

Business Standard

Corporate insolvency: Rethinking irregular transactions

So far 786 applications have been filed to recover over Rs 2.2 trillion allegedly lost through irregular transactions. Retrieving this needs a law, policy and regulatory focus

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In a landmark judgment in the matter of Anuj Jain Vs Axis Bank Ltd (February, 26 2020), the Supreme Court upheld the recovery of 758 acres of land valued at over Rs 5,300 crore, which was lost through irregular transactions. Till June this year, 786 applications have been filed to claw back Rs 2,21,104 crore allegedly lost through irregular transactions by firms undergoing the corporate insolvency resolution process (CIRP). If this value is retrieved fully, several firms would be rescued. If this value was not alienated, many would not have got into CIRP in the first place.

The Insolvency and Bankruptcy Code, 2016 (Code) has identified two sets of irregular transactions, whereby a firm may lose value in the run-up to the commencement of CIRP. The first set, known as avoidance transactions, comprises preferential transactions, undervalued transactions and extortionate transactions. The Code mandates the CIRP and liquidation process to disregard these transactions to retrieve the value lost during the lookback period, which is two

years in respect of transactions with related parties and one year in other cases, notwithstanding the sanctity of the contract underlying the transactions. The second set, known as fraudulent transactions, comprises fraudulent trading or wrongful trading. The Code requires the CIRP to recover the loss made through these transactions. The law empowers the adjudicating authority to order recovery of the value lost through irregular transactions, based on an application from the resolution professional or liquidator.

Reversing avoidance transactions promotes the objective of the Code in many ways. First, they are a key source of additional value in corporate insolvency, over and above the existing assets of the firm. If these transactions are undone and the lost value is recovered, creditors would stand to realise higher value than they would otherwise. The higher the realisation, the higher is the likelihood of a firm being rescued through a resolution plan.

Second, the Code requires the beneficiaries of avoidance transactions to disgorge the value unlawfully appropriated by them through such transactions. This maximises the value of the assets of the firm. If the market knows that there is no way one can get away with avoidance transactions with impunity, no one would resort to such opportunistic behaviour. In such a case, the value continues to reside in the firm and consequently the possibility of the firm getting into stress is minimised. Thus, mitigating these transactions not only helps rescue the firm, but also prevents the need for rescue.

Third, the Code provides a waterfall for distribution of liquidation proceeds among stakeholders. It requires resolution plans to consider the order of priority in the waterfall. This prioritisation balances the interests of various stakeholders. If someone resorts to avoidance transactions to appropriate any value from the firm in the run-up to the CIRP, a junior stakeholder may take precedence over a senior stakeholder, disturbing the balance among them enshrined in the Code.

Fourth, the Code requires the persons, who are knowingly parties to carrying on the business with the intent to defraud creditors, to make good the loss. It also makes the directors of the firm liable for the loss to creditors that arise during the twilight period, which begins from the time when a director knew or ought to have known that there was no reasonable prospect of avoiding CIRP. While improving corporate governance, these incentivise the firm as well as directors to seek resolution in the early days of stress when the possibility of rescue is higher.

In case of avoidance transactions, the underlying property/value returns from the beneficiary to the firm. In case of fraudulent transactions, recourse is against the

director or the person responsible, who is required to make good the loss even if he has not gained anything personally.

Applications filed in respect of irregular transactions, as reported in the IBBI newsletter for December 2021 quarter, indicate that firms going through CIRP have lost at least 10 per cent of claims admitted against them through irregular transactions during the lookback period. This is disconcerting. In the quarter ending June 2022, the creditors realised only 10 per cent of their claims through resolution plans, and these firms had assets valued at only 7 per cent of the admitted claims, when they entered into CIRP.

The firms, which ended up with resolution plans through CIRP, had reportedly lost Rs 41,667 crore through irregular transactions, accounting for about 4.98 per cent of the amounts claimed against them. In contrast, the firms that ended up with liquidations had reportedly lost Rs 1,21,121 crore through irregular transactions, which accounts for 15.43 per cent of the amounts claimed against them. Thus, CIRPs are likely to result in liquidations of firms where relatively more value has been lost through irregular transactions.

The data also indicates that firms getting rescued through CIRP are typically left with assets valued at 17 per cent of the claims when they entered into CIRP. Firms getting liquidated through CIRP had reportedly lost 15 per cent of the claims through irregular transactions and were left with assets valued at 5 per cent of the claims by the time they reached CIRP. If there was no irregular transaction, these firms would be left with assets valued at 20 per cent of claims. In that case, all of them would be rescued through resolution plans.

Assuming that the entire amount underlying the applications does not pass the legal muster, sizeable amounts have been lost to some of those firms which went under. Further, looking at the opportunity cost in terms of lost value, employment, taxes and output combined, these reflect a considerable drain on the economy. Now that there is a reasonable idea of the incidence of irregular transactions by promoters/management of some firms, it is time that the relevant policies and laws are spruced up to minimise recurrence. Any progress on this front will be a huge gain for the economy.

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First Published: Oct 25 2022 | 11:41 PM IST

Page URL :https://www.business-standard.com/article/opinion/corporate-insolvency-rethinking-irregular-transactions-122102501086_1.html

