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We must rethink insider lending in cases of corporate insolvency

Related-party creditors of insolvent firms should be asked to show that the credit extended was not actually equity in disguise

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Should insiders that lend to their own companies stand in the same queue as arm's-length creditors in insolvency? The answer, at least in liquidation, is largely 'yes' under the Insolvency and Bankruptcy Code of 2016. A promoter may support its company by infusing equity in the guise of debt through a group entity. If the company later enters insolvency, the creditor, despite having enjoyed informational and structural advantages and effectively provided risk capital, may still rank alongside external financial creditors.

Judicial decisions reaffirm this. In Times Innovative Media Ltd, the appellant contended that the related-party creditor should be treated as an equity investor and be placed at the bottom of the liquidation waterfall. The appellate authority rejected the contention, holding that since the statutory waterfall makes no distinction between related and unrelated creditors, a claim cannot be subordinated merely because the creditor is related to the debtor.

This approach aligns with the Supreme Court's reasoning in the M. Rajagopalan case in the context of distribution under resolution plans. The court clarified that the Code does not mandate identical treatment for all creditors within the same class, nor does it prohibit differential treatment. Distribution under a resolution plan largely falls within the commercial wisdom of the committee of creditors (CoC).

Related parties occupy a peculiar position in the insolvency framework. The Code bars relatedparty financial creditors from participating in the CoC to avoid conflict of interest and disqualifies related parties of ineligible promoters from submitting resolution plans to preserve process integrity. It subjects their transactions to heightened scrutiny through longer look-back periods and avoidance mechanisms to unwind deals favouring insiders. These safeguards recognize the potential for abuse inherent in their position.

Yet, in the liquidation waterfall, related-party lenders rank pari passu with unrelated ones. This can create distortions: it dilutes recoveries for arm's-length creditors, enables promoters to strategically structure or recharacterize intra-group funding as debt in anticipation of distress, and rewards insiders by allowing what is risk capital to recover ahead of those who assumed genuine commercial risk.

In India, the concern is amplified because financial creditors rank above operational creditors.

The outcome is counterintuitive: an insider lender whose funding closely resembles equity recovers ahead of an external supplier who extended trade credit on arm's-length terms. This raises a question: Should the insolvency framework remain blind to the structural advantages insiders possess?

Many insolvency regimes address this concern through doctrines such as equitable subordination in US bankruptcy jurisprudence. This empowers courts to subordinate a creditor's claim in certain circumstances. Courts typically apply a threepronged test: the claimant must have engaged in inequitable conduct; the misconduct must have injured other creditors or conferred an unfair advantage on the claimant; and subordination must not be inconsistent with the statutory scheme. The principle reinforced is that insiders should not benefit from their own misconduct.

Other jurisdictions rely on statutory rules. In Germany, most shareholder loans are automatically subordinated below unsecured creditor claims. Spain similarly places certain related-party debts near the bottom of the priority ladder. These frameworks reflect a legislative judgement that insider funding often resembles equity more than arm's-length debt.

International guidance reflects similar concerns. The United Nations Commission on International Trade Law's Legislative Guide on Insolvency Law recognizes that related parties are more likely to possess early knowledge of the debtor's financial distress and may have received preferential treatment. It, therefore, recommends special treatment for certain related-party claims, including subordination where appropriate.

Indian insolvency law provides no comparable mechanism for subordinating insider claims based on inequitable advantage. Adjudicating authorities cannot override the statutory waterfall on grounds of fairness alone. Any change in the treatment of related-party claims must, therefore, come through legislative reform.

The Code is built on two guiding principles: maximization of value and balancing stakeholder interests. Treating insider lenders identically to external creditors, without examining the economic substance of their claims, risks undermining both. The Code already recognizes that those responsible for a company's distress should not regain control through the resolution process. The same logic should inform how insolvency proceeds are distributed. Where insider lending is structured to secure an unfair advantage over external creditors, the law must have the capacity to correct it.

A carefully designed framework for subordinating related-party claims could address this concern without discouraging legitimate intra-group financing. The objective should not be to penalize insider lending, but to clearly distinguish between genuine commercial credit and opportunistic positioning. Where insider credit is extended on arm's-length terms and for legitimate business purposes, it should be respected as debt. But where the structure reveals an attempt to game the insolvency waterfall, the law should respond accordingly.

One approach would be to introduce a rebuttable presumption that related-party financial claims be subordinated below unsecured third-party claims. During the claims verification process, the resolution professional could identify relatedparty claims separately and seek enhanced disclosures on the commercial rationale for such a loan, its terms and whether equity was a realistic alternative to it. Where the transaction withstands scrutiny, the claim would be treated as debt. Where it does not, the claim could be subordinated to reflect its true economic character.

A regime that overlooks the distinctive position of insiders risks undermining the fairness that insolvency law seeks to achieve. Creditors who assume genuine commercial risk should not stand on the same footing as insiders who can structure their support as debt. Closing this gap would strengthen the fairness and credibility of India's insolvency framework.