PUFE Transactions

PUFE transactions have a significant bearing on the life and death of a company. According to IBBI Newsletter, applications filed till June 2022 indicate that the companies admitted to CIRP have lost ₹2,21,104 crore through these transactions during the relevant period. If this value is clawed back, several of them would be rescued. If this value was not alienated, several of them would not have got into CIRP in the first place. It, however, appears that the outcome from disposal of applications does not seem encouraging. While several factors are responsible for poor outcomes and need to be addressed urgently, the author feels that insolvency professionals can make a difference. He suggests the IPAs to empower the market to reward the insolvency professionals who are good at clawing back the value lost through these transactions and punish those who are not so good.

Read on to know more…

Dr. M. S. Sahoo

The author is Former Chairperson, IBBI & Distinguished Professor, National Law University Delhi. He can be reached at:

iiipi.journal@icai.in

It has been six years since the Insolvency and Bankruptcy Code, 2016 (Code) has been in service. Like any other economic legislation, it has evolved, developing deeper and stronger roots. It has established the primacy of the markets, reinforced the rule of law in resolution of insolvency, and professionalised the insolvency resolution process, thanks to the advent of two professions of professions, namely, insolvency profession and valuation profession.

The Code has yielded some great successes. From providing the freedom of exit to rescuing companies in financial stress to releasing the resources stuck-up in inefficient businesses to freeing entrepreneurs from the chakravyuha of zombie businesses to helping creditors realise their dues, and most importantly, bringing about significant behavioural changes among the debtors and creditors alike, the list of achievements of the Code is a long one. As per the last 'Ease of Doing Business' Report of the World Bank released in October 2019, India made a giant leap in its ranking in terms of 'resolving insolvency' from 136th to 52nd position three years ago. The Global Restructuring Review conferred on India the award for 'the most improved jurisdiction' in 2018.

Duty of Insolvency Professional

The Code has identified two sets of transactions, whereby a CD may lose value, in the run up to 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 processes to disregard these transactions to retrieve the value lost during the look back 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. Relevant period has no time limit in case of fraudulent 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. In common parlance, these avoidance transactions and fraudulent trading together are known as PUFE (preferential, undervalued, fraudulent and extortionate) transactions.

The law empowers the Adjudicating Authority (AA) to claw back the value lost through PUFE transactions, based on an application of an insolvency professional (IP), either as Resolution Professional (RP) or Liquidator. Section 25 of the Code casts a duty on the RP to preserve and protect the assets of the CD during the CIRP, including the continued business operations of the CD. For this purpose, it requires the RP to file applications with the AA for avoidance of transactions. Similarly, sections 43, 45, 50, 54F, and 66 of the Code require the RP or Liquidator to file applications in respect of PUFE transactions with the AA during the CIRP or liquidation process.

To ensure that the RP files an application without fail, the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (CIRP Regulations) provide timelines, requiring the RP to form an opinion if the CD has been subjected to any PUFE transactions, by 75th day of commencement of the CIRP, make a determination by 115th day, and file an application by 130th day with the AA, for appropriate relief. This timeline has been held to be directory because the CD must not suffer loss for lapse on the part of the RP. Section 47 of the Code, inter alia, provides that the AA shall require the Insolvency and Bankruptcy Board of India (IBBI) to initiate a disciplinary action against the RP or the Liquidator, where he has not reported undervalued transactions to the AA.

In the matter of *Ambit Finvest Pvt. Ltd. Vs. Rakesh Niranjan Ranjan & Ors*., an application was filed by a dissenting financial creditor for PUFE transactions. The AA dismissed the application on the ground, among other reasons, that a financial creditor has no right to file such an application under section 66 of the Code, which could be done only by the RP, while noting that the RP was satisfied that there was no cause to file an application. This has two implications. First, only the RP can file an application for PUFE transactions (except for undervalued transactions where a creditor, member or partner of the CD can file application) and no one else can. When the law says that only RP can do it, inaction of the IP frustrates the Code and CIRP, heightening the role of the IP in PUFE transactions. Second, it is the end of the matter if the IP is satisfied that there was no reason to file an application, indicating deference of the AA holds to the decision of the IP. The RP may take external help such as forensic auditors to help him detect and determine PUFE. He cannot escape the liability for failure of such external help. The law assigns this statutory responsibility to an IP in recognition of his ability, and thus cannot be outsourced.

"First, only the RP can file an application for PUFE transactions and no one else can. Second, it is the end of the matter if the IP is satisfied that there was no reason to file an application."

In a landmark judgement in the matter of *Anuj Jain Vs. Axis Bank Ltd*., the Supreme Court has delineated the duties and responsibilities of an RP in respect of avoidance transactions. It held that the RP shall sift through all transactions relating to the property/interest of the CD backwards from the insolvency commencement date and up to the preceding two years. After carrying out the volumetric and gravimetric analysis of the transactions, the RP must apply to the AA for necessary orders. In this matter, the Apex Court upheld recovery of 758 acres of land valued at about ₹5300 crore, which was lost through avoidance transactions. Despite statutory provisions and jurisprudence, the PUFE transactions have not gained much traction, though failure to claw back the value lost through these transactions is often fatal.

There are several factors, including legal clarity, which come in the way of retrieval of value lost through PUFE transactions. The order in the matter of *Venus Recruiters Pvt Ltd. Vs. Union of India* has cast a shadow on the pending applications where resolution plans have been approved or where the CD has proceeded for liquidation. The Court held that avoidance applications do not survive beyond the conclusion of the CIRP. A review petition is reportedly pending before the High Court. Government has proposed to amend the Code to address this and several other concerns. IBBI has recently amended the CIRP Regulations that requires the resolution plan to provide for how the applications in respect of PUFE transactions shall be pursued after the approval of the resolution plan and how the proceeds, if any, from such proceedings shall be distributed. It has made similar amendments to the Liquidation Process Regulations. As the remaining concerns are addressed, the IPs would continue to remain the centre of activity, interest and attention in respect of PUFE transactions.

Sole Objective of the Code

The Code requires retrieval of value lost through PUFE transactions in furtherance of its objective. What is its objective? It is not a panacea for every economic evil though some would believe or wish it to be. Some allege that the CIRP is frustrating the objectives of the Code, as several CIRPs are yielding less than 100% recovery for creditors. They ignore the fact that the Code does not provide for a recovery mechanism. In fact, it nowhere uses the word 'recovery' in its entire text, except where it provides for 'Debt Recovery Tribunal' as the AA for individual insolvency resolution.

The sole objective of the Code is reorganisation or insolvency resolution. Such reorganisation has several benefits, namely, promotes entrepreneurship, improves credit availability, maximises value of assets of the CD, balances the interests of the stakeholders, etc. One must not confuse objectives with benefits. The first Nobel Laureate in Economics, Jan Tinbergen stipulated a basic principle of public policy efficacy that a policy must not have more than one objective. There must be at least one policy for each target. One can have more than one policy to achieve one target but having one policy to achieve more than one target is troublesome. It is not easy to kill more than one bird with one stone, particularly when the birds are flying in different directions. There can be many tools for reorganisation. In fact, there are. One may reorganise using the framework available under the Companies Act, 2013 or the RBI Guidelines or even outside any formal framework.

The Code provides for a market mechanism for resolution of stress of a CD in two ways, namely, rescue the CD through a resolution plan or close it through liquidation, and leaves it to the market to choose either. The market usually chooses to rescue the CD if it is viable and to close it if it is unviable. The Code, however, prefers rescue of the CD to capture the going concern surplus which is lost if it is liquidated. Therefore, it does not envisage initiation of liquidation proceeding directly. Liquidation process commences only after the CIRP fails to rescue the CD through a resolution plan or a collective body, namely, committee of creditors (CoC) decides to liquidate it earlier. Therefore, one should consider if the Code has resolved insolvency, that is, rescued all viable CDs and closed all unviable ones, and what has been the quality, cost and time of such resolution. The tendency to evaluate the performance of the Code in terms of incidence of liquidations or extent of recovery must be eschewed to ensure that it remains firm on the track.

"The market usually chooses to rescue the CD if it is viable and to close it if it is unviable. The Code, however, prefers rescue of the CD to capture the going concern surplus which is lost if it is liquidated."

Reversal of PUFE Transactions

Reversing PUFE transactions promotes the objective of the Code in many ways. The Bankruptcy Law Reforms Committee, which conceptualised the Code, has identified avoidance transactions as a key source of additional value in corporate insolvency, over and above the existing assets of the CD. The Code accordingly enables the processes to undo these transactions and thereby claw back the value lost through them. If these transactions are undone and the lost value is clawed back to the CD, creditors would stand to realise higher value than they would otherwise. Higher the realisation, the higher is the likelihood of rescue of the CD through a resolution plan, which is the primary objective of the Code. If the market decides to liquidate the CD, the liquidation estate would include any assets or their value recovered through proceedings for avoidance of transactions. This improves realisation for creditors that promotes credit availability.

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 CD. Such a transaction could be considered criminal in certain circumstances, particularly when it is fraudulent, inviting criminal proceedings. If the market knows that there is no way one can get away with PUFE transactions with impunity, it does not make any sense for anyone to indulge in such transactions. In such a case, the value continues to reside in the CD and consequently the possibility of the CD getting into stress is minimised. Thus, provisions relating to PUFE transactions not only help rescue the CD, but also prevents the need for rescue.

Thirdly, the Code provides a waterfall for distribution of liquidation proceeds among stakeholders. It requires resolution plan in a CIRP to consider the order of priority in the said waterfall. This prioritisation balances the interests of various stakeholders of the CD. If someone resorts to avoidance transactions to appropriate any value from the CD in the run up to the CIRP, the stakeholders standing in waterfall would lose. Further, if a junior stakeholder appropriates any value of the CD in the eve of CIRP, a senior stakeholder may not get its share of value, which disturbs the balance among the stakeholders enshrined in the Code.

> **Section 66 (2) provides recourse against the director who carries on the business during twilight period and not against the beneficiary. A director is required to make good the loss even if he has not gained anything personally.**

Fourth relates to the value lost through fraudulent trading. Section 66(1) provides that if the business of the CD has been carried on with intent to defraud creditors or for any fraudulent purpose, the AA may require the persons, who were knowingly parties to the carrying on of the business in such manner, to make such contributions to the assets of the CD as it may deem fit. Unlike avoidance transactions, the recourse here is against the persons who are knowingly parties to defraud the creditors. This provision has been contested most because it is a criminal proceeding in the cloak of a civil proceeding, where the liability arises on a finding based on preponderance of probabilities.

Section 66(2) of the Code makes the directors of the CD liable for the loss to the 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 commencement of CIRP till the CD actually enters into CIRP. During this period, a director has an additional responsibility to exercise due diligence to minimise potential loss to creditors and he is liable for such loss. While improving corporate governance, this incentivises the CD as well as directors to seek resolution in the early days of stress when the possibility of the rescue is higher.

In case of avoidance transactions, the underlying property/value returns from the beneficiary to the CD. In case of fraudulent transactions, recourse is against the director or person responsible, who is required to make good the loss even if he has not gained anything personally. This provision has been used rarely. If used effectively, no CD would resist initiation of CIRP and consequently, the admission will be much faster, allowing commencement of CIRP in the early days of stress and making the possibility of rescue of the CD by resolution plan higher. It is incumbent upon IPs to scrupulously scrutinise the transactions made during the twilight period and file applications under Section 66 (2) to improve rescue rate.

Incidence of PUFE Transactions

Let us look at data to have an idea about the incidence of such transactions and its consequences. The IBBI Newsletter for the quarter ending December 2021 indicates that CDs undergoing CIRP have lost at least 10% of claims admitted against them through PUFE transactions during the look back period. The loss is likely to be a multiple of 10% if we consider loss prior to the look back period, the loss not detected by IPs, loss from business during twilight period, etc. This is disconcerting. In the quarter ending June 2022, the creditors realised only 10% of their claims through resolution plans, and these CDs had assets valued at only 7% of the admitted claims, when they entered into CIRP.

Till June, 2022, 786 applications have been filed to claw back ₹2,21,104 crore lost through PUFE transactions during the relevant period. If this value is clawed back, several CDs would be rescued. If this value was not lost, several of them would not have got into CIRP in the first place. This becomes more obvious seen in the prism of outcomes of CIRPs.

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

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

Inadequate Performance

There are instances, however, where some IPs don't discharge their responsibilities effectively. In the matter of Surat Fabrics (Textiles) Mills Ltd., the RP filed an application for avoidance transactions on 389th day of the CIRP. He filed this application after filing the application for approval of the resolution plan. He did not make any determination; merely relied on the forensic auditor's report and did not give independent reasons for determination of preferential transactions. The AA observed: "The feeling is inescapable that the RP has filed the application under section 43 read with section 44 of the Code only to avoid adverse scrutiny on the part of the IBBI and not with any real intention to pursue the alleged preferential transactions to their logical end."

The law enables filing of applications both at CIRP and liquidation stages. If this exercise is done during the CIRP, the need for this exercise at the liquidation stage would not arise. It is, however, observed from the IBBI Newsletter of December 2021 that the underlying value of applications filed for PUFE transactions during liquidation stage constitutes about 20% of the total value of all applications. This means that the IPs are failing to file applications in respect of 20% of the value of PUFE transactions during the CIRP. There is some reluctance, which could be motivated in some cases, in attempting to retrieve value lost through PUFE transactions.

Another issue is the quality of scrutiny of transactions by and the applications filed by RPs. In the matter of *Mrs. Renuka Devi Rangaswamy, RP of M/s. Regen Infrastructure and Services Pvt. Ltd. Vs. M/s. Regen Powertech Pvt. Ltd,* while dismissing an application in respect of fraudulent trading, the AA held: "The Applicant in the present case has miserably failed to prove the dishonest intention of the Respondents to defraud the creditors…Only allegations have been made by the Applicants and no documentary proof has been filed in support of the same, to show that the business of the corporate Debtor was carried out by the Respondents with a dishonest intention and to defraud the creditors".

There is a tendency to consider a transaction to be simultaneously preferential, undervalued fraudulent and extortionate and file an application to avoid that transaction. The scope of inquiry, the ingredients, and the consequences are different for each of these transactions. For example, intent is not material for preferential transaction, while it is material for fraudulent trading. The beneficiary gives up the benefits in case of former while the persons responsible are liable. In the matter of *Anuj Jain Interim Resolution Professional for Jaypee Infratech Limited Vs Axis Bank Limited Etc*., the Supreme Court advised both the RP and the AA to deal with these transactions separately and distinctively.

> **"IPs must not hide under the non-cooperation from the CD, statutory auditors or CoC to hide his/her own inefficiency or hesitancy. An IP, who claws back the maximum value lost through PUFE transactions, should get a premium in the market."**

IBBI's Newsletter for the quarter June 2022 shows that the AA has so far disposed of 86 applications for PUFE transactions valued at ₹18,000 crore. This has ploughed back a total sum of ₹60 crore (excluding repossession of 758 acres of land in the CIRP of Jaypee Infra). This means that only 0.3% of value underlying the applications is being ploughed back. The cost of ploughing back seems higher than the amount being ploughed back, indicating quality of work of the RP which probably is not withstanding the judicial scrutiny. There are several factors that contribute to such poor outcomes. Of them, the IP and quality of his work is most significant. The role of IP is focussed in this article because it is a Journal of the leading IPA, which is the first level regulator of IPs.

Conclusion

PUFE transaction is a life and death matter for the CD. Clawing back the value lost through PUFE transactions solely rests on the shoulders of IPs. No one else can file such an application, and whatever the RP does, it is final, subject to the satisfaction of the AA. Therefore, it must not be half-hearted, and a tick-box approach. IPs must not take shelter under the non-cooperation from the CD, statutory auditors or CoC, or even inability of forensic auditor, to hide his/her own inefficiency or hesitancy. An IP, who claws back the maximum value lost through PUFE transactions, should get a premium in the market. Likewise, the market should penalise those, who neglect or do a poor job in respect of PUFE transactions, in addition to the penalty by IBBI and IPA. To enable the market to do so, it must have the information. The IPAs should disclose the performance of each IP in terms of detection, filing and success of PUFE transactions.