Article

Discerning the Reach of Avoidance Proceedings:

An analysis of IDBI Limited v. Jaypee Infratech Limited

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In *IDBI Limited v. Jaypee Infratech Limited* [CA No. 26/2018 in CP No. (IB)77/ALD/2017, Order dated 16.05.2018] [1], the National Company Law Tribunal, Allahabad Bench, dealt with a crucial aspect of insolvency proceedings, that is, vulnerable transactions. The resolution professional (RP) of the Corporate Debtor filed application in relation to a *mortgage* of an immovable *property belonging to the Corporate Debtor* to *secure* the *debt of a related party* (that is, the holding company of the Corporate Debtor). The RP sought the following directions, *inter alia*, –

(i) such transaction be declared a "preferential transaction" under section 43 of the Code;
(ii) the lenders in whose favour the security interest was created shall be directed to release such security under section 48(1)(c) [that is, in effect, the RP contended that the transaction was an undervalued transaction too, since section 48 provides for order in case of undervalued transactions]
(iii) such transaction entered into by the promoters/directors of the Corporate Debtor are "fraudulent and wrongful transactions" within the meaning of section 66 of the Code.

In totality, the transaction was alleged to be preferential *plus* undervalued *plus* fraudulent transaction.

Before we discuss details of the ruling, it is important to understand the essential elements of these vulnerable transactions and how they are distinct yet might be connected to each other.

A. Forms of Vulnerable Transactions

The Insolvency and Bankruptcy Code, 2016 ("Code") talks about four forms of vulnerable transactions –

(i) Preferential transactions
(ii) Undervalued transactions
(iii) Transactions defrauding creditors
(iv) Extortionate credit transactions

In view of the context involved, the discussion will be restricted to first three types of vulnerable transactions only.

At the outset, it is relevant to note that the word "transaction" includes a[n] agreement or arrangement in writing for the transfer of assets, or funds, goods or services, from or to the corporate debtor – section 3 (33), and the word "transfer" includes sale, purchase, exchange, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien" – section 3 (34). Therefore, the words "transaction" and "transfer" are omnibus expressions. In

[1] http://ibbi.gov.in/webadmin/pdf/whatsnew/2018/May/IDBI%20BANK%20VS%20JAYPEE%20INFRATECH%20LTD.%20(1).%20(1).compressed_2018-05-17%2023:16:10.pdf

article titled, "*Security Interests as Preferential Transactions*"[2], the author has discussed how and under what circumstances a security interest can/cannot be treated as preferential transaction – the views are reflected in the observations made in *Jaypee Infratech (supra)*.

Let us now see the distinct features of preferential, undervalued and fraudulent transactions.

(i) **Preferential Transactions [section 43] –** The core feature involved is preference to a particular creditor (or a class of creditors). Where the property of the corporate debtor is transferred for the benefit of a creditor/surety/guarantor for or on account of an antecedent debt owed by the corporate debtor, such that the creditor/surety/guarantor is put in a more beneficial position that it would have been in case of distribution of assets under section 53, such transfer may be classified as a preferential transaction. Exception has been provided to a security interest which secured "new value". All these features of preferential transactions have been categorically discussed in the Article named above.

Relevant time, i.e. look-back period in case of preferential transactions is 2 years for related parties and 1 year for unrelated party.

(ii) **Undervalued Transactions [section 45] --** A transaction shall be considered undervalued where the corporate debtor makes a gift to a person, or enters into a transaction with a person which involves the transfer of one or 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. Hence, undervalued transactions are to be judged so on the basis of the "consideration" involved in the transaction.

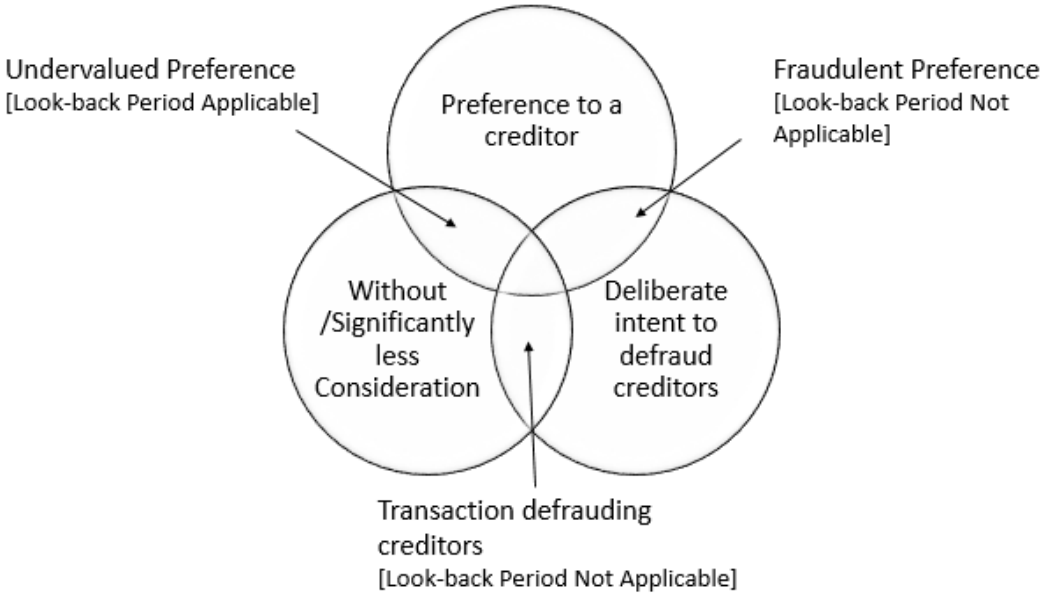
Relevant time, i.e. look-back period in case of undervalued transactions is 2 years for related parties and 1 year for unrelated party.

(iii) **Transactions defrauding creditors [section 49]** – The section classifies certain undervalued transactions as transactions defrauding creditors if such transactions were deliberately entered into by the corporate debtor for keeping its assets beyond the reach of any person who is a rightful claimant against the corporate debtor or to adversely affect the interests of such a person in relation to the claim. Note that the word used is "deliberate", which implies considered and calculated purpose of putting the assets beyond the reach of the claimant. Here, it must be noted that in order to be covered under section 49, the transaction must be an undervalued transaction under section 45.

[2] http://vinodkothari.com/blog/security-interests-as-preferential-transactions/

It may also be noted that there is no "relevant period" prescribed in such transactions (as also clearly stated in Notes to Clauses]. A fraud is a nullity forever, and as rightly pointed out in UNCITRAL Legislative Guide on Law of Insolvency, the objective test of a fixed period of time cannot be suitably applied to such transactions since the intent of the debtor is what matters the most.

There might be overlaps in between such transactions, as depicted below –



Another aspect of avoidance proceedings is holding the promoters/directors personally liable for carrying out the business of the corporate debtor with an intent to defraud creditors of the corporate debtor or for any fraudulent purpose. The same has been imbibed in section 66 of the Code.

B. THE RULING IN JAYPEE INFRATECH

The facts of *Jaypee Infratech case (supra)* can be outlined as below –

The holding company was also the principal contractor of the Corporate Debtor. The RP alleged that the directors of the Corporate Debtor mortgaged unencumbered land owned by it to secure one of the debts of the holding company.

Questions which arose for consideration are, *inter-alia* –

(i) whether impugned transactions were carried out with an intent to defraud creditors of the Corporate Debtor or for any fraudulent purpose and thus covered under section 66;

(ii) whether impugned transactions are preferential transactions under section 43 or undervalued transaction under section 45;

(iii) whether look-back period shall be 1 year or 2 years.

The questions may be discussed as follows, alongwith the deliberations of NCLT –

(i) Whether the transaction was a preferential transaction:

It may be noted that in view of the conditions specified under section 43 (2), the debt, the creditor, and the assets – all should belong to the corporate debtor. In this case, the lender in favour of whom the mortgage was created was not the creditor of the Corporate Debtor, but it was the creditor of a related party, i.e. the holding company. Therefore, the provisions of section 43 are not directly attracted in this case.

However, NCLT noted that *the holding company is also one of the operational creditors of the Corporate Debtor*. Section 43(2) requires that the transfer should be <u>for the benefit of</u> a creditor of the corporate debtor. Hence, this being a deeming provision, applies in case of impugned transaction, that is, mortgage executed by the Corporate Debtor thereby creating a security interest in favour of the lenders of the holding company, <u>which is a creditor of the Corporate Debtor</u>, and is <u>put in a beneficial position</u>, than it would have been in the event of distribution of assets made in accordance with section 53.

The stand taken by NCLT implies that once the Corporate Debtor has granted security interest in favour of its holding company, <u>it has the effect of reducing the direct liability of the holding company</u> towards the transferee lender. So, the holding company which is also one creditor, is being a <u>beneficiary here</u>. Say, if section 53 is applied, the assets which ought to be part of liquidation estate of the Corporate Debtor, would be used for paying off the liabilities of the holding company. The holding company, as an operational creditor, might not directly get back its dues; however, indirectly it will be relieved off of the dues of its creditors who are secured by the assets of the Corporate Debtor.

(ii) Whether the relief of "ordinary course of business" available:

The provisions of the Code carve out exceptions for transactions entered into ordinary course of business from being challenged as avoidable transactions. For example, section 43 (3) (a) excludes "a transfer made in the ordinary course of the business or financial affairs of the corporate debtor or the transferee".

NCLT held that the transaction of creating a security interest by way of mortgage in favour of lenders of a third party, on the unencumbered land of the Corporate Debtor without any consideration or counter guarantee, cannot be treated as transfer in the ordinary course of business or financial affairs of the corporate debtor. The exclusion clause cannot be interpreted that the ordinary course of business also includes transferee's ordinary business because transferee can never do transfer himself. The impugned transfer did not benefit either the business or the finances of the Corporate Debtor in any way. Such transfer is for the benefit of the related party, therefore cannot be excluded under section 43 (3). The word "transfer made" itself indicates that it relates to the transferor and not the transferee. Therefore, the ordinary course of business of transferee bank will not exclude the transactions from the purview of preferential transactions.

(iii) Whether the transaction was an undervalued transaction:

The alleged transaction has been made without any consideration to the Corporate Debtor. Therefore, the transaction was said to be covered under section 45 (1) of the Code, and will be treated as undervalued. The arguments as to collateral security being common practice in banking industry and reciprocity in the relationship the holding and the Corporate Debtor were rejected by the NCLT.

(iv) Whether look-back period will be 1 year or 2 years:

It was argued that the relevant sections of the Code [sections 43,45,60(5),66] came into effect as on 01.12.2016. Therefore, the limitation period of 1 year/2 years will apply only to transactions made on or after 01.12.2016 and not beyond that date. NCLT rejected the contention stating that the retrospective effect of such provisions is imbibed in the legislation itself. The look-back period is to be determined with reference to the insolvency commencement date and not the date when the Code came into effect. Therefore, in this case, since the beneficiary is a related party, the look-back period would be 2 years from the insolvency commencement date.

Here, the ruling of *Levit v. Ingersoll Rand*, 874 F.2d 1186 F.2d (7th Cir. 1989) might be relevant. The court held that look-back period shall be determined on the basis of the ultimate beneficiary of the transaction, that is, whether the beneficiary is an outside creditor or an inside creditor.

The author would also like to reiterate that since the transaction has already been classified as one defrauding creditors (see below) by the NCLT, there was no need of

delving into the question of lookback period. Reason being – no look-back period has been specified for fraudulent transactions. Where a fraudulent transaction is also a preference transaction, there shall be no need of putting the limits of "look-back period".

(v) On question whether the transaction was to defraud creditors:

The NCLT noted that the Corporate Debtor was facing financial crunch and its account was declared NPA. The Joint Lenders Forum lenders advised the Corporate Debtor to not to create any mortgage/charge on any asset/land parcel without approval from the lenders of the Corporate Debtors. However, NCLT noted that the impugned transactions were done not only without the consent of JLF but also contrary to the decision of JLF.

C. THE DOCTRINE OF ALTER EGO

Though NCLT did not delve into the concept, yet it might be relevant to discuss the same here.

A corporate has a separate legal existence. However, "alter ego" is the doctrine that treats a corporation and those who own its stock to be identical[3]. When a corporation has been so dominated by an individual or another corporation and its separate entity so ignored that it primarily transacts the dominator's business instead of its own and can be called the other's alter ego, the corporate form may be disregarded to achieve an equitable result. See, *Passalacqua Bldrs. v. Resnick Developers* S., 933 F.2d 131; *Gartner v. Snyder*, 607 F.2d 582; *Directors Guild v. Garrison Prods*., 733 F.Supp. 755) quoted in *Austin Powder Co. v. McCullough*, 216 AD 2d 825, 827 [1995][4].

More often than not, the doctrine of alter ego will be invoked in cases involving fraudulent transactions, that is, where there is a deliberate intent on the part of the debtor to give away its assets to or for the benefit of its alter ego or vice versa.

In *Iridium India Telecom Ltd. V Motorola Incorporation and Other*, (2011) 1 SCC 74, [Criminal Appeal No. 688 of 2005][5], the Supreme Court of India observed,

> "The Courts in England have emphatically rejected the notion that a body corporate could not commit a criminal offence which was an outcome of an act of will needing a particular state of mind. The aforesaid notion has been rejected by adopting the doctrine of *attribution and imputation*. In other words, the criminal intent of the "alter

[3] The Law Dictionary.
[4] https://www.leagle.com/decision/19951041216ad2d8251130; pg. last visited on 13.05.2018
[5] https://indiankanoon.org/doc/18288042/

ego" of the company / body corporate, i.e., the person or group of person that guide the business of the company, would be *imputed* to the corporation."

There are several cases upholding the doctrine – see *Sampsell v. Imperial Paper & Color Corp.,* 313 U.S. 215 (1941)[6], *Cappuccitti v. Gulf Indus. Products, Inc.*, 222 S.W.3d 468[7], In *Klein v. Sporting Goods, Inc.*, 772 S.W.2d 173, Court of Appeals of Texas (14th Dist.)[8].

In formulating a basis for predicating liability the courts have variously used the "agency", "identity" or "instrumentality" theories. The "instrumentality" rule seems to furnish the most practical and effectively applicable theory for breaking down corporate immunity where equity requires that this be done to circumvent fraud or other legal wrong. See *Lowendahl v. Baltimore & Ohio R.R. Co.*, 247 A.D. 144, 156 (1st Dep't), aff'd, 272 N.Y. 360 (1936)[9]. Besides, it must also be kept in mind that the unlawful control must be shown to have been exercised at the time the acts complained of took place.

In *Berkey v. Third Avenue R. Co.,* 244 N.Y. 84[10], it was said that "the corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterized as an `*alias*' or a `*dummy*.' All this is well enough if the picturesqueness of the epithets does not lead us to forget that the essential term to be defined is the act of operation. *Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent.* Where control is less than this, we are remitted to the tests of honesty and justice."

D. Concluding Remarks

The *Jaypee Infratech case (supra)* sets a precedent as regards avoidance proceedings under the Code. It decodes the depth and the reach of preferential transactions. It would be interesting to see what lies ahead, and whether the applicability/non-applicability of the doctrine of "alter ego" is at all considered in this case.

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[6] https://supreme.justia.com/cases/federal/us/313/215/case.html; pg. last visited on 13.05.2018
[7] https://www.courtlistener.com/opinion/2004820/cappuccitti-v-gulf-indus-products-inc/; pg. last visited on 13.05.2018; Source: http://www.texasbarcle.com/Materials/Events/10306/131264_01.pdf
[8] https://www.leagle.com/decision/1989945772sw2d1731921; *Ibid*
[9] https://casetext.com/case/lowendahl-v-baltimore-ohio-rr-co-1; pg. last visited on 13.05.2018.
[10] https://casetext.com/case/berkey-v-third-avenue-railway-co-1; pg. last visited on 13.05.2018