The Concept Of Related Party

INTERPRETATION BY LETTER OR SPIRIT OF IBC

- ***Richa Saraf***

Editor's Note: *As they say, 'eat with relatives, do business with strangers'. In law, though there is no bar on related party transactions, yet such transactions have to pass 'arms' length' test to be considered genuine and within due parameters of law. IBC too, puts certain limitations on related parties – a financial creditor who is a related party is not entitled to participate in the meetings of Committee of Creditors. Also, related parties of ineligible persons are barred from submitting a resolution plan under section 29A.*

However, there is no explicit provision under IBC requiring separate treatment of a creditor who is a related party while determining the liquidation value payable to such creditor – section 53 does not provide for any differentiation between a related creditor and an unrelated creditor. For instance, an unsecured financial creditor (whether related/unrelated) is placed above an ordinary operational creditor. This, by itself, becomes a gateway for misuse of law by related parties. So, is it possible to have an equitable remedy against such related parties? According to NCLT Allahabad, dues of related parties can be 'equitably subordinated', such that the provisions are not abused to write-off the dues of operational creditors. The ruling sets an important precedent – however shall be followed on case-to-case basis. This article discusses the perspectives on 'related party' in the light of similar rulings[19].

In the case of *J.R. Agro Industries P. Limited v. Swadisht Oils P. Ltd.*, NCLT Allahabad (24.07.2018) observed that "***if claim of related party is given priority over operational creditors, it would not be just to operational creditor***". In the instant matter, the related party and the corporate debtor had common directorship and common promoters, therefore, keeping in view the global practices, especially UNCITRAL legislative guide to insolvency law, NCLT opined that claim of a related party, whether in the nature of loan, should rank subordinate to the claim of operational creditors, and should be treated at par with equity shareholders under Section 53 (1) (h) of the Code.

Who is a Related Party?

The first question for discussion here is who will construe to be a "related party" with reference to the corporate debtor. While Section 5 (24) provides for the definition of related party of the corporate debtor, however, the expression "related party" describes a commutative relationship, i.e. X can be related party of Y, if either X is related to Y, or Y is related to X. It cannot be argued that X is not a related party to corporate debtor, if corporate debtor falls in the definition of "related party" with reference to X.

The definition stipulated in the Code is constructed so as to be limited from the perspective of corporate debtor. Prior to the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018, there was no definition with respect to an individual- this gap has been filled by the Ordinance, 2018, however, there is still nothing in the Code as regards related party of a company or body corporate (other than corporate debtor). In such a scenario, since Section 3(37) of the Code provides

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that for words/expressions not defined in the Code, the definitions given in the Companies Act, 2013 will be applicable, the definition under Section 2 (76) of the Companies Act, 2013 becomes relevant.

As per Section 2 (76) (iv) of the Companies Act, 2013, if a director of the company is a member or director of the other company, that other company becomes a related party. Similar clause is reflected in Section 5 (24) (d) of the Code as well, though it is constructed solely from the perspective of the corporate debtor.

It will also be relevant to mention here that Section 5 (24) (m) of the Code is drafted most widely, and indicates that the stance of the draftsman is on the reality of inter-relationships between the two entities. If the two entities are really operating under a common control, the indicia as given in Section 5 (24) (m) will apply. Thus, interchange of personnel, participation in policy-making, or provision of technical information are indicators of association of the two entities. It is not necessary that the company in question must be supplier of technical information, or must be participating in policy-making or would cause inter-change of personnel. If there is a common source of control over both the entities, resulting into these circumstances, it cannot be denied that the two entities become "associated" for that reason.

This discussion is also relevant for the purpose of determining who will constitute a part of committee of creditors, particularly with reference to first proviso to Section 21 (2) of the Code. The intent of Section 21 (2) of the Code in denying voting rights to related parties is to ensure that the corporate insolvency resolution process is driven by external creditors. Even though related parties may have claims, and may even file for the corporate insolvency resolution process, such parties cannot drive the insolvency resolution process, as that would be rife with conflicts of interest. Such a wholesome intent cannot be rendered infructuous by giving a narrow or technical interpretation to the meaning of the term.

Priority of Related Party Claims in the context of *Swadisht Oils*

In the case of *Swadisht Oils (supra),* the Resolution Professional emphasized that the approval of resolution plan by the Adjudicating Authority is a mere formality because the committee of creditors had already approved the plan, with requisite voting percentage (infact with 100% voting rights), and the resolution plan satisfied all the requirements of Section 30 of the Code, and the regulations thereunder. It was clarified that the related party was not allowed to attend and participate in CoC meetings, hence, there was no occasion to influence the decision of CoC members, yet the resolution plan pays almost nil dues of the operational creditors, and instead prioritises the claim of related party unsecured financial creditor as per waterfall mechanism (Section 53). "Section 53(1)(d) treats all unsecured financial creditors at par so far as priority for their payment is concerned and does not discriminate between unrelated creditors and related creditors", and accordingly, it was further stated that **express legal provisions cannot be bypassed even on the ground of equity.**

> ***"SECTION 53(1)(D) TREATS ALL UNSECURED FINANCIAL CREDITORS AT PAR SO FAR AS PRIORITY FOR THEIR PAYMENT IS CONCERNED AND DOES NOT DISCRIMINATE BETWEEN UNRELATED CREDITORS AND RELATED CREDITORS"***

It was contended that Regulation 38(1)(b) provides that liquidation value due to operational creditors should be paid in priority to any financial creditor, in any event, before the expiry of thirty days after the approval of a resolution plan, and like in most of the cases, in this case as well, the liquidation value for operational creditors, after meeting the claims of financial creditors, was computed to be "nil", and any payment to be made to such operational creditors, which was over and above such value, should be considered to be a "bonanza" to them.

In the instant case, a related party was getting approximately 62% of its dues back, while the operational creditors were getting almost nil. In such circumstances, it was beyond imagination that, after approval of the plan, the operational creditors will be willing to continue their supplies to the corporate debtor, to keep it as a going concern. Here, it is important to reflect upon foreign Insolvency Laws, wherein priority to secured creditors is given over unsecured creditors, but there is no distinction between financial & operational creditors.

The NCLT relied on the United Nations Commission on International Law, which specifically provides for subordinate ranking of related parties claims as regards ordinary unsecured claims, and pointed out that this particular case, is a glaring example where admittedly a related party, is getting priority over operational creditors, even though the same promoters are considered to be responsible for insolvency and restructuring of the corporate debtor, which appears to be discriminatory.

Under the UNCITRAL Legislative Guide, related persons claim rank inferior to the claims of similar other unsecured creditors, while in IBC, unsecured financial creditors (even if related party), rank higher to the claims of unsecured operational creditors. Under prevailing practices in UK and US also, operational creditors claim rank above the claim of related party claim. It was observed that promoters' loan to the company is like equity participation, which mostly remains without time value of money, i.e. without any agreement to pay interest and without any time limit for repayment, even if otherwise, the waterfall mechanism under Section 53 should not be merely applied by books, by ignoring the intent, since then, in every case of defaulted/loss-making companies, the liquidation value of operational creditors will always be nil, and they will never get their dues in IBC cases.

The related party of corporate debtor, whether in a familial or business capacity, are such category of creditors that require special consideration. Under some insolvency laws, these claims are always subordinated, and under other laws, they are subordinated only on the basis of inequitable conduct. Other approaches for treatment of these claims do not relate to ranking, but only to restrictions on voting rights. In IBC, an intra-group transactions may be subject to avoidance proceedings, if proved to be fraudulent, preferential or undervalued, and in UNICITRAL legislative guide, such transactions are classified differently from similar transactions conducted between unrelated parties (such a debt may be treated as an equity contribution rather than a loan), with the consequence that the debt obligation will rank lower in priority than the same obligation between unrelated parties.

In this regard, it is relevant to cite Para 55 of UNCITRAL legislative guide of insolvency law, which specifies that when in the natural person or organisation owes debts to more than one creditor, the priority scheme established under applicable law may provide for subordination of certain types of claim, for example, those of related persons, determining the order in which those debts should be paid. Even while a priority scheme is in place, a creditor with a higher priority may be paid after one

with lower priority because of court order. The Bench contemplated that owners and equity holders may have claim arising from loans extended to the debtor, and regarding claims arising from such equity interests (including claims with respect to their debt, accruing interest), and that many insolvency laws have adopted a general rule that the owners and equity holders of the business are not entitled to a distribution of the proceeds of assets until all other claims that are senior in priority have been fully repaid, passed a similar order.

The NCLT deliberated upon the concept of equitable subordination (subordination by court), wherein a valid and enforceable claim, is paid later in the distribution scheme, than it would otherwise be paid in normal course. The doctrine originally arose to prevent related persons from using legal mechanism to obtained advantages in priority, and is generally applied if any conduct under consideration results in unfair advantage to a creditor or some harm to other creditors. The Bench examined that it may change/ re-arrange the priority of claims, to prevent a creditor who has committed fraud, illegality, or has acted inappropriately to gain advantage over other creditors, from benefiting in any manner, and such that a fair distribution occurs. Accordingly, ordered that the related party claim should be treated in the category of "equity shareholders" as provided in Section 53(1)(h) of the Code, and be considered below the rank of both the unsecured financial creditors and as well as other debts and dues.

Also, in the light of the facts and circumstances of the case, considering the arguments advanced, and to give justice to the operational creditors, the Bench ordered for modification of the resolution plan, and further directed the Registrar to send a copy of this order to IBBI, Secretary, MCA and Central Government through RD, for consideration on the issues which have been pointed out, so that related party of the corporate debtor cannot misuse the provisions of Section 53, to defraud the creditors.

Beyond the Lines . . .

A related party which assigns its debt, assigns no more benefits/entitlements what it had. Therefore, if a related party assigns its debt to an otherwise unrelated party, the latter is subject to the same limitations as the related party would have in relation to the IBC proceedings of the corporate debtor.

In *Pankaj Yadav v. State Bank of India*, the NCLAT held that "the assignment is the transfer of one's right to recover the debt of another person as a contractual right. Rights of an 'assignee' are no better than those of the 'assignor'. It can be, therefore, held that 'assignor' assigns its debt in favour of the 'assignee' and 'assignee' steps in the shoes of the 'assignor'. The 'assignee' thereby takes over the right as it actually did and also takes over all the disadvantages by virtue of such assignment."

Precisely speaking, a related party cannot indirectly achieve, what it could not directly achieve, by recourse to an assignment of debt.