolphin Bell Lawrie and another*, [2001] UKHL 2.

adversely affect the interests of such a person in relation to the claim. The key distinction between undervalued transactions and transactions defrauding creditors is the element of *intent*. While such intent to deprive or adversely affect the right of persons in respect of their claim is irrelevant in the case of undervalued transaction, it must be proven to the satisfaction of the NCLT for a transaction to be considered fraudulent. Another crucial distinction between such transactions is that there is no “look-back” period for fraudulent transactions. This is in line with the general principle that fraud vitiates everything.

A significant implication of a transaction being found to be fraudulent is the penalty that may be attracted in each case. Under Section 69 of the IBC, officers of a company which has undertaken such fraudulent transactions may be punishable with imprisonment for a term of up to five years and a fine extending up to rupees one core. No such penalty is prescribed for undervalued transactions.

EXTORTIONATE TRANSACTIONS

Under Section 50 of the IBC, an extortionate transaction involves the receipt of financial or operational debt within two years preceding the insolvency commencement date at terms requiring exorbitant payments to be made by the corporate debtor, may be avoided by an order of the NCLT. Unlike other avoidable transactions (mentioned above), which seek to address *transfer* of assets by the corporate debtor, extortionate transactions address *receipt* of credit by the corporate debtor, although the ultimate effect is the transfer of value outside of the corporate debtor.

A typical instance of an extortionate credit transaction would be credit availed by the company at unreasonably high interest rates. In one matter, the NCLT, New Delhi bench (the “**NCLT Delhi**”) found the agreed rate of interest of 65% per annum to amount to an extortionate transaction.³ The NCLT Delhi further observed that generally in private loans, a maximum interest rate of 24% per annum is accepted by the parties.

KEY TAKEAWAYS

As is clear from the above, transactions which may be vulnerable under the IBC generally relate to a period as far back as two years before the commencement of insolvency of a corporate debtor. Accordingly, it is critical for contracting parties and creditors to ensure that they have access to the latest financial position of a company before entering into any transaction, particularly those involving transfer of assets or

³ *Shinhan Bank v. Sugnil India Private Limited and others*, order dated July 9, 2019 of the NCLT Delhi in Company Petition No. IB- 492/ND/2018 and Company Application No. 184/2018.

value from such company. In the event of any signs of financial distress, the risk of any such transaction being avoided should be appropriately considered and weighed.⁴

The provisions relating to preferential transactions and fraudulent transactions protect persons who entered into such transactions in good faith and for value (with the additional requirement of lack of notice of the relevant circumstances in the case of fraudulent transactions). To be able to avail of such protection, it would be advisable for contracting parties / lenders to ensure that there exists sufficient documentation evidencing that the transaction was for fair value and had been undertaken based on reasonable diligence and enquiry into the affairs of the company. Whether a transaction may fall under the ambit of any of the avoidable transactions under the IBC should certainly be included in the check list of items for diligence by the parties prior to entering into any major transaction.

In *Jaypee Infratech*, the Supreme Court noted that the enquiry for the purpose of each of the avoidable transactions under the IBC is different and that specific material facts would have to be pleaded to prove that a transaction falls under each of such categories. Accordingly, parties should analyse their transaction from the perspective of the specific provisions applicable in respect of each of the categories of avoidable transactions to prevent such transactions from falling foul of any such provision at a later date.

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⁴ While the financial position of the company may not always be relevant for its admission into insolvency, we assume that a financially sound company would avoid admission into insolvency at all costs.