DISCERNING THE REACH OF AVOIDANCE PROCEEDINGS:

An Analysis of IDBI Limited v. Jaypee Infratech Limited

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Editor's Notes: *The Code calls upon the Resolution Professional/ Liquidator, as the case may be, to bring to the knowledge to the Adjudicating Authority, transactions of preferential, undervalue, extortionate, fraudulent, or unlawful nature, if any, identified during the course of CIRP or liquidation. Considering the huge sums involved in these transactions, provisions for the same, in IBC as well as on a global scale, is of utmost importance.*

The following articles covers discussion on one of the rulings concerning vulnerable transactions.

In *IDBI Limited v. Jaypee Infratech Limited* [CA No. 26/2018 in CP No. (IB)77/ALD/2017, Order dated 16.05.2018], the NCLT, 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*, so as to declare the transaction as preferential, undervalued and "fraudulent and wrongful" under the Code

A. Forms of Vulnerable Transactions

The Code talks about four forms of vulnerable transactions, three of them as relevant to the context being – preferential transactions, undervalued transactions, and transactions defrauding creditors. Note that there might be overlaps in between such transactions, i.e. a transaction can be preferential, undervalued, and fraudulent at the same time.

Here it is relevant to note that the words "transaction" and "transfer" are omnibus expressions. In "*Security Interests as Preferential Transactions*", 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)*.

Further, section 66 holds 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.

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 [section 66];
(ii) whether impugned transactions are preferential transactions [section 43] or undervalued transaction [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 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 for the benefit of a creditor of the corporate debtor. Hence, this being a deeming provision, applies in case of impugned transaction. The holding company, which is a creditor of the Corporate Debtor, is put in a beneficial position, 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, it has the effect of reducing the direct liability of the holding company towards the transferee lender. So, the holding company which is also one creditor, is being an indirect beneficiary here.

(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.

Berkey v. Third Avenue R. Co.,

"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."

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[62]. 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], *Sampsellv. Imperial Paper & Color Corp.*,313 U.S. 215 (1941), *Cappuccitti v. Gulf Indus. Products, Inc.,* 222 S.W.3d 468, In *Klein v. Sporting Goods, Inc.*, 772 S.W.2d 173, Court of Appeals of Texas (14th Dist.),*Iridium India Telecom Ltd. V Motorola Incorporation and Other*, (2011) 1 SCC 74, [Criminal Appeal No. 688 of 2005].

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 *Berkey v. Third Avenue R. Co.,* 244 N.Y. 84, 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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[62]The Law Dictionary.