

Insolvency and Bankruptcy Law in India

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Week 10

Lecture 47

Hi, we are in session 47 on liquidation under the IBC, and today we will be discussing transactions that defraud creditors under sections 49, 50, etc. But before that, let's do a quick recap of what we discussed in the previous session.

In the previous session, we discussed four things: sections 45, 46, 47, and 48. Section 45 talks about the avoidance of undervalued transactions. Section 46 discusses the relevant period for which these undervalued transactions can be examined. 47 provides for applications to be made by creditors, and 48 provides for orders to be made by the adjudicatory authority in the case of, you know, undervalued transactions. This is what we understood in session number 46.

Currently 47, we are going to understand transactions that defraud creditors and other transactions. Section 49 of the IBC is one of the important provisions that classifies the third category of avoidance transactions, specifically those aimed at defrauding creditors. In this section, I have attempted to organize it into subsections to provide clarity on its structure. Where the corporate debtor has entered into an undervalued transaction, as referred to in section 45, subsection two. Primarily, to qualify as a defrauding transaction under Section 49, the transaction must first have fallen under Section 45 and satisfy two conditions, as outlined below. Now see where the cursor is moving if it is a transaction falling under section 45, plus the adjudicatory authority is satisfied that such transaction was deliberately entered into by such corporate debtor for two reasons. Number one, keeping the assets of the corporate debtor beyond the reach of any person who is entitled to make a claim against the corporate debtor, or in order to adversely affect the interest of such a person in relation to the claim. See, it is not the end; if you see the word "conjunction" between A and B, it is "OR," so it is not necessary that both conditions be met. Even if one of the conditions, either A or B, is met, this will constitute a transaction under Section 49.

However, one important thing to note is that it should, as a pre-qualification, fall under Section 45 as an undervalued transaction. If it is such a transaction that is aimed at, you know, defrauding the creditors, then the adjudicating authority shall make an order. The order can be placed in the following ways. Number one, restoring the position as it

existed before such a transaction, as if the transaction had never happened. That is, the property will revert to the company, and the third party will have to relinquish the property that they purchased in an undervalued transaction. Two, protecting the interests of persons who are victims of such transactions involves not only reversing the property but also all incidental orders that will protect the interests of other parties involved who have a stake in the transaction, which is very important. The corporate debtor will recover the asset, and all other parties who made payments in good faith should have their money returned. Additionally, financial creditors and operational creditors, whose claims are crucial in the liquidation or CIRP, must also have their interests protected by way of an order. Therefore, the order is a broader one, but it is subject to a condition that an order under this section shall not affect any interest in property that was acquired from a person other than the corporate debtor and was acquired in good faith. So, if a third party buys any property from any person other than a corporate debtor.

Then, this section cannot be invoked against such a person, provided it is in good faith. The concept of “good faith” is of great importance. Then part 2 shall not require any person who received a benefit from the transaction in good faith for value and without notice of the relevant circumstances to pay any sum unless they were a party to the transaction. So repeat shall not require any person who received any benefit from a transaction in good faith for value and without notice of the relevant circumstances. So, if I received some money from this transaction without being aware that there was something suspicious, and if I acted in good faith, then I can’t be required to return any sums by way of an order. So, these are the two exceptions to the order.

Let’s move to the next section, which is section 50. Moving on to Section 50, which deals with extortionate transactions. Have you heard the word “extortion”? Extortion is common sense in the world of crime. It involves holding someone for ransom and demanding money through blackmail. In the world of crime, extortion is what we are familiar with. However, when it comes to economic offenses, especially under Section 50 of the IBC, although the words ‘extortion’ and ‘extortionate’ are used, they are employed in a different context. Let’s understand what it is. Where the CD has made a party to an extortionate credit transaction involving the receipt of financial or operational debt during the period within two years preceding the insolvency commencement date, the liquidator or RP may make an application for the avoidance of such transaction to the adjudicating authority. The terms of such a transaction required the corporate debtor to make exorbitant payments.

Now, consider two different dimensions of avoidable transactions. Number one is the undervalued transaction, where CD deserved a larger sum of money, but it only received a small amount; it’s an undervalued transaction. On the other hand, when the CD makes a payment, it is not paying a smaller amount; instead, it is paying an exorbitant amount for a certain transaction. In both cases, ultimately, the CD is affected, and because of the CD,

the claimants are also affected. And hence, whatever money you have to receive, you shall receive a reasonable amount of money, and when you have to make a payment, you shall always make only a reasonable payment of money. You cannot pay more, nor can you receive less than what is expected. These two transactions have completely contrasting views. In case you receive money, take what you need. In case of payment of money, pay only as much as you have to; you can't pay more. The moment you pay more than a certain sum, a sum deemed excessive for a particular transaction, it falls under the category of extortionate transactions.

I'm sure we're clear, but the period to which these extortionate transactions can be applied is the two years preceding the insolvency period; we cannot go beyond that period. However, what will be the circumstances under which it will be treated as extortionate? Those circumstances will be provided by the Insolvency and Bankruptcy Board of India, also known as the IBBI. The moment we see an extortionate transaction, we must take action to avoid it. As in the case of the other three types of transactions, we naturally transfer adjudicatory authority and inform them that there is a certain transaction that is avoidable in nature; please reverse this transaction and issue orders accordingly. Even for an extortionate transaction made under Section 50, there is a Section 51 that deals with the order to be passed by the adjudicating authority.

Therefore, under Section 51, we will examine the types of orders that the adjudicating authority is authorized to pass. If the adjudicating authority is convinced or satisfied that exorbitant payments were to be made by the corporate debtor, it shall, by an order, restore the position as it existed prior to such transaction. And therefore, any excess payments of money that you made will now become recoverable. Set aside the whole or any part of the debt created through the extortionate transaction, modify the terms of the transaction to eliminate the extortionate portion, and require any person who is a party to repay any amount that he has received on account of the extortionate transaction. And the last one requires any security interest to be relinquished in favor of RP or the liquidator.

These are a few orders that can be passed by the NCLT here as an adjudicating authority, and it can also pass any other order deemed necessary. Now, let's examine an example of an extortionate transaction; without this, we cannot fully understand what we are discussing. An example is Bye Bye Motors Limited, which borrowed loans from various bankers. The company was on the verge of default. The moment I use the word default or the phrase verge of default, it should immediately strike your mind that the next step is going to be CIRP insolvency proceedings. And remember, whether we, as professionals, know it or not, the corporate debtor and its management will likely anticipate that this is the next step that will happen. And the moment they anticipate a CIRP application, their mischief will begin in different forms and shapes. And this is one of the forms we will discuss now. So, when the company was on the verge of defaulting, predicting CIRP, it borrowed a fresh loan from a banker named CDFI last.

This is a banker. This bank has agreed to give a loan, but the bank said your monthly interest rate could be 5% per month. If you are agreeable to this sum of money, I will lend it to you; otherwise, I will not. Now, in a desperate scenario, you may agree to pay such amounts of interest and borrow.

Let's quickly understand, on average, in a good credit scenario, what the interest rate payable by the borrower is. Let me tell you. In individual hand loans, when A lends B a certain amount of money, he might charge a monthly interest rate of 2%. However, when a corporation borrows from a bank, the interest rate is typically 14% per annum. If you divide this rate by 12 to convert it to a monthly basis, the maximum monthly interest rate can be approximately 1% to 1.5%. This is called a reasonable interest rate if the borrower is creditworthy.

But against an average interest rate of 1 to 1.5%, if a certain banker is charging a whopping 5% from a certain party, then what should happen? So, the CD signed the loan documents, agreeing to the company's and banker's interest rate. After borrowing at this interest rate of 5% per month, an insolvency petition was filed against the company within the next six months. Obviously, as predicted, insolvency has arrived. Now, you can easily understand from the example I gave that the moment an RP or liquidator takes charge of this corporate debtor, the first thing they will do is see the transactions that have happened in the past two years and primarily pick up this transaction and say this is one transaction in the nature of an extortionate transaction because the average rate of interest paid is about one and a half percent per month, and this particular banker is charging about 5% per month or something about 60% per annum.

The moment he sees this interest rate, he will feel it is extortionate. Then what happens? The resolution professional will take this matter to the adjudicating authority and prove beyond a doubt that this is an extortionate transaction, and the adjudicatory authority will pass an order in favor of the resolution professional and call this an extortionate transaction. This is a problem with this kind of avoidance transaction. Whatever smartness a corporate debtor or its management uses, at the end of the day, an experienced liquidator or resolution professional who actually takes charge of the corporate debtor will instantly come to know the foul play done by the management and the corporate debtor and take them to task by reporting these transactions to the adjudicating authority.

Now I'm going to take you to a live case. Instead of an example, consider the case of Shinhan Bank versus Sungil India Pvt. Ltd. The adjudicating authority is the NCLAT, not the NCLT. That means this is an understandable appellate jurisdiction. The facts of the case are as follows. Mrs. Vaiva Metals and Alloys Pvt. Ltd., which is an operational creditor of Sungil India Private Limited, which is a corporate debtor, filed an application under section 9 of the IBC as an operational creditor initiating an action of CIRP. The

application was admitted on June 1, 2018, and Mr. Rajesh Parakh was appointed as the resolution professional. Before the application for CIRP, there are two important facts for you to know: there was a CIRP initiated, but before that, what happened? That is what gives you an idea about an extortionate transaction.

The lenders lent short-term loans to the CD, which failed to repay the loans. The lenders then extended the loan period and charged an interest rate of 5% per month. Now you can easily relate this to the example we studied in the previous slides, as well as the real-life story that occurred between Shinhan Bank and Sungil India Private Limited. As I mentioned in the previous example we studied and the live case we are examining here, the cases are very similar. In this case, the lenders lent loans to the corporate debtor at a phenomenally high interest rate of 5% per month, which was done just before the commencement of CIRP proceedings.

Hence, the instant thought would be that RP will have to report these transactions. So let's see fact point number five: what happened? The lenders made a claim pursuant to a public notice by RP, as if nothing had happened. They had made a claim, boss, that you've called for claims; I'm making a claim. I have a principal amount to be received from the corporate debtor, plus an interest rate of five percent, which is what they owe me. The claim included the principal amount plus interest at a rate of five percent per month, as verified by the RP, who has already studied the claims. As soon as he verified the claims, he accepted the principal amount, realized that the interest rate was extortionate, and completely rejected the amount owed for interest. So only the principal was accepted. When an application was made, this is an appeal because, as a reminder, RP initially rejected your claim and the interest amount. The moment RP rejected your interest amount, the first move you made was to approach the NCLT, stating that RP had made a mistake and should allow my entire claim.

Now, when an application was made, the NCLT's adjudicatory authority rejected the entire amount of the claim. This is very surprising. Usually, this doesn't happen. But in this case, the adjudicating authority, instead of sticking to the matter of interest, has gone one step beyond and said, "Boss, if you are charging extortionate interest on your principal amount, not only is your interest in doubt, but also your principal cannot be paid. Now, therefore, the whole amount I am calling an illegal claim, and you will not be qualified to come here as a financial creditor." This is a very serious grievance for the creditor; hence, they have appealed to the NCLAT against the NCLT's decision to admit my claim. You have no business to actually reduce my claim.

What are the appellants' arguments? Appellants argue that the creditors who lent money have clearly exceeded the time limit for avoidance transactions. According to them, it is way past the time limit. The adjudicating authority made a mistake by completely rejecting the claim. We can understand if you're calling the interest rate exorbitant or

extortionate, but how can you completely ignore the principal amount that we have actually lent, which you cannot claim as illegal? These are the two vital arguments from the appellant's side. Obviously, we do not have to listen to the respondents.

We will need to review the conclusions. The appellate tribunal, namely the NCLAT, held that the transactions are absolutely extortionate within the meaning of Section 50 of the Act. Forget about the time limit and the difference that you're claiming. It stated that the claimants shall be treated as unsecured creditors and may submit their claims accordingly. Hence, you cannot be treated as a financial creditor. You cannot claim the entire money in order of preference under section 53, but you will stand at almost the bottom of the table as an unsecured creditor.

After the operational creditor, you might get your money. So this is how extortionate transactions that are trying to suck the blood of the corporate debtor can be treated by the NCLT. Hence, friends, I think at the end of all that we have understood about the four kinds of avoidance transactions, what is the simple lesson that we should learn as corporate debtors? The simple lesson is to be fair and transparent. Though you are anticipating a CIRP or liquidation proceedings, you cannot act smartly by entering into these avoidance transactions against the interests of the claimants. If you do, we will find ways to avoid these transactions and improve the situation for the claimants, while making it worse for the CD and for the individuals who have engaged in these avoidance transactions, correct?

So, let's move on to one more important concept. While this is important, you would have realized that if there is a PUFEE transaction, it is preferential, undervalued, defrauds creditors, or a fraudulent transaction. Lastly, there are extortionate transactions. If you have these four transactions, RP cannot take action on his own. RP must report to AA and wait for AA's instructions. While you wait for the AA's order, can liquidation be commenced? Can liquidation be concluded? Can dissolution be implemented? For this question, the answer is provided in Regulation 44A of the IBBI Liquidation Process Regulations 2016, which clearly states that both liquidation and dissolution are possible.

However, the liquidator or the RP shall provide a plan outlining how they will proceed during and after liquidation, as well as what will happen to the proceeds received from these cases with the adjudicating authority. How do you distribute these proceeds? If you have clarity on these two aspects, then please continue to liquidate and dissolve the company while PUFEE transactions are pending in an adjudicatory authority's court. Right, so this brings us to the conclusion of this session. Quick summary: We have covered Section 49, which pertains to transactions that defraud creditors. I've already told you to remember that the pre-qualification for these transactions to qualify under Section 49 is that they should be considered undervalued; only then can they come under Section 49.

Section 50 addresses extortionate transactions, and Section 51 deals with orders in respect of such transactions. We understood both of them with the help of the respective case laws. And this concludes all four avoidance transactions. In the next session, we will delve into the core process of liquidation, providing an overview, and may also explore IBBI regulations. Just before I wrap up, one critical point I have not covered so far is any regulation except the one you now see on the screen, which is Regulation 44. The rest of the regulations will be covered through these sessions, specifically Session 47.

Thank you so much.