

# **Insolvency and Bankruptcy Law in India**

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**Week 05**

**Lecture 21**

Welcome to all.

As part of the course on insolvency and bankruptcy law in India, we will discuss the concept of the constitution of the committee of creditors today. In this session, we discussed the basic section, and subsequently, we addressed the fact that a related party cannot be part of the committee of creditors.

Now, in today's lesson, we are going to discuss who is considered to be a related party because if you want to be a part of the committee of the creditor, or if someone wants to be part of the committee of the creditor, first of all, the resolution professional shall decide who is considered to be a related party.

In today's lesson, we will discuss who is considered a related party, as there are various circumstances and scenarios to consider. Therefore, in Section 5, Subsection 24, Clause a, we will primarily discuss Section 5, Subsection 24 today. So, whether a director or partner of corporate debtor or a relative of such director or partner of corporate debtor is considered to be a related party? There is a question mark.

In the case of *GS Constro and Infra Private Limited versus Gajesh Labhchand Jain, RP of E&G Global Estates Ltd.*, the NCLAT held that persons involved in day-to-day management or who accept notices as suspended directors may not be referred to as the board of directors. In a company, we have many C-level people and the board of directors who are involved in day-to-day activities. Generally, the board of directors is not expected to be involved in day-to-day activities; however, they are the individuals who guide the company. Therefore, C-level personnel or any other individuals involved in day-to-day activities or who accept notices are significant. Why? Because when an Interim Resolution Professional is appointed, they will send notice to the existing board of directors and management. So, here, whoever accepts the notice is the suspended director. They are considered to be related parties. The suspended director or any person who has control over the day-to-day affairs of the company is considered a related party in the case of a corporate debtor.

Then, in another case, *Velli Parasmasivam and V. Prism Johnson Ltd.*, the NCLT Chennai bench held that the landowners who gave land for development in the real estate industry are related parties. Suppose, I'm having a real estate project. In that real estate project, let's take the example of a corporate debtor who came forward to construct the building. I have the land, and what I am doing is giving the land. The corporate debtor is constructing the building; therefore, this is referred to as a development agreement. In this development agreement, the landowner is considered to be a related party because I am also a related party. I'm also interested in that project. So, I'm also interested in the company. That's why I'm considered a related party. The landowner who gives land for development in the real estate industry is considered a related party.

Then, who else is considered a related party? In one case, *Asset Reconstruction Company, India Limited, versus R. Gopal Krishna Raju*, the NCLT Chennai branch held that a joint development agreement related to property with the CD. Suppose, I have a joint development agreement, as we previously discussed in the case. Therefore, if I have a joint development agreement with the CD, which is the corporate debtor, I am considered a related party according to this definition. Then please remember how to determine it. Whether the related party status must be determined based on the past status or the present status, how are you supposed to determine that? Please remember that the related party status should be determined based on the present status. There is a possibility that you were previously a related party, but now you may have no interest in the corporate debtor.

So, at the time of the commencement of the insolvency date, you don't have any relation with the corporate debtor; in such cases, you are not considered to be a related party. Therefore, we must take the current scenario into consideration. In the case of *Phoenix Arc Private Limited versus Spade Financial Services Limited*, the Supreme Court held that the financial creditors who are related parties in presenti would be debarred from the COC. So, if any financial creditors at present, in presenti means at present, are interested in the corporate debtor, then whoever is interested in the management of the company is debarred from the COC because related parties are not allowed in the COC; thus, you cannot form the COC with related parties. Then, in another case law, *One City Infrastructure Pvt. Ltd. vs. Haryana Telecom Ltd.*, the NCLAT held that the directors who had resigned 6 months prior to the filing of the application. Therefore, the director had already resigned before the application was filed under Section 7. That is Section 7, where any financial creditor is required to make an application; Section 10 states that a corporate debtor is also required to make an application. This means that if a financial creditor made an application, the director who was present at that time was not aware that the financial creditor was going to file a case; obviously, he cannot predict the future. That is why the director, who had already resigned six months prior to the filing of the application under Section 7, is not considered a related party.

However, please note that if he is resigning with fraudulent intent to avoid, then in such cases, he is considered a related party. Therefore, we must verify whether the director who resigned from the company is doing so because the company is going through insolvency or liquidation. When resigning from the company, you normally have to verify this fact. In another case law, Royal Partners Investment Fund Limited versus Mohanlal Jain, the NCLT Mumbai bench held that persons must be shown to be related parties as of the date of commencement of insolvency. Please remember, in this case law, it was reiterated that the Supreme Court, in the case of Phoenix Arc Private Limited, held that the persons must be related parties as of that date; if they are related on that date, then they are debarred from the COC.

In the case of Royal Partners Investment Fund Limited versus Mohanlal Jain, the Mumbai Bench of the NCLT reiterated that the person to be shown as a related party must be so as of the insolvency commencement date; they should be a related party. Only then do we exclude him from the COC. Then, in another case law, Qamrudin Faizi versus Kaizen AAC Block Pvt. Ltd., the Mumbai Bench of the NCLT stated that if any person resigns to escape the consequences of Section 5, Subsection 24, they may not be permitted.

As I already mentioned, if you are resigning in the normal course of business, perhaps due to personal reasons, then that's acceptable. But if you are resigning only to escape the consequences of section 22, then you want to sit in the COC. You are aware that the company is going into liquidation, and someone will likely file a case against it. Therefore, in advance, if you are aware that resigning from the company is not permitted after knowing the information, then you should not proceed.

Therefore, you must consider the circumstantial evidence accordingly. In another case, Bank of India v. IRIS Electro-Optics Pvt. Ltd., NCLT Hyderabad Bench, if the resignation is malicious and made with a guilty intention, then such a person cannot be allowed to be a member of the COC. This pertains to the status of a related party. How can it be determined? Is he eligible, whether a key marginal person of CD or a relative of KMP? So key managerial personnel of CD. Who is considered key managerial personnel? There is a definition under the Companies Act. Key managerial personnel include all the board of directors, managing director, manager, whole-time director, company secretary, CFO, CEO, or any other person. Therefore, they are all considered key managerial personnel within the meaning of the Companies Act. Therefore, key managerial personnel of CD, including corporate debtor or relatives of KMP, are not eligible. They are considered related parties. then, an LLP partnership in which a director, partner, or manager of the CD is involved.

Therefore, if any person, LLP, or partnership exists where a director, partner, or manager of a CD is a partner, then in such cases, they are not eligible to act as a member in the

COC and are considered related parties. Then, a private company or public company in which a director, partner, or manager of the CD is a director and holds more than 2% of the shares, along with their relative, cannot be a member of the COC. For example, if the CD has one director and this director has a relation, meaning they hold shares in a public or private company, then such a private company or public company cannot be a member of the COC if they own more than two percent of the share capital. Then, let us discuss whether any body corporate, whose board of directors, managing director, or manager, in the ordinary course of business, acts on the advice, directions, or instructions of a director, partner, or manager of the corporate debtor. Suppose they are accustomed; suppose one body corporate is present, with its board of directors, manager, or key manager in attendance. If these key managers are acting in the ordinary course of business in accordance with maybe one director or partner of the corporate debtor, and the directors of this corporate debtor are giving instructions to that body corporate, then whether that body corporate is considered to be a related party to the corporate debtor is in question. Therefore, it was held that, in the case of Anuj Jain versus Axis Bank, the Supreme Court ruled that the transaction must be part of the undisturbed common flow of the business.

What is considered to be in the ordinary course of business? So, when I say that, let us consider one example. Suppose we take the example of Mr. A, who is a director of the corporate debtor. In accordance with the directions given by Mr. A, there is a corporate body, which we can imagine as ABC Company; therefore, in accordance with Mr. A's directions, ABC Company is acting. When they are considered to be acting in accordance with the directions given by Mr. A, if that is the case. So, in this case, it was held that if this company is accustomed to act on the transaction done by this company, which is a part of the undistinguished common flow of the business, that is regularly whatever they are doing, this company is doing, this is done in accordance with Mr. A's directions only. He is considered to be a related party. It was held in the case of Anuj Jain versus Axis Bank by the Supreme Court.

In another case, Jayanta Banerjee versus Shashi Agarwal, the NCLAT noted that a company in which the director of the corporate debtor was also a director was involved. Suppose one company is there, the corporate debtor is there, and the director of this corporate debtor is also a director in this company. Then, will this company be a related party or not? The company in which the director of the corporate debtor was also a director would fall within the purview. That means this company is considered to be a related party for the purpose of this corporate debtor. Then, in another case, Telangana State Trade Promotion Corporation versus AP Gems and Jewelry Park Pvt. Ltd., the NCLAT judgment in this case law states that the nominee director of the creditor on the board of the CD is considered a related party. Suppose the financial creditor; generally, this is a normal practice for a financial creditor. Whenever you lend money to a company

to protect your interests, it is a general tendency for the financial creditor to appoint a nominee director. As a person lending money to a company, I should ensure that the company is running properly; that's why I may appoint a nominee director. Whenever I appoint a nominee director, this director will hold the office at the discretion of the financial creditor. At the time the company makes the decision before the CIRP process, even if this nominee director is present. That is why the court is stating that the nominee director of the creditor on the CD board, the individual acting as the nominee director, is considered a related party, as they were present when the decisions were made previously. So, he is not eligible. Perhaps the financial creditor can appoint someone else, but the nominee director who previously served as a director in that company cannot be appointed as a member of the COC. He is considered to be a related party.

Then who else is considered? Section 5, (34) clause H: Any person on whose advice, directions, or instructions a director, partner, or manager of the corporate debtor is accustomed to act. We previously discussed the previous slide as well. On the advice, we are discussing this here as well. Then what is the difference between Clause F and Clause H? In the previous scenario, we discussed that a corporate debtor has one director and is a single body corporate. This is the corporate debtor. As per the directions given by the director of this body corporate, this corporate debtor is acting. That means who is accustomed to acting? This body corporate is accustomed to acting in accordance with the directions given by the corporate debtor's director. We are now discussing the scenario where any person, on whose advice, directions, or instructions a director, partner, or manager of the corporate debtor is accustomed to act, influences the director of this corporate debtor.

So, in the previous scenario, the corporate debtor is influenced by that person. In this scenario, there is H; another person is influencing the director of the corporate debtor. There is a difference between clause F and clause H. Nevertheless, in these two scenarios, you are not eligible to serve on the committee of creditors. You are considered to be a related party. So let us discuss a few judgments. In the case of *Srei Infrastructure Finance Limited versus Ashish Chhawchharia*, RP of Odisha Slurry Pipeline Infrastructure Limited, the NCLAT held that "any person" includes, when they are using the term "any person," because if you observe the definition, it refers to any person at whose address. So, who is considered to be a person? Any person includes an individual, firm, company, or any other entity. Therefore, any person who influences the director of the corporate debtor can be anyone. Any person, firm, or company can be an individual. Therefore, whoever influences the director of the corporate debtor is considered a related party.

Then, in the case of *Phoenix Arc Private Limited versus Sapde Financial Services Limited*. Therefore, the Supreme Court held that influence may be either indirect or direct. When I say that, according to whose directions, that means I have some influence.

This influence can be direct or indirect. In both ways, I can have an influence. Then, in another scenario, a body corporate refers to a holding subsidiary, an associate company of the corporate debtor, or a subsidiary of a holding company to which the corporate debtor is a subsidiary. So, what they are saying is that a body corporate, which is a holding subsidiary or an associate company of the corporate debtor, means that the corporate debtor is present for this company; you may have a holding company, a subsidiary company, or an associate company, or a subsidiary of a holding company to which the corporate debtor is a subsidiary. That means they are saying to imagine that this X company is there. Imagine that my right hand is always the corporate debtor for the time being.

Now, there is a corporate debtor, and for this corporate debtor, there is a holding company. Alternatively, our subsidiary company is available, or as an associate company, anything is possible. This company, which is a holding company, also has one subsidiary company, and another subsidiary company is in place. So, these are all the individuals considered related parties for the purpose of this corporate debtor.

Now, let us consider the case of *V. Mahesh, Liquidator of Nagarjuna Oil Corporation Limited, versus Sai Ramesh Kanuparthi, RP of Coastal Oil and Gas Infrastructure Pvt. Ltd.* The Amaravati Bench of the NCLT held that. What is the meaning of associate companies? An associate company includes a joint venture of CD. Suppose CD has a joint venture with another company; even this joint venture is also considered to be an associate. Under normal circumstances, the definition of an associate company is provided in the Companies Act. Under the companies, an associated company means any company in which that company has more than 20% of the share capital of another company. For example, if Company A holds more than 20% but less than 50% of the share capital in Company B, then these two companies are considered associated companies. Under this legislation, okay, an associate company does not mean that it only has the share capital. Suppose there is a possibility of a company having a joint venture. They may not have any share capital, but they may have some intellectual property. They are working together; in such a scenario, the associate company is included within the meaning of an associate company because these two companies are working together. Therefore, these two companies are closely related parties.

However, if an insolvency process is underway against this company, it is closely associated; therefore, this company cannot be a member of the COC. Then, another scenario: Clause (j) Any person who controls more than 20% of the voting rights in the corporate debtor on account of voting rights, ownership, or a voting agreement. So, if any person. So, what do you mean by a person? Again, you have to refer to the definition of a person. Therefore, a person encompasses both natural and artificial aspects. In the case of *Srei Infrastructure Finance Limited vs. Ashish Chhawchharia, the RP of Odisha Slurry Pipeline Infrastructure Limited*, the NCLAT held that one of the creditors indirectly

controlled more than 20% of the shares and voting rights. In this corporate debtor, there is one creditor who provided the loan. This creditor also holds 20% of the shares indirectly, thereby indirectly controlling more than 20% of the shares in the corporate debtor. Therefore, such a creditor is considered to be a related party.

In another case law, *SAI Peace and Prosperity Apartment Buyer Association versus ASK Investment Managers Private Limited*, the NCLAT held that a portfolio manager exists. This portfolio manager invested in the debentures of the corporate debtor. By virtue of when you are issuing the debentures, the debenture holder will generally have certain rights depending on the agreement between the company and the debenture holders. By virtue of the agreement between the company and the debenture holders, this portfolio manager, who has invested in the company, exercises significant influence over the corporate debtor due to various clauses in the agreement. Actually, this portfolio manager has invested in the debenture; that means it is debt capital. He is a creditor, but is he considered to be a related party or not? Yes, because even though he is a creditor, he has some influence on the corporate debtor by virtue of clauses in the agreement. Therefore, in this case, the NCLAT held that he is considered a related party.

Then let us discuss another scenario: any person who controls the composition of the board of directors or the corresponding governing body of the corporate debtor—any person who is able to control the composition—should be appointed as a director, and who should retain this position? When should he retain? So, everything is decided by someone. Any person who controls the composition of the board of directors or the corresponding governing body. Sir, in the case of a company, the board of directors will be present; in other cases, you may have a different scenario. So, suppose a body corporate exists in India; we would refer to it as a board of directors. In other countries, the name may be different, which is why they use the term governing body. Regardless of the name you use, it remains the governing body. Therefore, it is considered a related party, as held in the case of *Telangana State Trade Promotion Corporation versus AP Gems and Jewelry Parks Private Limited*. In this case, the NCLAT held that where a creditor has the right to nominate two directors, the creditor also has the right to appoint the two nominated directors, which means they have control over the composition of the board of directors. Therefore, two directors must be appointed by him only, which is why this creditor is called a related party. In another case, *Sri Infrastructure Finance Limited*, these cases generally do repeat. So, *Sri Infrastructure Finance Limited versus Ashish Chacharya, RP of Odisha Slurry Pipeline Infrastructure Limited*, NCLAT. In this case, the NCLAT held that creditors who controlled the majority of the shareholding in the CD indirectly had the means to influence the composition of the board of directors. When you control the majority of the share capital in the corporate debtor, you obviously have control over the board of directors. Therefore, they are considered related parties within the meaning of this section.

Then, in another case, *IDBI Trusteeship Services Limited v. Abhinav Mukherjee*, the NCLAT held that any person associated with the CD due to participation in the policymaking process is also considered a person associated with the CD. Suppose someone is participating in policy making. The CD is creating a policy framework, and if one person is participating in that framework, then obviously, why would they participate unless they have some influence on the board of directors? Generally, you don't allow another person to do this. Therefore, a person participating in the policy framework is considered a related party within the meaning of this section. There is actually Clause M, Section 50, Section 5, Subsection 24, Clause M. So, within the meaning of Clause M, a person who is associated is also considered to be a related party.

Please remember how you will determine whether someone is a related party or not. Therefore, whether someone is a related party or not, we will decide based on the individual, rather than the transaction. If that person is related in one transaction, suppose they are going out. They cannot say that they are not related because you are the same person who was involved previously. That's why it is not transaction-centric; it is person-centric. So, because the persons are the persons, that is, individual persons are there who are going to be influenced or who are going to influence. So that's why we will consider the person, but not the transaction. In the case of *Phoenix Arc Pvt. Ltd. vs. Spade Financial Services Ltd.*, the Supreme Court held that a financial creditor who is not a related party in the present is not subject to the provisions of the Insolvency and Bankruptcy Code, 2016. Previously, he may have been related, although he was a related party at the time, but he is not a related party presently. So we don't see the previous transaction. We'll see the person. So, is he related or not at present? If he is not related, then he is eligible. So it is not barred; he can be a member of the COC.

Then, according to the Insolvency Law Committee Report 2020, it was noted that the committee was of the opinion that the disability imposed under Section 21, Class 2, Subsection 2 pertains to the related party financial creditor, rather than the debt owed. We are talking about the person, not the debt, so that is where we are imposing the restriction. That's why we can say that. A person is involved; if a person is involved, they cannot be considered a related party. We will not consider the debt transaction. In another case, *Law City Securities and Financial Services Private Limited versus Sudip Bhattacharya, RP of Reliance Naval and Energy Engineering Limited*, the NCLT Ahmedabad bench held that where a related party debt is assigned for valuable consideration to a third party, such third party can be a member of the COC. Okay, so if a related party has already been assigned, that means someone else purchased or someone else received valuable consideration; then obviously the third party is not considered to be a related party. Because it is already separated from the related party to the third party, who is unrelated to the company, CD Financial Services, a service provider, becomes a related party solely on account of conversion or a constitutional debt to equity, and remains a member of the

COC. So, if you observe any financial service provider, if he is becoming a related party, what they are saying is under section 21, subsection 2, second provision, which states that, as we have already discussed, if any financial service provider has given debt to the company, and this debt is converted into equity. If this debt is converted into equity, when he becomes an equity shareholder, he becomes a member of the company, and thus is a related party under normal circumstances. However, in this case, because he is a financial service provider, merely converting his debt into equity does not qualify him as a related party. Why? Because he is not the investor who is actually making the investment. He is a lender due to certain circumstances. Due to the policy, the debt is converted into equity, so when you convert the debt into equity, you cannot equate this person with the normal members. That's why he is not considered a related party. In the case of Phoenix Arc Pvt. Ltd. vs. Spade Financial Services, we have already discussed it.

In the same case, the Supreme Court held that a financial service provider whose debt is converted into equity remains a member of the COC. Because he is giving the loan in a professional capacity as a financial service provider, it is regulated by the regulatory authorities, so they are not converting just like that; when they are converting the debt into equity, this is as per the RBI regulations, so that's why they still remain a member of the COC. In the case of SAI Peace and Prosperity Apartment Buyers Association versus ASK Investment Managers Pvt. Ltd., NCLAT held that if the transaction is not a pure play, for example, if a financial service provider is converting debt into equity, but it is not a pure play, then it is not being done properly. In such cases, the financial service provider cannot be a member. He cannot be a member of COC. So, it should happen according to the rules.

Additionally, each creditor in a consortium must be a party to the COC. Please note. Who can be a member of the COC? Each creditor, in a consortium of 10 people, is a financial creditor who invests together, providing loan, debt, and equity capital. So together, they are giving, and each and every creditor shall be a part of the COC. Then, in another case, Esspee Sarees Private Limited versus Skipper Textiles Private Limited. In this case, the NCLT Kolkata Bench held that when a financial institution is part of a consortium, it retains its individual entity and identity in the COC. As I mentioned earlier, although you are part of the consortium, each individual financial creditor within the consortium will have voting rights proportional to the percentage of the loan they provide; each financial institution will hold a stake in the Committee of Creditors. They'll have their identity separately. Let us recap what we have discussed today.

In today's session, we discussed who is considered a related party. In the previous session, we discussed that the related parties of the financial creditor cannot be a part of the committee of creditors. In this class, we have discussed who is considered a related party. That is Section 5, Subsection 24. Then, Class A, Class B, Class C, and all these classes deal with those who are considered related parties. A director, a partner of a

corporate debtor, a relative of such debtor, or a partner of the corporate debtor is considered a related party.

Then, any, body corporate whose board of directors, managing director, or manager, in the ordinary course of business, acts on the advice, directions, or instructions of a director, partner, or manager of the corporate debtor. These are the concepts we have discussed, along with the relevant judgments. Then any person on whose advice, directions, or instructions a director, partner, or manager of a corporate debtor acts, if they are accustomed to act in accordance with the directions of any person, is considered to be a related party. Then, any person who controls a composition of the board of directors or the corresponding governing body of the corporate debtor is considered a related party.

Then, if any person has control over the composition, they are considered a related party to the corporate debtor. The disqualifications are based on the related party being person-centric, not transaction-centric. This means we should understand that it is not transaction-centric, but person-centric. We have discussed the meanings of person-centric and transaction-centric in this class. Then, a financial service provider becomes a related party solely on account of the conversion or substitution of debt to equity or remains a member of the COC. Here, we have discussed the scenario where a financial service provider lends money and subsequently converts that loan into equity. In such cases, is the provider considered a related party? We have discussed that merely because the debt of the financial service provider is converted into equity, he will not be considered a related party for the purpose of this clause.

Today, in this lesson, we discussed who is considered a related party, so we can understand who cannot be a member of the committee of creditors.

Thank you.