

# **Insolvency and Bankruptcy Law in India**

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**Lecture 45**

Hi, welcome to the 45th session on the Insolvency and Bankruptcy Code, where we are discussing a precise topic: liquidation.

Today, we will cover preferential transactions as part of the liquidation process. However, before that, let us quickly recap what we did in the previous session. In the previous session, we covered Section 41 of the IBC, which discusses the determination of a claim's valuation and how the liquidator will assess its value. After that, we discussed Section 42, which states that if the resolution professional or liquidator rejects a claim, an appeal can be made to the adjudicatory authority. We then proceeded to Section 52, where we clearly outlined the position of secured creditors in liquidation proceedings. Then, Section 53 is what we have covered, which is essentially the waterfall mechanism, or how the distribution of assets is done after liquidation or under CIRP. The last topic we discussed in the previous session was the dissolution of a corporate debtor, which I mentioned is the final stage of liquidation, after which the company will come to a complete termination. So, this is a quick recap of what we did yesterday.

Today, we will begin with preferential transactions. However, before I introduce you to preferential transactions and explain what Section 43 is about, it is essential for us to understand the background of the entire concept. There are four types of transactions that we refer to as avoidance transactions under the IBC. What do you mean by avoidance transactions? This would mean that transactions falling under the four categories, which I will discuss now, can be avoided if a liquidator or resolution professional believes so upon application to the adjudicatory authority; these four transactions, which have already occurred, will now be avoided. That means the transaction will be reversed. Why is this done? This is done because the four transactions that were conducted in the past were either made with the negative intent of actually affecting the claimants at the time of CIRP or liquidation, or were made to give a specific advantage to a party possibly related to the corporate debtor.

Therefore, the moment a liquidator identifies this kind of transaction, they will inform the adjudicatory authority that certain transactions have occurred that are not in the best interest of the corporate debtor, and the adjudicatory authority will reverse these

transactions; that is why they are called avoidance transactions. Now, what are those transactions? Number one is called a preferential transaction, where, due to the transaction, a certain party receives a preference in the event of liquidation or CIRP that it would not have otherwise received, which is not a healthy transaction for other claimants under liquidation or CIRP. Hence, this transaction should be avoided. The second transaction is referred to as an undervalued transaction. What do you mean by that? It refers to situations where the company should have received a reasonable amount of money for a certain transaction, but instead received a lesser value. The claimants in liquidation or the CIRP should avoid such transactions. Now the third transaction is called the fraudulent transaction, which is done to the creditors; whatever sums they were due to receive will not come to them because of a transaction that has occurred between CD and some other party; hence, that is also not a healthy transaction for the claimants and should actually be avoided. The last one is called an extortionate transaction, where the company has paid a reasonably excessive amount of money to the third party. Such transactions are not healthy. So, these are the four headings.

Out of these, the first heading is what we are covering, which is referred to as a preferential transaction. This provision ensures that related parties do not use any insider information about the corporate debtor to make unlawful gains for themselves. The effect of that section is that it invalidates all such preferential transactions that are entered into by the corporate debtor within a relevant time. These transactions have been entered into with a specific intent based on information already available to the CD, and they are detrimental to other claimants; hence, they will be canceled now if proven in the court of the adjudicatory authority. What is a preferential transaction? If you want to understand this, we have to go to section 43, subsection 1, which clearly explains what the preferential transaction is, where the liquidator or the resolution professional, as the case may be, is of the opinion that the corporate debtor has, at a relevant time, given a preference in such transactions and in such manner as laid down in subsection 2 of the same section.

Then he shall apply to the adjudicating authority for the avoidance of such preferential transactions and for one or more orders that can be delivered under section 44. This is essentially a preferential transaction. I'll provide an example shortly to illustrate how you can understand the preferential transaction. Section 43(2) discusses how a transaction will be deemed a preferential transaction. A corporate debtor shall be deemed to have given a preference if there are two transactions. Number one, if there is a transfer of property or an interest thereof of the CD for the benefit of a creditor, or a surety, or a guarantor, for or on account of any antecedent financial debt, operational debt, or the liabilities owed by the CD. That means there were certain debts that had already been created between the CD and the creditor, and now the CD is entering into some arrangement with the creditor

to give him a special position within the company so that at the time of liquidation or CIRP, this creditor will be in a better position than he was before.

Then the second part of the transaction states that the transfer under clause A has the effect of putting such creditor, surety, or guarantor in a more beneficial position than it would have been in the event of a distribution of assets under Section 53. It is clear that if I, as a creditor, had not entered into this transaction with the CD, I would have received only a smaller amount under Section 53 at the time of liquidation or CIRP. But now that I have entered into this transaction, I will definitely be in a better position. That is part B of section 43, subsection 2.

Now I'll give you a clear example. How do you understand what a preferential transaction is under section 43? Mr. Neil and Mr. Kamal are just random examples. There is no relation to any actual or real company outside of this. So, Mr. Neil and Mr. Kamal are directors of Neil Kamal Import and Export Private Limited. In 2020, the company borrowed 5 crores from Mr. Raj Kamal, who is the brother of Mr. Kamal, the company's director, without providing any security. This transaction is very important. The company borrowed money from the brother of a director without providing any security. The brother trusted the company and its prospects and gave a loan of 5 crores, which is a huge amount. However, in December 2024, the company's office building situated at Nariman Point, Mumbai, was given as security. So, in case the money is not repaid to Mr. Rajkamal, Mr. Rajkamal can recover the money from the security created on that property. This is the whole idea.

The property is worth 25 crores. Look at the whole transaction now. What is happening? Mr. Rajkamal lent only 5 crores, but what he is now getting is a property worth 25 crores as security for his loan. If the security had not been given, then Mr. Rajkamal would have received only 1 crore under CIRP or liquidation. Now, in this scenario, the CIRP had already begun against the company. Hence, when the resolution professional is appointed to oversee the entire process, the first thing they will do is investigate this transaction and report to the adjudicating authority, stating that the company has created a certain security for an antecedent financial transaction to put that creditor in a preferential position. Hence, he will ask the adjudicating authority to set aside this transaction, and Mr. Rajkamal will be treated as if he had no security whatsoever from Neil Kamal Company.

I'm sure the transaction is now quite clear to you. We will attempt to understand the consequences through the lens of case law. However, Section 43 also provides exceptions where a certain transaction may not be treated as a preferential transaction and, therefore, will not be set aside. What are those transactions that will not be dealt with as a preferential transaction? Number one transfer made in the ordinary course of the business or financial affairs of the corporate debtor or the transferee. Now, if I am a real estate

company and I am in the business of buying and selling properties, I might sell a certain property to a certain party, depending on the market scenario, at a price that is less or more. But it is my ordinary course of business. I have not done any favors for any creditor. Hence, such a transaction may not be termed a preferential transaction. I am reading part B now.

Any transfer creating a security interest in property acquired by the corporate debtor to the extent that such security interest secures value and was given at the time of, or that contains a description of such property as a security interest and was used by the corporate debtor to acquire such property. That means that if I acquire a certain property, borrow money, and create a security interest in such property through an agreement, then the creation of a security interest will not be considered a preferential transaction. The last exception is that such a transfer was registered with an information utility on or before 30 days after the corporate debtor received possession of the property. Regarding part B, there are two conditions: first, you must have acquired this property with funds provided by the lender and created a security interest in the same asset through an agreement.

Additionally, you should have registered this agreement with an information utility center within 30 days of occupying or possessing that certain property. If these two conditions are met, then your transaction may not be termed a preferential transaction. Lastly, the fact that a transfer is made in person by order of a court does not preclude such transfer from being deemed to give preference by the corporate debtor. Remember, as far as a normal court is concerned, like a high court or a district court, these courts may not examine your transaction from the perspective of an avoidance transaction. If a dispute arises between two parties, the court may order the transfer of property to one party without examining the details of avoidance transactions. But just because there is an order of the court, you cannot say that this is not an avoidance transaction. Despite being in order from the court, the transaction may still be considered an avoidance transaction and may be cancelled by the adjudicatory authority if approved by the reservation professional or liquidator with substantial evidence.

Going forward, there is a presumption of a preferential transaction. When can the courts or the resolution professional presume that a certain transaction was entered into only to put a certain party in a preferential position? If it is proved that the person receiving benefits from the CD had sufficient information about the commencement of the CIRP or is a related party of the CD, the transaction during the relevant period will be presumed to be a preferential transaction. So, very importantly, we are trying to understand the parties' intent. The intent of the parties is simple: I, as a creditor, know that the company is in bad shape and is going into insolvency. Before it goes into insolvency, I, as a creditor, would want to secure my position; hence, I put pressure on the company.

The company actually does some transactions to put me in a preferential position, and hence, these transactions can be avoided. Conditions for presumption; we are now covering part B of those conditions. The presumption applies if the person had sufficient information about the initiation of CIRP or if the person is a related party of the CD. Only in these cases will we presume that a preference is given to a certain party. The last point is very important. Who has the burden of proof? That means, should the liquidator or the resolution professional prove that this is a preference transaction, or is it the responsibility of the other party to prove that it is not a preferential transaction? Hence, let's look at this paragraph. It will be presumed that the interest was acquired or the benefit was received not in good faith unless the contrary can be shown by the other person receiving the benefit.

Now, remember, if I am the creditor, I receive the benefit; it is my duty to prove that I have not entered into any preferential transaction, that the transaction was in good faith, and that it's a bona fide transaction. Unless and until I prove that, there is a presumption and belief that the transaction was actually preferential transaction. Now, there's case law. This will clarify to you what a preferential transaction is. Anuj Jain is an IRP for JP Infratech Limited versus Axis Bank. This is specified under Section 43 of the code, and the adjudicatory authority is none other than the Honorable Supreme Court of India. Now, the facts of the case. Firstly, JP Infratech Limited is a subsidiary of JIL, another JP Group company. JIL borrowed loans from various bankers and secured those loans with assets, which is a normal practice. JIL has created a mortgage on its own properties to secure the loans borrowed by the holding company on a subsequent date. Now, remember that when I say the loan occurred on a certain date and the security was created on a later date, we are referring to an antecedent transaction.

As mentioned in section 43, the moment an antecedent transaction is covered or protected by a subsequent transaction, there is a significant chance that it will become a preferential transaction. So, JIL wanted to secure the loan borrowed by JIL and had given its own properties as collateral to the lenders; if allowed, or if it goes well, this will impact the other lenders and also the homebuyers' association. Because JP Infratech Limited was building houses and had several projects under development, the company is now undergoing the resolution process. Several residential housing projects, which had welfare societies, were significantly affected by the CIRP. Now they will come and say that they want these assets to be with them so that they can actually engage in housing building activities. However, if these properties are now mortgaged to the creditors of the holding company, then the housing societies will have no control over those assets, and they'll be significantly affected. This is why the discussion about whether this is a preferential transaction is happening now: yes or no. Fact number five: At the time when the CIRP commenced, the RP made an application to the NCLT stating that he had witnessed certain preferential transactions and wanted them to be canceled. However, the

good news is that the NCLT understood what the RP wants to say, and it has canceled all the preferential transactions.

Now that it has canceled all the preferential transactions, it is a good relief for RP. But there will be a party that is obviously affected or aggrieved by this order. Who is that? All creditors who obtained mortgages on the properties of JIL will now be aggrieved by the NCLT's order. Therefore, they filed an appeal to the NCLAT. That's point number 6, the fact being 6 if you see. It's an application to the NCLAT. Now, what did NCLAT do? The NCLAT actually favored the creditors and stated that there was no preferential transaction, taking a completely opposite view to that of the NCLT. Now, if you are looking at this practically, it will make you nervous as a lawyer, an advocate, or a corporate professional. A learned and honorable adjudicatory authority favors an RP or liquidator and deems a certain transaction preferential.

On appeal, the appellate tribunal takes a complete 360-degree turn and actually favors the appellants, saying that there is no preferential transaction. This is the uncertainty in the legal system. But anyway, we are not going to debate those. So, when the NCLAT stated that there was no preferential transaction, it is now the RP who is affected by the NCLAT's order. Now, therefore, there will be an appeal to the Supreme Court by the RP and his accompanying parties for the benefit of liquidation and CIRP to take an order for the avoidance of these preferential transactions. What happened after that? There are two issues that are cropping up. Issue number one is whether the transactions should be avoided, treating them as preferential transactions; whether the mortgagees who received this preferential treatment shall be dealt with as financial creditors, or whether we should completely classify them as illegal claims and treat them as unsecured creditors. Two very critical issues have arisen from this case, and let's examine what happened during the term at the time of the conclusion. The Supreme Court, rightly, set aside the orders of the NCLAT. It went back and appreciated the orders of NCLT. It upheld its orders. It declared the transaction as preferential and hence concluded that these transactions should be avoided once and for all. The transactions are avoided. There are two ways of looking at it. One is that whatever preferential position is set aside, he will now be a normal creditor.

Sometimes, what we do is make them completely non-financial creditors and call them unsecured creditors, who will make claims under Section 53 of the Act after all the preferential creditors have received their money. Now, very interestingly, if there is a preferential transaction when an application is made by the RP or a liquidator, what order will be passed by the NCLT or adjudicating authority, and what kind of orders can it pass, and what will be the impact of such orders on the CIRP or liquidation? First, a property that is part of a preferential transaction will now be listed in the CD that can be ordered first. That means the property has been removed from the CD's control for a preferential transaction; hence, it cannot be part of the liquidation estate. Now, what the

adjudicatory authority is saying is that it has to be reversed, and then the property will be part of the liquidation estate, which is a great benefit to the claimants under liquidation or CIRP. The second type of order that the adjudicatory authority can pass is that the sale proceeds, whatever has been received by the corporate debtor or transferor, will now be part of the liquidation estate and hence will be equally shared by the parties as per section 53.

The next consideration is whether any security is created; if so, such security interest will be discharged, and hence the secured property will be free in the hands of the corporate debtor. The fourth one is that if any sums are received by third parties that are not CD, those third parties should return the sums to the liquidation estate. Like a commission agent who has earned a substantial commission, they will be asked to return that commission so that it becomes part of the liquidation estate. If a person is discharged from liability preferentially, remember there are two types of transactions. It is not always the creditor who gets preferential treatment. They can also be a debtor of the company who receives preferential treatment. How? If I have borrowed a loan from a CD, and the CD states that you will pay me 5% of your loan, and I'll completely relinquish your liability, that is also a preferential position. Therefore, in that case, if I'm discharged from my liability, the adjudicatory authority will now make me liable again. So, these are the five types of orders that the NCLT may pass. Apart from that, it may also provide security or create a charge on a property that is to be coming to CD.

The seventh point is that claims as a financial creditor or operational creditor must be proved in liquidation or CIRP. If there's a suspicion that a preferential transaction has occurred, the adjudicatory authority will declare that I'm setting aside your preference. You must then prove your claim like any other creditor and receive payment from the RP or liquidator. This is one of the greatest orders that can pass. The last one is the release or discharge of any financial or operational debt that is to be proved in liquidation or CIRP. Once it is discharged, there can be no further claim that those parties can make. These are a few orders that can be made by the adjudicatory authority in cases where it identifies a preferential transaction. However, remember that any person who has acted in good faith, such a person's transaction cannot be affected by the order of the NCLT.

As I read the paragraph now, an order by the NCLT under Section 44 will not affect any interest in property that was acquired from a person other than the corporate debtor in good faith and for value. This protection extends to any interest derived from such property if it comes from a third party. Now I think we have a much clearer understanding of what preferential transactions are. Just before I conclude and summarize, I would always suggest that after listening to these sessions, you should go back to the Bare Act and try to make your own reading and your own points regarding the critical areas that you would want to examine under the IBC.

After that, we will also occasionally review regulations to help you understand how to apply them to the provisions under the IBC and make necessary revisions. It helps you retain the subject better. As I mentioned in the previous session, please also continue to track real-life cases that are occurring. The IBBI portal gives you substantial information on real-time cases that are ongoing; please track them.

To conclude the session summary, we have learned what a preferential transaction is under Section 43. In what circumstances do we deem that there is a preference for who has the burden of proof? And lastly, in such cases where it is established that there is a preferential transaction, what kind of orders can be passed by the adjudicatory authority under section 44 in the case of JP Infratech Limited to understand preferential transactions? This brings us to the end of the 45th session, and we will meet again in the 46th session.

Thank you.