EXPLORING AVOIDANCE TRANSACTIONS WITHIN CORPORATE INSOLVENCY PROCEEDINGS UNDER THE IBC, 2016

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ABSTRACT

Avoidance Transactions, also referred to as Vulnerable Transactions, represent a specific subset of restricted transactions that Debtors are prohibited from engaging in under the provisions of insolvency laws. The Insolvency and Bankruptcy Code of 2016, which serves as a comprehensive framework for insolvency and bankruptcy law in India, identifies four primary types of avoidance transactions: preferential, undervalued, fraudulent, and extortionate transactions, collectively known as "PUFE Transactions". While previous legislations addressing insolvency law have addressed one or more of these PUFE transactions, they have done so with variations in approach.

To delve into the evolution of these transactions within Indian insolvency jurisprudence and their significance in the current Insolvency and Bankruptcy Code of 2016, this article will provide a concise overview of each avoidance transaction type, along with insights into the roles played by key stakeholders in this domain. Furthermore, it will underscore the necessity for a comprehensive system to address the shortcomings and loopholes in the existing mechanism, proposing potential changes for more effective implementation aligned with the objectives of the IBC, 2016.

Keywords: Insolvency, Avoidable transaction, CIRP, IBC, Preferential Transactions.

Introduction

The inception of legislation addressing avoidable transactions within the Indian Insolvency framework dates back to the Presidency Towns Insolvency Act of 1909[1] and the Provincial Insolvency Act, 1920.[2] Subsequently, the incorporation of avoidable transaction provisions extended to the winding up of companies, notably through Sections 529A to 542 of the Companies Act 1956 and Sections 326 to 339 of the Companies Act 2013. However, a significant paradigm shift occurred with the introduction of the Insolvency and Bankruptcy Code, 2016 (IBC, 2016). Sections 43 to 51 and 66 of the IBC were implemented to specifically address avoidance transactions, leading to the repeal of the aforementioned acts from 1909 and 1920. Concurrently, the provisions of the Companies Acts, 2013 were to be read in conjunction with the IBC, 2016.

To discern the nature of avoidance transactions, namely Preferential, Undervalued, Fraudulent, and Extortionate, understanding the underlying criteria or factors is imperative. These criteria, either explicitly outlined in the Code or derived from judicial precedents, encompass concepts such as the 'relevant time period' (also known as the "look back period" or "twilight period"), 'bonafide transaction/good faith', 'ordinary course of business', 'financial affairs of the debtor', and 'creation of new value'. Conversely, comprehending the legislative approach to avoidance transactions necessitates delving into the regulatory structure, guidelines, implementation modalities, and, notably, the powers and responsibilities vested in key stakeholders. These stakeholders include the resolution professional, managerial personnel of the corporate debtors, creditors, and the Adjudicating Authority/Courts.

Therefore, this article seeks to elucidate these concepts by examining the perspectives of authorities/courts, incorporating diverse scholarly opinions, and referencing committee reports. Through this exploration, we aim to underscore the evolution of the concept of avoidable transactions and its paramount significance within the framework of the IBC, 2016.

I. Avoidance Transactions in IBC

The Insolvency and Bankruptcy Code of 2016 delineates four distinct categories of transactions known as Avoidance Transactions, each carrying its own significance within the legal framework:

[1] Presidency towns Insolvency Act, 1909, § 55,56 & 57, No. 3, Acts of Parliament, 1909 (India).
[2] Provincial Insolvency Act, 1920, § 53,54 & 55, No. 5, Acts of Parliament, 1920 (India).

1. Preferential transactions, as outlined in section 43 of the IBC, 2016.
2. Undervalued transactions, as stipulated in section 45 of the IBC, 2016.
3. Fraudulent transactions, as delineated under section 49 of the IBC, 2016.
4. Extortionate transactions, as defined within section 50 of the IBC, 2016.

These classifications serve to identify and address specific types of transactions that may have occurred prior to insolvency, highlighting their importance in the resolution process.

II. Examination and Parameters of Avoidance Transactions

A. Understanding Preferential Transactions

In the context of Insolvency and Bankruptcy Code (IBC), 2016, Section 43 delves into Preferential Transactions, encompassing corporate debtor activities during the 'relevant period' preceding the initiation of Corporate Insolvency Resolution Process (CIRP) or liquidation proceedings.

The term 'preferential' signifies the legislation's intention to regulate transactions providing undue advantage to a creditor, encompassing liability, whether antecedent or operational. This aims to prevent these creditors from gaining an advantage over others in the 'waterfall mechanism' outlined in Section 53 of the IBC, 2016.[3]

Key terms such as 'transaction,' 'transfer,' and 'transfer of property' are defined in Section 3, subsections 33, 34, and 35 of the IBC, 2016, respectively. These definitions establish the scope of transactions falling under avoidable categories.

Crucially, for a transaction to be classified as preferential, it must have been undertaken by the corporate debtor within the 'relevant time period' or 'look-back period.' Section 43 establishes two distinct timelines: a 2-year period before CIRP initiation for related parties[4] and a 1-year period for all other parties before the commencement of the resolution process. This temporal distinction is justified by the likelihood of related parties possessing advanced knowledge of the corporate debtor's financial affairs, potentially colluding to divert assets before insolvency.

Notably, the burden of proof that a transaction is not preferential lies with the recipient of the transfer. While the legislation doesn't explicitly provide a rationale for the extended time period

[3] Insolvency and Bankruptcy Code, 2016, §53, No. 31, Acts of Parliament, 2016 (India)
[4] Insolvency and Bankruptcy Code, 2016, §5(24), No. 31, Acts of Parliament, 2016 (India).

for related parties, the suspicion of collusion due to superior information justifies this distinction.

However, Section 43(3) provides exemptions for transactions undertaken in the 'ordinary course of businesses,' those linked to the 'financial affairs of the corporate debtor,' transfers that 'create/secure new value,' or transfers registered with an information utility. These exemptions, rooted in the commercial doctrine of good faith, are discussed in detail later in this article.

When all conditions defining a preferential transaction are met, and no exceptions apply, the resolution professional/liquidator is mandated to file an application under Section 44 of the IBC, 2016. This initiates the Adjudicating Authority's assessment of the avoidance of such preferential transactions.

B. Undervalued transaction

In accordance with the IBC, 2016, Sections 45 and 46, should the resolution professional/liquidator determine that the corporate debtor engaged in transactions during the 'relevant time,' they have the authority to submit an application to the Adjudicating Authority, seeking to declare the transaction as a 'void transaction' and reverse its consequences.

If, upon scrutinizing the corporate debtor's books of accounts, any transaction involving the gift or sale of an asset is found to have been undervalued significantly compared to the amount initially paid by the corporate debtor, such a transaction is considered undervalued, unless it falls within the scope of the 'ordinary course of business.'

The determination of undervalued transactions follows the same timeframe as preferential transactions. For related parties, this timeframe is set at 2 years, while for all other parties, it is 1 year, both measured from the initiation of the Corporate Insolvency Resolution Process (CIRP).

The primary aim of this provision is to curb the diversion of corporate assets by the management of the corporate debtor, especially when they possess knowledge of the company's precarious financial condition. Such transactions, occurring in the proximity of insolvency, are intended to be prevented by this regulatory framework.

C. Fraudulent Transactions Exemption

Section 49 within the IBC 2016 serves as an extension of Section 45, focusing on transactions that deliberately defraud creditors by undervaluing assets. The corporate debtor, in executing such transactions, aims to deprive creditors and other potential claimants of their rights, adversely impacting their claims.

This provision grants the Adjudicating authority the power to issue orders that nullify the contested transaction, restoring the previous state of affairs to safeguard the interests of those affected. However, third parties can escape the implications of this section if they can demonstrate that their involvement in the transactions was in good faith, for valuable consideration, and that they were unaware of pertinent circumstances.

Conversely, directors or partners of the implicated debtor can be exempted from the IBC 2016 if they can establish due diligence in mitigating loss for the corporate debtor's creditors or prove their lack of awareness regarding the anticipated insolvency proceedings of the corporate debtor.

D. Extortionate credit transactions

The IBC, 2016, introduces Section 50 to address excessively high payments made by corporate debtors to lenders due to loans or credit agreements. This provision encompasses all transactions conducted by the corporate debtor.

Within a span of two years before the initiation of CIRP, the RP/liquidator must scrutinize credit facilities to determine if the corporate debtor has engaged in transactions involving exorbitant interest rates or agreements that are prima facie unfair. Upon discovering such a transaction or receiving information about it, the RP/liquidator is obligated to apply to the court for the annulment or modification of said transaction.

In contrast to other avoidable transactions, the burden of proof lies with the creditor to demonstrate that the transaction was not extortionate or unfair. However, to reverse the transaction, the liquidator/resolution professional must show that the transaction was unfair and extortionate.

If the debt is financed by a regulated financial service provider, it falls under the scope of Section 50 of the IBC, 2016. Notably, the timeframe for avoiding extortionate credit transactions is fixed at two years, with no distinction made based on the relationship between parties.

Notably, under this provision, the RP/liquidator is empowered to enlist the assistance of the corporate debtor's employees to identify transactions where the debtor company was compelled to engage in such dealings.

III. Exclusions, Directives, and Obligations under the Code in the context of Transactions to Avoid

A. Unspecified Exemptions from Transactions Liable to be Avoided as per the Act.

In the course of the aforementioned discourse, it is evident that transactions come with certain exemptions, and if proven, these transactions are not deemed avoidable. However, certain exemptions not explicitly outlined in the Code are subject to diverse interpretations, potentially granting unwarranted advantages to wrongdoers. The subsequent detailed discussion delves into these exceptions:

1. Ordinary Course of Business

As per the language used, the term 'ordinary course of business' encompasses any transaction integral to the routine dealings of the corporate debtor, even within the 'relevant period', "which are either continued, or contemplated to be continued with a profit motive"[5]. Examples include deductions from the corporate debtor's current account by a bank or the sale of flats/properties by a real estate developer to a non-related party. However, if a scenario arises where the corporate debtor, while making a loan payment, favors one party (especially a related party) and neglects to pay another creditor during the ordinary course, it falls under the provisions of Section 43 of IBC, 2016.[6]

2. Creation of New Value through Security Interest

Under this principle, any transaction initiated by the Corporate Debtor that results in a gain of 'something new' or 'of value,' such as the purchase of stock, goods, or the creation of a charge on the company's asset to secure a loan for acquiring a new property, exemplifies 'creation of new value'. To qualify for an exemption under this category, it is crucial that a preliminary examination of the transaction suggests 'value enhancement' or 'strengthening' of the corporate debtor's book/business. Such transactions are then considered exceptions and are not treated as preferential or any other avoidable transaction.

3. Good Faith/Bona Fide Transfer

The defense of good faith/bona fide transfer is applicable to an individual acquiring a property (subject to CIRP/liquidation proceeding) in 'good faith' and 'for a considerable value' from a third party other than the corporate debtor. However, if it can be satisfactorily proven that the

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[5] State of Andhra Pradesh v. Abdul Bakshi & Bros, (1964) STC 644.
[6] Tirumala Balaji Alloys v. Sumit Binani, (2019) SCC OnLine NCLAT 1459.

purchaser was a 'related party' and/or possessed 'sufficient information' about the initiation/commencement of the CIRP proceedings of the corporate debtor, the defense of good faith/bona fide transfer cannot be permitted.

B. Directives and Obligations

1. Role of the Resolution Professional/ Liquidator

The Resolution Professional (RP) assumes a pivotal position with access to the entirety of the corporate debtor's documentation, overseeing the company's operations, and serving as the representative and agent of the debtor. The RP not only manages the affairs of the corporate debtor but also scrutinizes whether the business was conducted unlawfully or with the intent to defraud creditors. Subsequently, the RP is tasked with informing the adjudicating authority of any such wrongdoing by filing an application under Sections 25 2 (j), 43, 45, and 50 of the IBC, 2016. The determination of avoidable transactions or exceptions rests on the factual inquiry conducted by the RP, providing substantial discretion to report these transactions to the Adjudicating authority.

Regulation 35A of CIRP Regulation 2016[7] mandates the RP to form an opinion on the avoidance transaction within the initial 75 days of the CIRP commencement. In cases where the RP perceives an 'avoidance transaction,' a decision must be made by the 115th day of the CIRP and confirmed using Form H annexed to CIRP regulations. However, the recent judgment in Tata Steel BSL Limited v. Venus Recruiter[8] by the High Court of Delhi clarified that these timelines are considered directory, allowing the adjudication of avoidance applications to continue even after the resolution process concludes.

It is important to note that the RP lacks the authority to personally conduct an audit and is obligated to engage independent professionals for this purpose. Furthermore, as no consent from the Committee of Creditors (CoC) is required for a 'transaction audit,' the process cannot be denied.

In contrast, the liquidator is entrusted with investigating the corporate debtor's affairs to identify devalued or preferential transactions. In the event of a reasonable belief in fraud by the corporate debtor or its employees, the liquidator is obligated to file an application to hold these individuals accountable. Consequently, even if the RP believes no avoidance transaction

[7] IBBI (Insolvency resolution process for corporate persons) Regulations, 2016.
[8] Tata Steel BSL Limited v. M/s Venus Recruiters Pvt Ltd. 2023 SCC OnLine Del 155.

occurred, the Code empowers the liquidator to file additional applications for avoidance based on undisclosed matters according to their judgment.

2. The Adjudicating Authority

Section 44 of the Code grants authority to the tribunal to issue corrective directives aimed at neutralizing the impact of preferential transactions. This involves instructing the transfer of the property or its proceeds back to the Corporate Debtor or transferring it to the RP/Liquidator. Additionally, the authority, in accordance with this provision, holds the power to compel the guarantor, who may have disposed of their property during the relevant period, to be accountable for settling the debt.

In the case of undervalued and fraudulent transactions, the Authority is not only authorized to enlist the assistance of experts in determining undervalued transactions but also has the jurisdiction to declare the entire transaction null and void. Subsequently, the Authority can annul the transaction by reinstating the previous status. Similarly, the Authority, under Section 51 of IBC 2016, can take action to restore the prior position by setting aside any extortionate transaction, whether in its entirety or partially.

Furthermore, under Section 48 of IBC 2016, the Authority holds the power to initiate proceedings against the RP/Liquidator on disciplinary grounds for willfully omitting to report any avoidable transaction. In parallel, under Section 49 of the IBC 2016, the Authority is vested with the authority to direct an investigation into any transaction by the police authorities.

However, as emphasized in a recent judgment by the NCLAT in Sahara India v. Shri Nandkishor Vishnupant Deshpande and Anr[9], the Authority cannot independently initiate any of the aforementioned actions. The ruling underscores that the NCLT lacks the authority to autonomously categorize a transaction as a preferential transaction under the provisions of the Insolvency and Bankruptcy Code, 2016.

3. Creditors' Recourse Under Code

Creditors and other entities are granted recourse under Section 47 of the Code, an addition aimed at complementing Section 45 and ensuring oversight over the actions of the liquidator and the resolution professional. This section offers a means for creditors or any concerned party to seek redress from the authority in cases where the resolution professional, despite possessing

[9] Sahara India v. Sh Nandkishor Vishnupant Deshpande and Anr [2021] S.C.C. OnLine NCLAT 875.

ample information and opportunity, neglects to report an undervalued transaction to the adjudicating authority.

IV. Limitations and Gaps in the Current System

While the Tata Steel v Venus Recruiters Private Limited case may have seemingly brought clarity regarding the timeline for adjudicating avoidance applications in relation to the Corporate Insolvency Resolution Process (CIRP), a notable deficiency remains in the absence of a defined timeframe for the resolution of such avoidance applications. This absence could potentially emerge as a significant challenge in the future.

Considering the framework of the Insolvency and Bankruptcy Code and the mandatory timelines established for the completion of CIRP, issues surrounding the lingering of avoidance applications may emerge as a pressing concern. The Anuj Jain judgment sheds light on the ambiguous interpretation of terms like 'ordinary course of business' and 'financial affairs' under Section 43, with courts and authors offering conflicting perspectives. This inconsistency underscores the need for regular court intervention. Despite this, no amendments have been proposed to date to provide clear definitions for these concepts, leaving room for potential misuse of the exceptions.

Additionally, the delays in admitting applications under Sections 7, 9, or 10 of the IBC, 2016, may lead to an ineffective 'relevant period' calculated from the commencement of CIRP. This further emphasizes the need for a comprehensive review of the current mechanisms to address these drawbacks and loopholes in the insolvency resolution process.

V. Potential Resolutions: The Way Forward

To address the challenges highlighted in the Venus judgment, a crucial step forward is proposed by the Insolvency Law Committee's report. This entails a legislative amendment aimed at decoupling the proceedings related to avoidance transactions from the Corporate Insolvency Resolution Process (CIRP). Such a modification would inject greater flexibility into the handling of these transactions, liberating them from the stringent timelines inherent in the CIRP.

Furthermore, the report offers a significant remedy concerning the definition of the "relevant period." It suggests that the initiation date of the CIRP should serve as the threshold date for the lookback period regarding avoidable transactions under the Code. Transactions occurring from the initiation date until the commencement of insolvency should be encompassed within this retrospective analysis.

In addition to legislative adjustments, it is imperative for Resolution Professionals to adopt a purposive and practical approach when scrutinizing transactions and determining the relevant period. Rigid adherence to a literal interpretation not only hampers the scrutiny process but also risks erroneously classifying transactions as exceptions. This approach risks undermining the overarching scheme and objectives of the IBC, 2016.

Lastly, there is a pressing need for comprehensive definitions and robust guidelines to navigate exceptions not explicitly outlined in the Code. Addressing these ambiguities is essential for ensuring the effective implementation of the insolvency framework.

Conclusion

A cursory examination of the provisions in the aforementioned acts suggests that the definition and approach to handling avoidance transactions have, for the most part, remained consistent. However, the subsequent acts have brought about a more nuanced and detailed classification of these transactions. Over time, legislators recognized the need for a more robust framework to identify avoidance transactions. This included the necessity for additional powers and checks on all involved parties to prevent such transactions from escaping the attention of the Adjudicating authority.

Despite ongoing challenges that require legislative attention, it is crucial to acknowledge the proactive efforts of both legislators and the judiciary. They have worked to ensure that the provided mechanism continually evolves to safeguard the interests of creditors and the general public.

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