

# Insolvency and Bankruptcy Hotline

October 25, 2018

## VULNERABLE TRANSACTIONS UNDER BANKRUPTCY CODE: PROMOTERS AND LENDERS BOTH BEWARE INTRODUCTION

In *IDBI Bank Ltd. v. Jaypee Infratech Ltd.*<sup>1</sup>, the Allahabad Bench of the National Company Law Tribunal (“NCLT”) has held that certain mortgages created by Jaypee Infratech Ltd. (“JIL”) in favour of the lenders of its holding company Jaiprakash Associates Ltd. (“JAL”) amounted to *preferential, undervalued and fraudulent* transactions under the Insolvency and Bankruptcy Code, 2016 (“Code”).

In reaching its decision, the NCLT also held that the transactions fell within the *look back* period of two years prior to the commencement of insolvency proceedings, as prescribed for preferential and undervalued transactions between related parties under the Code.

Accordingly, the NCLT reversed these transactions and ordered the lenders of JAL to release and discharge the security interest created through the mortgages, thereby directing that the properties so mortgaged be deemed to be vested in JIL henceforth.

### FACTS

- JIL was a special purpose company promoted by JAL for certain design, engineering, development and construction projects. JAL held approximately 70% of the shares of JIL.
- JIL started facing financial difficulties and failed to honour its project completion deadlines. It also started defaulting on its loan payments due to its financial creditors. The Life Insurance Corporation declared JIL as a Non-Performing Account (“NPA”) on September 30, 2015. Other lenders declared it as a NPA on March 31, 2016.
- JIL mortgaged 858 acres of unencumbered land owned by it to secure the debt of JAL, vide mortgage deeds entered into on March 4, 2016, May 24, 2016, December 29, 2016 and March 7, 2017 (“**Impugned Transactions**”).
- On August 9, 2017, the NCLT admitted an application filed by one of JIL’s financial creditors, IDBI Bank Ltd., for initiating Insolvency Proceedings under the Code, and appointed an Interim Resolution Professional (“IRP”).
- The IRP examined various transactions entered into by JIL with its promoter shareholders, pursuant to his duties as a resolution professional.
- The IRP consequently filed an application before the NCLT seeking declarations that the Impugned Transactions were (i) fraudulent transactions under Section 66 of the Code; (ii) preferential transactions under Section 43 of the Code; and (iii) undervalued transactions under Section 45 of the Code; and sought consequent reliefs (“**Application**”).

The text of the relevant provisions of the Code have been provided as an Annexure [here](#).

### JUDGMENT

#### (i) The Impugned Transactions were fraudulent transactions under Section 66 of the Code

The NCLT held that the mortgage of lands through the Impugned Transactions in favour of a related party were entered into with the intent to defraud JIL’s creditors. The NCLT relied upon the following factors in reaching its decision:

- Timing of the Impugned Transactions:** The Impugned Transactions had been entered into at a time when JIL had been declared by an NPA and was facing a severe liquidity crunch. The value of the land mortgaged was in the range of INR 5000 – 6000 crores, as per the valuation report prepared at the time of the mortgage. The NCLT reasoned that the lands so mortgaged could have instead been sold by JIL to meet its payment obligations to its financial creditors, and deliver the flats to homebuyers. Despite this, JIL’s directors had entered into the Impugned Transactions in utter disregard of their fiduciary obligations. They had failed to exercise due diligence in minimizing the potential losses to JIL’s creditors, while instead, providing benefits to JIL’s related party. This demonstrated an intent to defraud JIL’s creditors.
- Absence of Counter Guarantee and Consideration from JAL:** The mortgage of the land was created without any counter guarantee or consideration from JAL. It was, thus, in the nature of asset stripping.
- Absence of Lender and Shareholder Approval:** A Joint Lender’s Forum (“JLF”) comprising of JIL’s lenders was constituted in 2015 to overcome JIL’s financial difficulties. No approval was provided by either the JLF or JIL’s shareholders, prior to entering into the Impugned Transactions.

The NCLT observed that considering the financial position of JIL, it was *highly unlikely* that JIL’s lenders would have consented to the creation of a mortgage over JIL’s unencumbered lands in favour of a related party.

JAL contended that nominee directors of JIL’s lenders had been present at JIL’s board meetings during which the decision to mortgage JIL’s lands had been taken. Accordingly, their approval to the Impugned Transactions could

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- be implied. However, the NCLT held that mere presence of nominee directors could *not* be treated as consent to the Impugned Transactions, because their loan agreements would have the requirement for express approval for such transactions.
- d. **Creation of mortgage contrary to the decision of the JLF:** The NCLT observed that not only had JIL entered into the Impugned Transactions without the consent from the JLF, but *also in express contravention of their instructions*. The NCLT referred to the minutes of the JLF dated March 28, 2016. The minutes of this meeting recorded the fact that JIL had certain unencumbered land, and proposed to swap this land to reduce part of its debt. The JLF proposed to transfer these lands to a trust with JIL's lenders as beneficiaries. The JLF proposed to sell the land within a 60 month period thereafter and distribute the proceeds of the sale between JIL's lenders. Relying upon these minutes, the NCLT observed that not only had JIL mortgaged its lands without obtaining the consent of its lenders, it had acted in *complete contravention* of their decision.

## (ii) The Impugned Transactions were preferential transactions under Section 43 of the Code

The NCLT stated that a transaction would be classified as "*preferential*" when (1) a resolution professional formed an opinion that a corporate debtor (2) had at the relevant time (3) given preference to a related party (4) in the manner prescribed under Section 43 (2)<sup>2</sup> of the Code. The NCLT also rejected JAL's contention that the Impugned Transaction fell within the exception of a transaction 'made in the ordinary course of business.' We have discussed the NCLT's findings below:

- a. **The resolution professional had 'formed an opinion':** JAL sought to argue that the IRP had mechanically filed the Application instead of '*forming an opinion*'. However, the NCLT disregarded this argument. The tribunal observed that the resolution professional was not required to provide a judgment for initiating action under Section 43. If the resolution professional believed that a corporate debtor had given a preference (i) at the relevant time (ii) in the manner prescribed under Section 43 (2) and (iii) to the persons prescribed under Section 43 (4), he could apply to the NCLT to avoid the transaction. The resolution professional could *only* form an opinion by perusing the records available with him. In this case, it was clear that the resolution professional had sought an explanation from the relevant parties upon perusing the records. Thereafter, he had filed the Application. Accordingly, it could not be said that he had not 'formed an opinion.'
- b. **Preference had been given at the relevant time to a related party:** The NCLT held that it was clear from the definition of 'related party' under the Code, that the term included holding and subsidiary companies. As JIL was a subsidiary of JAL, the two entities were patently 'related parties' for the purposes of the Code.

The NCLT observed that section 43 (4) of the Code prescribed a look back period of *two years prior to the insolvency commencement date* for transactions between related parties. Therefore, in this case, the look back period commenced two years prior to the insolvency commencement date (i.e., August 9, 2017) on August 10, 2015. As the Impugned Transactions were entered into after this date, they fell within the relevant time period.

JAL asserted that certain provisions of the Code, including the provisions on preferential transactions, were prospective sections which only came into force on December 1<sup>st</sup>, 2016. Accordingly, the look-back period would only apply to transactions made after December 1<sup>st</sup>, 2016. However, the NCLT dismissed this argument. The Tribunal observed that the look- back period prescribed under the Code triggered from the insolvency commencement date and *not* on the date on which the relevant provisions of the Code came into effect.

## c. JIL had given a preference in the manner prescribed under Section 43 (2) of the Code:

JAL sought to argue that a transaction could only be considered a preferential transaction under Section 43(2) when there (i) was a transfer of property or interest and (ii) it was for the benefit of a creditor, surety, or guarantor of the debtor. JAL contended that as it was *not* JIL's creditor, and accordingly it did not meet this criteria.

The NCLT accepted JIL's contention that a given transaction would only amount to a preferential transaction if it was for the benefit of a creditor, surety or a guarantor. However, based on the facts that (i) JAL featured in the list of JIL's operational creditors wherein it had claimed certain amounts, and (ii) JAL's own averments revealed that it had extended substantial financial and managerial assistance to JIL, the NCLT held that JAL was indeed JIL's creditor.

The NCLT also examined the term 'transfer of property or interest' under Section 43 (2). It held that a 'transfer' had been defined in wide terms under Section 3(34) of the Code to encompass a '*sale, purchase, exchange, mortgage, pledge, gift, loan, or any other form of transfer of right, title, possession or lien.*' Therefore, a transfer would include a creation of security interest on the assets of a corporate debtor such as JIL's.

The tribunal reasoned that the creation of such security interest through the Impugned Transaction had the effect of putting JAL in a beneficial interest vis-a-vis the position it would have been in if JIL's assets were distributed as per the distribution waterfall prescribed under Section 53 of the Code. Accordingly, the Impugned Transaction had created a preference in favour of JAL.

## d. The Impugned Transactions were not in the ordinary course of business

JAL's lenders, i.e., ICICI Bank and Standard Chartered Bank, had acquired a security interest through the Impugned Transactions. These lenders sought to rely on the exclusion provision under Section 43(3) of the Code which provided that a preferential transaction would not include transfers made 'in the ordinary course of business.' They canvassed the argument that it was customary for banks to seek credit enhancement through creation of security interests by borrowers and their group companies.

However, the NCLT dismissed this argument. The Tribunal held that the language of the exclusion clause was to be interpreted to mean the ordinary course of business of the *transferor* (i.e. JIL), and not the transferees (i.e. JAL's lenders). A transfer made by the transferor for the benefit of its related party *without any counter guarantee or consideration* could *not* be considered a transaction in the *ordinary course of business*. It did not benefit the business or finances of JIL in any manner. Accordingly, the Impugned Transactions could not be excluded on the ground of being 'in the ordinary course of business.'

### (iii) The Impugned Transactions were undervalued transactions within the look back period

The NCLT also found that the Impugned Transactions fit squarely within the definition of undervalued transactions under the Code. JIL had mortgaged its land without any consideration or counter- guarantee from JAL.

The NCLT summarily dismissed JAL's contention that as the transaction were *not* between JIL and JAL, it could not be considered an '*undervalued transaction*.' The Tribunal considered the Impugned Transaction to be in the nature of a tripartite transaction between JIL, JAL, and JAL's lenders.

Since the transactions were entered into during the two year period prior to the insolvency commencement prescribed under the Code, the Impugned Transactions were caught within the net of the look back period for undervalued transactions as well.

Upon finding that the Impugned Transactions were fraudulent, undervalued and preferential transactions, the NCLT ordered the release of the encumbered lands from JAL's lenders, and directed they be vested in JIL.

### ANALYSIS

The NCLT's well- reasoned order is the first judgment to assess the scope of preferential, undervalued and fraudulent transactions under the Code. The principles laid down by the NCLT in its judgment are likely to form the touchstone of jurisprudence governing avoidance proceedings under the Code. The order has had the effect of stopping a debt- ridden company from attempting to put its assets out of the hands of its creditors.

It is common to have a company provide security and guarantee in respect of financial assistance being availed by a group entity/related party/sister concern. However, one has to be careful about their own financial standing before providing such security/guarantee. What is important is that promoters/directors of the company might be asked to compensate the company for any such transaction, if the effect of the same cannot be reversed. There is a direct personal liability on individuals stemming from the Code under such circumstances. Further, lenders will need to carry out a due diligence of the guarantor at the time of providing a loan to the borrower. Earlier, the diligence was restricted to the title of the security which is being provided by the guarantor. However, as evident from the present case, even if the security is unencumbered, it can still fall under the ambit of a vulnerable transaction.

However, as JAL has filed an appeal against the NCLT's order, it remains to be seen whether the NCLAT and eventually the Supreme Court of India will uphold the findings of the Tribunal.

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You can direct your queries or comments to the authors

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<sup>1</sup> CA No.26/2018 in Company Petition No.(IB)77/AD/2017

<sup>2</sup> For the text of Section 43 (2), please refer to the Annexure

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