FRAUDULENT INITIATION OF INSOLVENCY PROCEEDINGS

- ***Richa Saraf***

Editor's Note: *IBC is a benevolent law – it seeks to help a falling debtor and simultaneously explores avenues for value maximisation in the hands of creditors. However, one cannot rule out the vulnerability of the law as to potential misuse by unscrupulous persons – the rampant way in which section 22 of SICA was (mis)used is not unknown. Therefore, in order that the provisions of IBC are not misused for defrauding stakeholders, section 65 calls for imposition of penalty in such cases. Here, application of judicial mind may become necessary at the time of admission of application for corporate insolvency resolution process.*

Section 65 was incorporated in the Code so that the provisions of IBC cannot be misused by any person, who has initiated the insolvency resolution process or liquidation proceedings, with a fraudulent or malicious intent, and for any purpose other than for the resolution of insolvency or liquidation, as the case may be. The article will be particularly focusing on the effect of this provision on persons who have fraudulently or maliciously initiated insolvency proceedings. We will also be relying on a recent case law, wherein NCLT has taken broad and sweeping interpretation, in consonance with the spirit of law.

In the matter of *Shobhnath v. Prism Industrial Complex Ltd., (05.07.2018)*, the NCLT Allahabad discussed a very pertinent question- whether insolvency petition can be entertained in a case where financial fraud exists? The petitioner, being a financial creditor, contended that the petition is complete in all aspects, and in conformity with Section 7 of the Code. There was existence of debt, duly acknowledged by the corporate debtor, and subsistence of default, duly fulfilling the conditions laid down under Section 3 (11) and 3 (12). Not only this, the petitioner filed one affidavit stating that the proceedings will be in the interest of the stakeholders (debenture holders/ depositors, in the instant case) and the corporate debtor. Also, similar affidavit was filed by the corporate debtor, stating that the insolvency proceedings will be in the best of interests of the corporate debtor as well as its stakeholders, as the claims of various classes of creditors can only be satiated by disposing the assets of the corporate debtor, however, considering the adverse market position, the value derived from the asset may not be sufficient to repay all the debts.

Consideration of The Issues Involved:

While examining the matter, the Hon'ble NCLT considered several aspects:

a) **Report of Amicus Curiae**: The Bench relied on the report of the Amicus Curiae, appointed in another matter (against the same corporate debtor), and considered the possibility of diversion of funds to group companies and/ or directors and/ or associates, and also raised suspicion that all the properties/ assets of the corporate debtor might have been sold/ disposed of illegally.

b) **Perusal of financial statements of the corporate debtor:** NCLT relied on the balance sheet of the corporate debtor for determination of several issues:

(i) The recent updated balance sheet of the corporate debtor was not available, hence, it was difficult to ascertain the current state of affairs of the corporate debtor and its properties.

(ii) On perusal of the last available balance sheet, it was observed that land is the sole tangible asset of the corporate debtor, which was highly inadequate to quench all the claims.

(iii) The fact that there was no information available about the area, location or market value of the land, was taken on record.

(iv) **Odds of diversion/ siphoning of funds:** It was also evident from the study of the balance sheet that having raised money from numerous investors, the promoters/ directors have siphoned the funds out into various affiliated companies.

Issues considered by Hon'ble NCLT:

- ***Report of Amicus Curiae***
- ***Financial Statements of CD***
- ***Odds of siphoning of funds***
- ***Impact of admission***
- ***Moratorium***
- ***Constitution of CoC***

c) In the instant case, interests of a large number of retail investors was involved, however, none of these retail investors, could be intending to be benevolent to think of resolution or revival of the corporate debtor.

d) **The after-effects of admission of petition:** The consequential impact of commencement of insolvency proceedings was analysed:

(i) **Initiation of moratorium-** means the creditors will not be able to take legal action against the corporate debtor.

(ii) **Constitution of committee of creditors and the system of voting on the basis of majority by value**-NCLT could not rule out the probability that the corporate debtor might have created creditors with high value, who may care least for the interest of retail investors, from whom money has been raised, and hence, the so- called resolution plan may harm the interest of such investors.

The intent of the corporate debtor was regarded as suspicious, malafide and intended to divert the attention of the Tribunal from the main issue and to linger on the proceedings. The Tribunal further went on to state that on perusal of the report of the Amicus Curiae, it appears that the corporate debtor has committed a financial fraud.

The enactment of insolvency resolution process under the Code, is a step towards resolution or rectification of an insolvency, wherein a company is under financial distress and the creditors are proposing to collectively bail the company out. These provisions are for repairing a broken house which can still be repaired, and can avoid demolition. The intent of insolvency proceedings cannot be to interfere in cases where there are financial irregularities, illegalities or indication of a financial fraud. Considering the object for which the Code was formulated, public interest involved, and for meeting ends of justice, it was held that the petition cannot be admitted only on the ground that the corporate debtor has not opposed the petition.

NCLT regarded that while Section 65 only stipulates for punishment for fraudulent and malicious initiation of insolvency proceedings, the intent is very clear that while a petition is filed, under the Code, fraudulently with malicious initiation of insolvency proceedings, then in that case, the petition should not be admitted. Thus, the petition was dismissed and a show cause notice was issued under Section 65 of the Code, against the petitioner as well as the corporate debtor.

Conclusion:

There may be several instances where the application is filed at the behest of the corporate debtor itself, or the applicant is a mere puppet in the hands of the corporate debtor. The Adjudicating Authority, in such cases, should place the matter under strict scrutiny and declare that the parties are acting hand-in-glove.

Suppose the corporate debtor has availed money from its related party, and paid the dues of the workmen and secured financial creditors, who are to get priority during liquidation (or during resolution for that matter), and has instead created another class of secured financial creditors, replacing all the other secured financial creditors. The operational creditors and the unsecured financial creditors could not be paid. The intent can be to defraud such operational creditors or they may genuinely want to repay the debts of poor workmen, and ofcourse the secured creditors were paid off to acquire the security interest in the assets of the corporate debtor, so that the assets may be utilised to pay other stakeholders as well. However, it might so happen that due to some unavoidable circumstances, the very new category of secured creditors, who are also related party to the corporate debtor, initiate insolvency proceedings the corporate debtor. The intent may be for resolution of the corporate debtor, however, there will only be either of the two aftermaths:

a) a resolution plan be submitted as regards the corporate debtor, in such a case, operational creditors and dissenting unsecured financial creditors will be getting liquidation value only, which is equivalent to nil in most cases; or

b) the corporate debtor goes into liquidation, again, the operational creditors and unsecured financial creditors will not be able to recover anything, since the liquidation estate might not be sufficient and there might not be anything left for the unsecured financial creditors and the operational creditors, after discharge of liabilities towards the secured creditors.

Can the above scenario be consider to be round- tripping of funds? Consider another situation, where the loan agreement itself states that the corporate debtor is in distress, and the loan is needed for making urgent payments, required to be made by the corporate debtor. Considering that the corporate debtor was admittedly into financial distress, such a lending, and that too, by way of an unsecured loan, would not be intuitively expected from an arms-length lender. Therefore, there is a natural reason to explore whether there existed relationship between such lender and the corporate debtor, more so, if the amount is payable on demand and there is no tenure for claiming back the amount. Now, if such a distress lender, seeks repayment by way of a demand notice within few months of granting of such loan, and thereafter on non- payment within stipulated time, initiates insolvency proceedings, under Section 7 IBC, again, within few months of granting of loan, whether such an application can be considered to be one in good faith or whether the case will be considered to be a fit case for fraudulent initiation of insolvency proceedings, as per Section 65 of the Code?

Even if the applicant is able to demonstrate that the application complies with all the requirements of law, and regardless of whether the corporate debtor has acknowledged the debt and is not resisting the insolvency proceedings, the Adjudicating Authority, before admitting any such application, should examine the prima facie facts and material available on record. Whether the loan amount was transferred via proper banking channels or was the debt only a balance sheet entry, with no nexus to actual lending, is another point, which should be considered while framing a decision.
