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INSOLVENCY AND BANKRUPTCY CODE, 2016

THE HON'BLE SUPREME COURT OF INDIA SETS THE LAW RELATING TO
AVOIDANCE OF PREFERENTIAL TRANSACTIONS UNDER THE INSOLVENCY
AND BANKRUPTCY CODE, 2016.

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Several countries across the world have made provision in their respective insolvency and bankruptcy laws to deal with the issue of “preferential transfers/transactions”, sought to be made or done by insolvent and bankrupt entities, with a view to prejudice the interests of *bonafide* creditors and stakeholders.

In common parlance, the term “preferential transfer/transaction” denotes a transaction where an insolvent debtor transfers or purports to transfer an asset to or for the benefit of a ‘particular creditor’ so that such beneficiary receives more than what it would have otherwise received through distribution of the bankruptcy estate.

Section 547 of the US Bankruptcy Code provides that a bankruptcy trustee may, for the benefit of the estate in question, recover a preferential transfer from the transferee. Similar provisions are made under Section 239 of the UK Insolvency Act, 1986.

Sections 328 and 329 of the (Indian) Companies Act, 2013, provide for avoidance of transfers involving “fraudulent preference” and/or which are made “not in good faith”, in context of winding up proceedings initiated against a company.

Sections 43 and 44 of the Insolvency and Bankruptcy Code, 2016, (“Code”), similarly provide for avoidance of “preferential transactions” made, done or undertaken or purported to be made, done or undertaken by a corporate debtor, in favour of a particular creditor, surety or a guarantor, upto two years prior to commencement of the corporate insolvency resolution process.

In the recent case of *Anuj Jain V/s. Axis Bank Limited and Others* (reported in 2020 SCC OnLine SC 237), the Hon’ble Supreme Court of India had the occasion to lay down the law relating to “preferential transactions” under the Code.

BRIEF FACTS OF THE CASE :

- (i) A corporate insolvency resolution process was commenced against Jaypee Infratech Limited (“JIL”), pursuant to an order dated 09 August 2017, passed by the Hon’ble

National Company Law Tribunal, Allahabad Bench, (“NCLT”) in an application filed by IDBI Bank Limited under Section 7 of the Code.

- (ii) Within a period of two years prior to the commencement of the corporate insolvency resolution process, the Corporate Debtor JIL had mortgaged several of its properties with various banks and financial institutions, as collateral for loans and advances made by such banks to its holding company, Jaiprakash Associates Limited (“JAL”).
- (iii) Upon commencement of the corporate insolvency resolution process, the Interim Resolution Professional (“IRP”), appointed for JIL, filed an application in the Hon’ble NCLT, seeking avoidance and setting aside of several of the said mortgage transactions, alleging them to be ‘preferential’, ‘fraudulent’ and ‘undervalued’ under Sections 43, 45 and 66 of the Code.
- (iv) By an order dated 16 May 2018, the Hon’ble NCLT allowed the application filed by the IRP and set aside the mortgage transactions, *inter alia* terming them to be ‘preferential’ under Section 43 of the Code.
- (v) In appeal, the Hon’ble National Company Law Appellate Tribunal (“NCLAT”), by an order dated 01 August 2019, reversed the findings of the Hon’ble NCLT and declared the mortgage transactions to be legal and valid.
- (vi) Thereafter, the matter was appealed to the Hon’ble Supreme Court of India. In course of its judgment, the Hon’ble Supreme Court proceeded to interpret and lay down the law relating to Preferential Transactions under the Code.

Interpreting the provisions of Section 43¹ of the Code, the Hon’ble Supreme Court of India held as under:

1. The sum total of sub-sections (2) and (4) of Section 43 is that a corporate debtor shall be deemed to have given a preference at a relevant time if –
 - (i) the transaction is of transfer of property or the interest thereof of the corporate debtor, for the benefit of a creditor or surety or guarantor for or on account of an antecedent financial debt or operational debt or other liability;
 - (ii) such transfer has the effect of putting such creditor or surety or guarantor in a beneficial position than it would have been in the event of distribution of assets in accordance with Section 53; and
 - (iii) preference is given, either during the period of two years preceding the insolvency commencement date when the beneficiary is a related party (other than an employee), or during the period of one year preceding the insolvency commencement date when the beneficiary is an unrelated party. {Para 19.1 of the judgment}

¹ For viewing text of Section 43 and other provisions of the Code, please use the following link : <https://ibbi.gov.in/uploads/legalframework/547c9c2af074c90ac5919fa8a5c60bd4.pdf>

2. By virtue of the word “deemed” appearing in Section 43 of the Code, any transaction that answers to the descriptions contained in sub-sections (2) and (4) is presumed to be a preferential transaction, even though it may not be so in reality. {Para 19.3 of the judgment}
3. When a transaction falls within the coordinates of Section 43, the same shall be deemed to preferential and the absence of *malafide* intention on part of the corporate debtor is no defence to validate any preferential transaction, falling within the ambit of Section 43 of the Code. {Para 17.4 of the judgment}
4. The following five questions must be examined in order to conclude whether a transaction falls squarely within the ambit of Section 43 of the Code:
 - (a) Whether such transfer is for the benefit of a creditor or a surety or a guarantor?
 - (b) Whether such transfer is for or on account of an antecedent financial debt or operational debt or other liabilities owed by the corporate debtor?
 - (c) Whether such transfer has the effect of putting such creditor or surety or guarantor in a beneficial position than it would have been in the event of distribution of assets being made in accordance with Section 53 of the Code?
 - (d) If such transfer is for the benefit of a related party (other than an employee), as to whether the same was made during the period of two years preceding the insolvency commencement date; and if such transfer is for the benefit of an unrelated party; whether the same was made during the period of one year preceding the insolvency commencement date?
 - (e) Whether such transfer is not an excluded transaction in terms of sub-section (3) of Section 43? {Para 20 of the judgment}
5. In the facts of the case, it was further held and observed by the Hon’ble Supreme Court that;
 - (i) The mortgage deeds in question executed by JIL to secure the debts of JAL amounted to creation of security interest for the benefit of JAL. JAL was the largest equity shareholder of JIL. JAL was also an operational creditor of JIL. JAL had been providing financial, technical and strategic support to JIL. JAL had also extended bank guarantees in respect of obligations of JIL. Accordingly, JAL was a creditor, surety and related party of JIL and JIL owed antecedent financial and operational debts and other liabilities to JAL. {Para 22.2.2 of the judgment}
 - (ii) By way of the impugned mortgage transactions, JAL’s liability towards its own creditors had reduced, to the extent of the value of the properties mortgaged by JIL. In the eventuality of distribution of assets under Section 53 (i.e. in the event of liquidation), the other creditors and stakeholders of JIL would have to bear the brunt because the mortgaged assets would not form

part of available estate of the Corporate Debtor. JIL thus gave a preference to JAL, in the manner laid down in Section 43(2) of the Code. Furthermore, the transactions had taken place during the look-back period of two years, as applicable to a related party, and were therefore covered under Section 43(4) of the Code. {Paras 22.4 and 24.5 of the judgment}

- (iii) As regards interpretation of Section 43(3)(a) of the Code, the Hon'ble Court adopted the doctrine of purposive interpretation and held that the term "or" appearing in the said Section shall be read as "and". {Para 25.5 of the judgment}
- (iv) The transfers in question may have been considered outside the purview of sub-section (2) of Section 43 of the Code only if it could be shown that same were made in the 'ordinary course of business or financial affairs' of both the Corporate Debtor JIL and the transferees or that the security interest was created in the process of acquiring any new asset or enhancement in its value or worth, by the Corporate Debtor. {Paras 25.2 and 25.5 of the judgment}
- (v) The phrase 'ordinary course of business' means that the transaction must fall into place as part of the undistinguished common flow of business done by the Corporate Debtor; that it should form part of the ordinary course of business as carried on, calling for no remark and arising out of no special or particular situation. {Para 25.6.1. of the judgment}
- (vi) That the business of JIL was to execute housing and building projects and not of creating mortgages to secure the loans and facilities obtained by its holding company. The impugned transactions were therefore not covered under the exceptions provided in Section 43(3) of the Code. {Para 25.6.2 of the judgment}

The Hon'ble Supreme Court of India therefore set-aside the order of the Hon'ble NCLAT and upheld the order of the Hon'ble NCLT.

In its judgment, the Hon'ble Supreme Court of India also laid down a guidance note on how an insolvency resolution professional must approach identification and avoidance of preferential transactions. {Para 28 of the judgment}
