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MORTGAGE OFFERED BY SUBSIDIARY UNDER INSOLVENCY TO SECURE PARENT COMPANY'S DEBT- A PREFERENTIAL TRANSACTION: SUPREME COURT

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In yet another landmark decision in relation to the corporate insolvency resolution process (CIRP) of Jaypee Infratech Limited (JIL), the Supreme Court in *Anuj Jain, Interim Resolution Professional for Jaypee Infratech Limited vs. Axis Bank Limited Etc. Etc. (Civil Appeal Nos. 8512-8527 of 2019)* dated 26.02.2020, has laid down the law on two aspects:

- the essential elements of a preferential transaction under Section 43 of the Insolvency and Bankruptcy Code 2016 (Code); and
- whether a mortgagee of property belonging to the corporate debtor but securing third party debt would be a 'financial creditor' of the corporate debtor under the Code.

Background

JIL had mortgaged 858 acres of land parcels as collateral to secure debt owed by its holding company – Jaiprakash Associates Limited (JAL) to various lenders (mortgage transactions). Consequently, during the CIRP of JIL, its Interim Resolution Professional (IRP) filed an application seeking avoidance of these mortgage transactions as preferential, undervalued and fraudulent transactions under Sections 43, 45, 49 and 66 of the Code before the National Company Law Tribunal, Allahabad (NCLT).

NCLT, by its order of 16.05.2018 held six (6) transactions to be preferential, undervalued and fraudulent, and permitted their avoidance. NCLT opined that – (i) the mortgage transactions were undertaken by JIL in favour of the lenders of JAL without any consideration or counter-guarantee, which rendered them undervalued transactions; (ii) they were not carried out in ordinary course of business; (iii) the mortgage transactions were vitiated by lack of consent of lenders of JIL which itself was under financial distress at the time of the said transactions; and (iv) the said transactions put JIL, one of the creditors of JAL in a more beneficial position than it would have been in the event of distribution of assets of JIL in a liquidation scenario as per Section 53 of the Code. By way of subsequent orders dated 09.05.2018 and 15.05.2018, NCLT also upheld decisions of the Resolution Professional of JIL (RP) rejecting claims of creditors of JAL to be recognised as financial creditors of JIL on the basis of these mortgage transactions.

The National Company Law Appellate Tribunal (NCLAT) in its decision dated 01.08.2019 in an appeal preferred by the lenders of JAL, set aside the order of NCLT, and held that – (i) the provisions pertaining to preferential transactions do not apply to these

mortgage transactions as the mortgages were not created in respect of antecedent liabilities of JIL as a result of which Section 43(2)(a) of the Code would not apply; and (ii) the mortgage transactions were undertaken in the ordinary course of business.

Appeals were therefore filed before Supreme Court against the decision of NCLAT by the RP, financial creditors of JIL and homebuyers of JIL.

Essential Elements of a Preferential Transaction

The Supreme Court, after carrying out an extensive analysis of Section 43(2) and (4) of the Code held that in the event the following conditions are met, a transaction is deemed to be a preferential transaction:

- the transaction is of transfer of property or interest of the corporate debtor, for the benefit of a creditor or surety or guarantor, for or on account of an antecedent financial debt or operational debt or other liability;

- such 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 distribution of assets in accordance with Section 53 of the Code; and

- such transaction has been carried out during the period of two years preceding the CIRP commencement when the beneficiary is a related party (other than an employee), or in case of an unrelated party, during the period of one year preceding the CIRP.

However, preferential transactions satisfying the above conditions are permissible if: (i) entered into during the ordinary course of business of the corporate debtor 'and' transferee; or (ii) resulting in provision of new value to the corporate debtor.

The Supreme Court has clarified that when analysing preferential transactions under the Code, intent of the parties for ascertaining fraudulent transactions is immaterial.

Factual adjudication of the mortgage transactions

In view of the above, on scrutinising the nature of transactions of JIL in favour of the lenders of JAL, it was held as under:

- While there was no direct creditor-debtor relationship between JIL and the lenders of JAL, however, JAL was the ultimate beneficiary of the said transactions, as these mortgage transactions created security interest which benefitted JAL.

- JAL had admitted to providing financial, technical and strategic support to JIL and was owed operational debt, therefore JIL owed antecedent financial debts as also operational debts and other liabilities to JAL.

- Considering that JAL was an operational creditor of JIL, it would have stood much lower in priority in case JIL went into liquidation. Thus, the said transactions put JAL in an advantageous position in relation to other creditors.

- Since JAL was a related party of JIL, the relevant look-back period would be a period of two (2) years and the mortgage transactions did in fact take place in this period.

- The mortgage transaction was not carried out in the ordinary course of business, as at the relevant time JIL was under tremendous financial stress and therefore could not have been providing mortgages to secure finances of its holding company.

Thus, the Supreme Court, while overturning NCLATs order held the mortgage transactions on grounds of being preferential transactions without considering it necessary to deal with the potentially fraudulent and undervalued nature of these transactions.

Status of mortgagees of assets of JIL pertaining to debts of JAL

Considering the mortgage transactions were held to be preferential and hence avoided, the lenders of JAL could in no case be financial creditors of JIL. The Supreme Court elaborated the position of such mortgagees in respect of their claim to be financial creditors of JIL should the avoidance allegations have failed.

The Supreme Court clarified that for any debt to be 'financial debt' under the Code, it ought to satisfy the condition of being disbursed against the consideration for time value of money and by any mode of disbursal prescribed for a financial debt under the Code. Since mortgages are not expressly covered under the said definition, the same cannot be viewed as financial debt.

The Court highlighted an interesting distinction between a person having 'security interest' and a financial creditor. The Court held that for a person to be a 'financial creditor' it needs to be shown that the corporate debtor owes a financial debt to such person. The Court further held that while every 'secured creditor' and every 'financial creditor' is a 'creditor', every 'secured creditor' may not be a 'financial creditor' for the purposes of the Code.

The Supreme Court has also analysed the unique position that is enjoyed by financial creditors whose *'stakes are intrinsically inter-woven with the well being of the corporate debtor'* and held that in view of the objective of the Code, a person having only a security interest in the corporate debtor, or as in the present case mortgagees, can easily be contrasted with a financial creditor as the former shall only have interest in realising the value of its security rather than simultaneously looking for revival of the corporate debtor. Thus, the Supreme Court held that persons who are mortgagees securing debts of third parties would not be 'financial creditors' under the Code. In light of this discussion, the Supreme Court held that though the lenders of JAL are secured creditors, they are not financial creditors of JIL.

Comment

While the Supreme Court has recognised the various forms of 'financial debt' as set out in the Code, it has excluded mortgages on the premise that they are not expressly covered under the definition of 'financial debt' under the Code. This, despite the Court recognising that the definition of 'financial debt' is not exhaustive. Curiously, the status of such mortgagees has not been clarified except for stating that they will not be 'financial creditors'. For eg, is the only impact that such mortgage debt lender will not get to participate in the committee of creditors of JIL? The decision should also not render third-party security holders as being in a different (or lesser) class than those secured creditors who have directly disbursed to JIL.

While in the short term there will be some uncertainty as to whether guarantees are also similarly hit by this judgment, it is hoped that this judgment is only viewed as applying to mortgages and not extending to guarantees since they are expressly included in the definition of 'financial debt' under the Code.

Furthermore, an argument was raised before the Court that these mortgage transactions were effectively also guarantees since the tri-partite mortgage deed contained a 'covenant to pay' clause. It would have been helpful if the Court had clarified why it rejected this argument, for eg, was this 'covenant to pay' clause restricted to the value of security mortgaged?

While interpreting the scope of preferential transactions, the Court appears to have disregarded the fact that Section 43 requires the transfer (in this case, mortgage) to be 'for or on account of an antecedent' debt. The mortgage transactions did not secure any antecedent debt owed by JIL to JAL, but instead to lenders of JAL. It begs the question: (i) whether the outcome would have been different if JIL did not owe any debt to JAL; and (ii) should the 'look back period' be one (1) year since the persons preferred (i.e. JAL lenders) are not related to JIL? It would have been helpful if the Court had also analysed whether the mortgage transactions were undervalued transactions, a potentially easier fit in the facts of this case.

Further, the interpretation advanced in this decision would also imply that other third-party securities in the nature of pledge and hypothecation, which are also terms that have not been included in the definition of 'financial debt' would not constitute 'financial debt' in relation to a corporate debtor. This could have far reaching implications for credit backed by such securities.

These are careful considerations for any third-party security backed credit transactions.

- *Prateek Kumar (Partner), Ashwin Bishnoi (Partner) and Raveena Rai (Senior Associate)*

For any queries please contact: editors@khaitanco.com

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Mumbai
One Indiabulls Centre, 13th Floor
Tower 1 841, Senapati Bapat Marg
Mumbai 400 013, India

T: +91 22 6636 5000
E: mumbai@khaitanco.com

New Delhi
Ashoka Estate, 12th Floor
24 Barakhamba Road
New Delhi 110 001, India

T: +91 11 4151 5454
E: delhi@khaitanco.com

Bengaluru
Simal, 2nd Floor
7/1, Ulsoor Road
Bengaluru 560 042, India

T: +91 80 4339 7000
E: bengaluru@khaitanco.com

Kolkata
Emerald House
1 B Old Post Office Street
Kolkata 700 001, India

T: +91 33 2248 7000
E: kolkata@khaitanco.com