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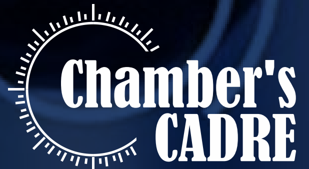

Related Party Transaction under IBC: Concept and Evolution

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Introduction

The concept of 'Related Party Transactions', i.e. transactions entered into by a corporate entity with its related parties, and the treatment of such transactions is a keenly regulated aspect of corporate governance. Their relevance gains more importance in the context of avoidance transactions of a corporate entity that is facing an imminent threat or likelihood of insolvency proceedings.

From a corporate insolvency resolution process (**"CIRP"**) perspective, avoidance transactions are essentially those transactions whose effects, an administrator or insolvency professional seeks to avoid against the entity undergoing insolvency for the reason that such transactions have eroded the value of the said entity and taken place during the 'twilight period', or the period during which the management of the entity is presumed to be aware of the possibility of commencement of insolvency proceedings. Transactions can be deemed avoidable for a number of reasons such as extension of undue preference to a particular creditor over others, undervalued transactions, extortionate transactions and those entered with the intent to defraud creditors.

Although an entity may enter into avoidance transactions even with an unrelated party, the treatment of avoidance transactions entered into with related parties as a sui generis category arises because related parties may have superior information relating to the said company's financial affairs which may be used to divert assets of the company away from its creditors and stakeholders in during the period leading up to the commencement of insolvency proceedings[1].

However, avoidance transactions and their effects on a company may not be ostensibly identifiable, particularly when looking back in time after the commencement of insolvency proceedings. Therefore, a well-developed and robust legal framework for identifying and reversing the effects of avoidance transactions for the protection of the insolvent entity's estate and the interests of its stakeholders has become a sine qua non for every modern insolvency process.

Every able administrator or insolvency professional knows, as a rule of thumb, that the managers or promoters of an entity may use their knowledge of early signs of financial stress of the indebted company (**"Corporate Debtor"**) for their own benefit or

1. Legislative Note to Clause 46 of the Insolvency and Bankruptcy Bill, 2016.

for the benefit of other related parties, which may hamper maximization of value for all stakeholders in insolvency. Therefore, related party transactions may significantly erode the value of an already financially distressed entity and even prejudice the resolution prospects.

The Insolvency and Bankruptcy Code, 2016 (**"IBC"**) is by far India's most comprehensive insolvency resolution framework and is armed with necessary provisions to deal with avoidance transactions and protecting the interests of the stakeholders of a Corporate Debtor who are aggrieved by such transactions.

In this paper, we will analyse the framework and development of jurisprudence of avoidance transactions in the context of related parties under the IBC, and the protection it offers against such transactions.

Who is a Related Party?

An exhaustive, yet precise and unambiguous definition as to who a related party is, in relation to a Corporate Debtor, is critical to ensure that no mischief slips through the cracks when it comes to avoidance transactions. For the purposes of avoidance transactions entered into by a Corporate Debtor, the IBC provides a comprehensive and exhaustive list of persons and entities, which are "related parties" of the Corporate Debtor[2]. These persons *inter-alia* include:

a. director, partner or key managerial personnel of the Corporate Debtor;

b. a limited liability partnership or a partnership firm in which a director, partner, or manager of the Corporate Debtor or her relative is a partner;

c. a company in which a director, partner or manager of the corporate debtor is a director and holds along with his relatives, more than two percent (2%) of its share capital;

d. a body corporate/limited liability partnership firm/partnership firm whose board of directors, partners, managing director, manager, in the ordinary course of business, acts on the advice, directions or instructions of a director, partner or manager of the Corporate Debtor;

e. a body corporate which is a holding, subsidiary or an associate company of the corporate debtor, or a subsidiary of a holding company to which the corporate debtor is a subsidiary;

f. any person who controls the composition of the board of directors or corresponding governing body of the Corporate Debtor;

g. any person who controls more than 20% of voting rights in the corporate debtor on account of ownership or a voting agreement;

h. any person in whom the Corporate Debtor controls more than 20% of voting rights on account of ownership or a voting agreement; and

i. any person who is associated with the Corporate Debtor on account of- (i) participation in policy making processes of the Corporate Debtor; or (ii) having more than 2 (two) directors in common between the Corporate Debtor and such person; or (iii) interchange of managerial

2. Section 5(24) of the IBC

personnel between the Corporate Debtor and such person; or (iv) provision of essential technical information to, or from, the Corporate Debtor.

Avoidance Transactions and Related Parties

One of the duties of a Resolution Professional (RP)/Liquidator (as the case may be) is to examine and identify if any transactions have been undertaken by the Corporate Debtor which qualify as preferential transaction, undervalued transaction, extortionate credit transactions or transactions with the intent of defrauding creditors or for any fraudulent purpose (together **"Avoidance Transactions"**). If the RP/liquidator is of the opinion that any Avoidance Transaction has occurred, then she is obligated to report the same to the Adjudicating Authority for necessary directions[3]. If the impugned transactions are adjudged to be an Avoidable Transaction, then the Adjudicating Authority may, *inter-alia*, issue necessary directions for reversing such transactions and directing the beneficiaries of such transactions to return any property or any beneficial interest back to the Corporate Debtor. Certain categories of Avoidance Transactions are particularly relevant in the context of related parties owing to the longer "lookback period".

The UNCITRAL Legislative Guide on Insolvency Law (**"UNCITRAL Guide"**) also acknowledges examining transactions entered into by a Corporate Debtor with its related parties with greater scrutiny from the perspective of identifying avoidance transactions[4]. The Legislative Guide also recommends longer lookback period for transactions entered into with related parties vis-à-vis identifying and addressing avoidance transactions[5].

Lookback Period and Related Parties

Under the scheme of the IBC, for a transaction to be considered an Avoidance Transaction, the transaction (except undervalued transactions undertaken deliberately for keeping assets of the Corporate Debtor beyond the reach of its claimants[6], and transactions committed with the intent to defraud creditors or for any fraudulent purpose[7]) is required to have occurred within a specified time period prior to/looking back from the date of commencement of CIRP of the Corporate Debtor (**"Lookback Period"**). Since, the inception of the IBC, there has been a general consensus that the Lookback Period is required to be longer for related parties compared to unrelated parties. The Bankruptcy Law Reforms Committee, in Volume I of its Report dated 4 November 2015 expressly observed that *"….There should be stricter scrutiny for transactions of fraudulent preference or transfer to related parties, for which the "look back period" should be specified in regulations to be longer[8]"*.

The determination of whether a transaction is an Avoidance Transaction is a mixed

3. Regulation 35A of the Insolvency and Bankruptcy Board of India (Insolvency Resolution for Corporate Persons) Regulations, 2016
4. UNCITRAL Legislative Guide on Insolvency Law, Paragraphs 182-184, p.146, 2005
5. UNCITRAL Legislative Guide on Insolvency Law, Paragraphs 182-184, p.146, 2005
6. Under Section 49 of the IBC
7. Under Section 66 of the IBC
8. Bankruptcy Law Reforms Committee, The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, Paragraph 5.5.7, Page 101 (November, 2015)

question of fact and law, and each transaction is required to be examined on a case to case basis. Although Avoidance Transactions can be undertaken with related or unrelated parties, it is interesting to note that a significant number of cases before Courts/Tribunals for determination of Avoidance Transactions are related party transactions.

We will now analyse each of the Avoidance Transactions envisaged under the IBC with a focus on related parties.

Preferential Transactions

Preferential Transactions are essentially transactions where *"an insolvent debtor makes a transfer to or for the benefit of a creditor so that such beneficiary would receive more than what it would have otherwise received through the distribution of bankruptcy estate*[9]*."*

The use of the term "preference" here is to denote the act of *'paying or securing to one or more of his creditors, by an insolvent debtor, the whole or part of their claims, to the exclusion of the rest"*[10]. As far back as the 15th century, the principles relating to avoidance of certain preferences have evolved, particularly in mercantile laws and insolvency/bankruptcy laws[11]. In fact, since 1874, almost all jurisdictions across the world have incorporated provisions for identifying and avoiding preferential transactions into their bankruptcy/insolvency laws[12]. The UNCITRAL Guide defines "preferential transaction" as *"a transaction which results in a creditor obtaining an advantage or irregular payment"*[13].

In India, the legal position pertaining to the identification and avoidance of preferential transactions under IBC are set out in Sections 43 and 44 of the IBC. Under Section 43 of the IBC, a transaction entered into by the Corporate Debtor is said to be a preferential transaction if the following ingredients are satisfied:

a. there is a transfer of property or an interest thereof of the Corporate Debtor for the benefit of a creditor or a surety or a guarantor for or on account of an antecedent financial or operational debt or other liabilities owed by the Corporate Debtor[14]; ***and***

b. the said transfer has the effect of putting such creditor or surety or guarantor in a beneficial position than it would have been in the event of a distribution of assets being made in accordance with section 53 of the IBC[15]; ***and***

c. such transaction does not fall under any of the below mentioned exceptions[16]:

   - the transfer was made in the ordinary course of business or financial affairs of the Corporate Debtor or the transferee; ***and***

9. *Anuj Jain, Interim Resolution Professional for Jaypee Infratech Limited vs. Axis Bank Limited Etc. Etc. CIVIL APPEAL NOS. 8512-8527 OF 2019*
10. *Anuj Jain, Interim Resolution Professional for Jaypee Infratech Limited vs. Axis Bank Limited Etc. Etc. CIVIL APPEAL NOS. 8512-8527 OF 2019*
11. Supra Note 9
12. Supra Note 9
13. Supra Note 4 at Paragraph 12(ff), p. 6
14. Section 43(2)(a) of the IBC
15. Section 43(2)(b) of the IBC
16. Section 43(3) of the IBC

- such transfer creates a security interest in property acquired by the Corporate Debtor to the extent that it : (a) secures new value and was given at the time of or after the signing of a security agreement that contains a description of such property as security interest, and was used by corporate debtor to acquire such property; and (b) such transfer was registered with an information utility on or before thirty days after the corporate debtor receives possession of such property.

The Supreme Court of India (**"Supreme Court"**) in the matter of ***Anuj Jain Interim Resolution Professional For Jaypee Infratech Limited vs. Axis Bank Limited Etc.***[17] has laid down the key principles for identifying preferential transactions as follows:

a. The Supreme Court distinguished Section 43 of the IBC from Sections 328[18] and 329[19] of the Companies Act, 2013 and observed that if the ingredients of Section 43 of the IBC (as set out above) are satisfied, then the transaction is deemed to be a preferential transaction, notwithstanding the intent of the parties;

b. The bare text of Section 43(3)(a) of the IBC stipulates that a transaction is exempt from being treated as a preferential transaction if it was carried out in the ordinary course of business or financial affairs of the Corporate Debtor **or** the transferee. However, the Supreme Court observed that a purposive interpretation of Section 43 demands that the phrase *"Corporate Debtor **or** transferee"* should be interpreted as *"Corporate Debtor **and** transferee"*. In other words, the Supreme Court observed that for a transaction not to be considered as a "preferential transaction" such transaction is required to have been undertaken in the "ordinary course of business" or "financial affairs" not only of the transferee but also of the Corporate Debtor;

c. The phrases "ordinary course of business" and "financial affairs" are not

17. Civil Appeal Nos. 8512-8527 Of 2019..

18. Section 328 of the Companies Act, 2013 reads as under:

"(1) Where a company has given preference to a person who is one of the creditors of the company or a surety or guarantor for any of the debts or other liabilities of the company, and the company does anything or suffers anything done which has the effect of putting that person into a position which, in the event of the company going into liquidation, will be better than the position he would have been in if that thing had not been done prior to six months of making winding up application, the Tribunal, if satisfied that, such transaction is a fraudulent preference may order as it may think fit for restoring the position to what it would have been if the company had not given that preference.

(2) If the Tribunal is satisfied that there is a preference transfer of property, movable or immovable, or any delivery of goods, payment, execution made, taken or done by or against a company within six months before making winding up application, the Tribunal may order as it may think fit and may declare such transaction invalid and restore the position."

19. Section 329 of the Companies Act, 2013 reads

"Any transfer of property, movable or immovable, or any delivery of goods, made by a company, not being a transfer or delivery made in the ordinary course of its business or in favour of a purchaser or encumbrancer in good faith and for valuable consideration, if made within a period of one year before the presentation of a petition for winding up by the Tribunal under this Act shall be void against the Company Liquidator."

defined in the IBC. The Supreme Court has applied the interpretation of the High Court of Australia in the matter of ***Downs Distributing Co Pty Ltd vs. Associated Blue Star Stores Pty Ltd (in liq)***[20] where it was held that "ordinary course of business" means *"that the transaction must fall into place as part of the undistinguished common flow of business done, that it should form part of the ordinary course of business as carried on, calling for no remark and arising out of no special or particular situation."* However, it is relevant to note that the Supreme Court did not interpret the meaning of the phrase "financial affairs" for the purpose of Section 43 of the IBC;

d. For determining whether an alleged transaction entered into by a Corporate Debtor with its related party was conducted in the "ordinary course of business" of the Corporate Debtor, the Supreme Court analysed the unique nature of the relationship between the Corporate Debtor and its related party. For instance, the Supreme Court *inter-alia* observed that the Corporate Debtor (being a special purpose vehicle) mortgaging its assets to secure the borrowings of its parent company cannot be construed to be in the ordinary course of business of such corporate debtor;

While the Lookback Period for examining Preferential Transactions is 1 (one) year from the date of commencement of CIRP of the Corporate Debtor (**"ICD"**) in relation to transactions entered into with unrelated parties, it is 2 (two) years from the ICD in relation to transactions entered into with Related Parties[21].

Given the uniquely influential position of a related party to undertake a preferential transaction, even at the initial stages of the IBC's development it was considered that *"a longer Lookback Period for transactions entered into with Related Parties is necessary for avoiding preferential transactions as a number of transactions diminishing creditor wealth entered into with Related Parties occur not only in the 'zone of insolvency' but as soon as early signals of trouble are visible. It further provides that Related Parties often have superior information of the Corporate Debtor's financial affairs and may collude with the corporate debtor to siphon off assets with the knowledge that the corporate debtor may become insolvent in the near future."*

In the event a transaction is adjudged to be a preferential transaction by the adjudicating authority under the IBC (i.e. the National Company Law Tribunal), it may inter-alia pass the following orders[22]:

a. require any property transferred in connection with the giving of the preference to be vested in the Corporate Debtor;

b. require any property to be so vested if it represents the application either of the proceeds of sale of property so transferred or of money so transferred;

20. (1948) 76 CLR 463

21. Section 43(4) of the IBC

22. Section 44(1) of the IBC

c. release or discharge (in whole or in part) of any security interest created by the corporate debtor;

d. require any person to pay such sums in respect of benefits received by him from the Corporate Debtor, such sums to the liquidator or the resolution professional, as the Adjudicating Authority may direct;

e. direct any guarantor, whose financial debts or operational debts owed to any person were released or discharged (in whole or in part) by the giving of the preference, to be under such new or revived financial debts or operational debts to that person as the Adjudicating Authority deems appropriate; and

f. direct for providing security or charge on any property for the discharge of any financial debt or operational debt under the order, and such security or charge to have the same priority as a security or charge released or discharged wholly or in part by the giving of the preference.

However, it is relevant to note that the under the IBC, the order passed by the Adjudicating Authority in relation to a preferential transaction does not[23]:

a. affect any interest in property which was acquired from a person other than the corporate debtor or any interest derived from such interest and *was acquired in good faith and for value*;

b. require a person, who received a benefit from the preferential transaction in good faith and for value to pay a sum to the liquidator or the resolution professional.

Undervalued Transactions

The UNCITRAL Guide defines "undervalued transactions" as "Transactions where the value received by the debtor as the result of the transaction with a third party was either nominal or non-existent, such as a gift, or much lower than the true value or market price, provided the transaction occurred within the suspect period[24]."

These transactions may be entered into by the Corporate Debtor either with a mala fide intention of causing wrongful gain to its related parties at the expense of its other stakeholders; or alternatively, in a situation wherein a Corporate Debtor who is in need of cash may sell assets quickly at a price significantly below the real value in order to achieve a quick result, without ever having any intention to defeat or delay creditors. However, in either of these cases, the net result, however, may be a clear reduction of the assets available to creditors in insolvency[25].

Under the IBC, a transaction is considered to be an "undervalued transaction" if the Corporate Debtor[26]:

a. makes a gift to a person; or

b. enters into a transaction with a person which involves the transfer of one or

23. First proviso to Section 44(1) of the IBC
24. Supra Note 4 at Paragraphs 174-176, p. 143 (2005)
25. Supra Note 4 at Paragraphs 174-176, p. 143 (2005)
26. Section 45(2) of the IBC read with *Dipti Mehta, Resolution Professional, Prag Distillery Private Limited vs. Shivani Amit Dhanukar MA 267 of 2018 In CP (I&B) 1067/NCLT/MB/2017*

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,

c. such transaction has not taken place in the ordinary course of business of the corporate debtor.

The National Company Law Tribunal, Allahabad Bench has held in the matter of ***IDBI Bank vs. Jaypee Infratech Ltd***[27] that a transaction can be said to be an undervalued transaction, if the consideration for entering into the transaction was significantly lower than what it would have otherwise been had it been entered at an arm's length basis.

It is relevant to note that like in preferential transactions, a transaction is exempt from being treated as an "undervalued transaction" if such transaction was carried out in the ordinary course of business of the Corporate Debtor[28].

If the Adjudicating Authority adjudges that a transaction is an undervalued transaction, then it may pass an order directing the following[29]:

a. restoring the position as it existed before such transactions and reversing the effects of such transaction thereof; and

b. requiring the Insolvency and Bankruptcy Board of India to initiate disciplinary proceedings against the liquidator or the resolution professional as the case may be.

Further, similar to preferential transactions, the Lookback Period for examining undervalued transactions is 1(one) year from ICD in relation to transactions entered into with unrelated parties, and 2(two) years for transactions with related parties[30]. The rationale for a longer Lookback period for related parties is that the *"management of the Corporate Debtor which has better knowledge of the Corporate Debtor's financial affairs may enter into transactions with related parties to strip the corporate debtor of value upon receiving early signals of financial trouble[31]."*

Undervalued transactions to defraud creditors

Under the IBC, an undervalued transaction in terms of Section 45 (2) of the IBC is the one with the intention of keeping 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 interests of such person is treated differently[32].

If the undervalued transaction has taken place in terms of Section of the IBC as stated above, the Adjudicating Authority can pass an order to:

a. restore the position as it existed before such transaction was entered into; and

b. protect the interests of the persons who are victims of such transactions.

However, the orders passed by the Adjudicating Authority shall not:

27. C.A No. 26/2018 in Company Petition No. (IB) 77/ALD/2017

28. *Dipti Mehta, Resolution Professional, Prag Distillery Private Limited vs. Shivani Amit Dhanukar MA 267 of 2018 In CP (I&B) 1067/NCLT/MB/2017*

29. Section 47(2) of the IBC

30. Section 46 of the IBC

31. Notes Clause 46 of the Insolvency and Bankruptcy Bill, 2015

32. Section 49 of the IBC

a. affect any interest in property which was acquired from a person other than the corporate debtor or any interest derived from such interest and *was acquired in good faith and for value*; and

b. require a person, who received a benefit from the undervalued transaction in good faith and for value to pay a sum to the liquidator or the resolution professional.

In the case of undervalued transactions within the meaning of Section 49 of the IBC, there is no Lookback Period for determining whether such transactions have taken place, and the RP/liquidator is required to

Extortionate Credit Transactions

A transaction would be considered as an "extortionate credit transaction" if the following conditions are satisfied[33]:

c. such contracts require the Corporate Debtor to make exorbitant payments in respect of the credit provided; or

d. are unconscionable under the principles of law relating to contracts.

In the event the Corporate Debtor has entered into such a transaction, the liquidator or the RP as the case may be, may make an application for avoidance of such transaction to the Adjudicating Authority if the terms of such transaction required exorbitant payments to be made by the Corporate Debtor. It is relevant to note that unlike in the case of preferential transactions or undervalued transactions, the Lookback Period is 2 (two) years, regardless of whether the counter-party is a related party or unrelated party.

Wrongful Trading/Fraudulent Trading

A transaction can be termed as wrongful trading/fraudulent trading if during the CIRP or a liquidation process it is found that any business of the Corporate Debtor has been carried on with intent to defraud creditors of the Corporate Debtor or for any fraudulent purpose.

If the Adjudicating Authority adjudges a transaction to be wrongful trading/fraudulent trading, then it may pass an order that any persons who were knowingly parties to the carrying on of the business in such manner shall be liable to make such contributions to the assets of the Corporate Debtor as it may deem fit[34].

As to whether a transaction can be considered as "fraudulent trading" or "wrongful trading" depends on the facts and circumstances of each case, and is a subjective assessment of whether it can be demonstrated that the transaction was entered into in order to defraud the creditors of the Corporate Debtor[35].

In the case of transactions under Section 66 of the IBC there is no Lookback Period for identifying transactions which could be considered wrongful trading/fraudulent trading. However, given that the nature of the transaction, it typically only persons in the management of the Corporate Debtor who could orchestrate a transaction to defraud creditors.

33. Section 50(1) read with Regulation 5 of the CIRP Regulations and Section 45(2) of the IBC read with *Dipti Mehta, Resolution Professional, Prag Distillery Private Limited vs. Shivani Amit Dhanukar MA 267 of 2018 In CP (I&B) 1067/NCLT/MB/2017*

34. Section 66(1) of the IBC

35. *IDBI Bank Limited vs. Jaypee Infratech Limited CA No. 26/2018 in Company Petition No. (1B)77/ALD/2017*

Therefore, in case the Adjudicating Authority determines that a transaction has taken place within the meaning of Section 66 of the IBC, it may direct that a director or partner of the corporate debtor (who qualify as the Related Parties of such Corporate Debtor), shall be liable to make such contribution to the assets of the Corporate Debtor as it may deem fit, if:

a. before the ICD, such director or partner knew or ought to have known that the there was no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process in respect of such corporate debtor; and

b. such director or partner did not exercise due diligence in minimising the potential loss to the creditors of the corporate debtor.

If the Adjudicating Authority adjudges a transaction as a fraudulent transaction then it may inter-alia direct that the liability of any person found guilty of committing wrongful trading/fraudulent trading to be a charge on any debt or obligation due from the Corporate Debtor to him, or on any mortgage or charge or any interest in a mortgage or charge on assets of the Corporate Debtor held by or vested in him[36]. Additionally, if the Adjudicating Authority has passed an order in relation to a person who is a creditor of the Corporate Debtor, it may, direct that the whole or any part of any debt owed by the Corporate Debtor to that person and any interest thereon shall rank in the order of priority of payment under Section 53 after all other debts owed by the Corporate Debtor[37].

Conclusion

The threat of related parties diluting the value of the Corporate Debtor, whether during the lookback period of 2 years prior to the insolvency commencement date, during the CIRP or even through payments and benefits under a resolution plan is sufficiently guarded against by a host of safeguards under the IBC. The robust framework for identifying avoidance transactions entered into with related parties and provisions to protect the interests of stakeholders of a Corporate Debtor is at the very heart of achieving one of the most important objectives of IBC - the resolution of insolvency while also ensuring maximisation of the value, preservation of the assets of the Corporate Debtor and safeguarding the interests of all stakeholders of the Corporate Debtor.

36. Section 67(1)(a) of the IBC
37. Section 67(2) of the IBC.

Each one has to find his peace from within. And peace to be real must be unaffected by outside circumstances.

Mahatma Gandhi