

Insolvency and Bankruptcy Board of India
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3rd February, 2021

Subject: Judgment¹ dated 1st February, 2021 of the Hon'ble Supreme Court of India in the matter of Phoenix Arc Private Limited Vs. Spade Financial Services Limited & Ors. [Civil Appeal No. 2842 of 2020 with Civil Appeal No. 3063 of 2020]

While disposing of the appeal against the Order dated 27th January, 2020 of the NCLAT, the Hon'ble Supreme held as under:

Sl. No.	Issue / Theme	Held	Para / Page No.
1	<i>Res judicata</i>	The NCLT, vide an order on 31 st May, 2018, allowed AAA Landmark Private Limited (AAA) and Spade Financial Services Private Limited (Spade) to submit their claims as financial creditors (FCs) with a direction to the IRP to consider the claims. However, on subsequent applications by two FCs, (Phoenix and YES Bank) seeking exclusion of AAA and Spade from the committee of creditors (CoC) on the ground that they were related parties, the National Company law Tribunal (NCLT) held that Spade and AAA did not qualify to be considered as FCs. In this backdrop, the order of the NCLT dated 31 st May, 2018 will not operate as res judicata, as it was passed without hearing FCs such as Phoenix and YES Bank.	30/21
2	Remanding the proceeding for reconsideration	An order of remand cannot be passed in a routine manner, and it should be passed only if a re-consideration is necessary. An unwarranted order of remand does not serve the cause of justice and merely extends the life of litigation. Remands in commercial matters should not become a ruse to subserve litigation luxuries.	39/27

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3	Real nature of transaction	<p>Money advanced as debt should be in the receipt of the borrower. The borrower is obligated to return the money or its equivalent along with the consideration for a time value of money, which is the compensation or price payable for the period of time for which the money is lent. A transaction which is sham or collusive would only create an illusion that money has been disbursed to a borrower with the object of receiving consideration in the form of time value of money, when in fact the parties have entered into the transaction with a different or an ulterior motive. In other words, the real agreement between the parties is something other than advancing a financial debt.</p> <p>The Code has made provisions for identifying, annulling or disregarding “<i>avoidable transactions</i>” which distressed companies may have undertaken to hamper recovery of creditors in the event of the initiation of CIRP. It recognises that for the success of an insolvency regime, the real nature of the transactions has to be unearthed in order to prevent any person from taking undue benefit of its provisions to the detriment of the rights of legitimate creditors.</p> <p>Since the commercial arrangements between Spade and AAA, and the corporate debtor were collusive in nature, they would not constitute a ‘financial debt’. Hence, Spade and AAA are not financial creditors of the Corporate Debt.</p>	<p>46/31</p> <p>48/33</p> <p>52/38</p>
4	‘Related Party’ under section 5(24) and 5(24A) of the Code	<p>The definition describes a commutative relationship, meaning that X can be a related party of Y, if either X is related to Y, or Y is related to X. The definition of ‘related party’ under the IBC is significantly broad. The intention of the legislature in adopting such a broad definition was to capture all kinds of interrelationships between the financial creditor and the corporate debtor. The definition under the IBC is exhaustive.</p> <p>The definition ensures that those entities which are related to the corporate debtor can be identified clearly, since their presence can often negatively affect the insolvency process.</p>	<p>58/43</p> <p>59/43</p>
5	Aim of the CoC	<p>The aim of the CoC is to enable coordination between various creditors so as to ensure that the interests of all stakeholders are balanced, and the value of the assets of the entity in financial distress is maximised.</p>	72/52
6	Rationale of the first proviso of section 21(2) of the Code	<p>The objects and purposes of the Code are best served when the CIRP is driven by external creditors, so as ensure that the CoC is not sabotaged by related parties of the corporate debtor. This is the intent behind the first proviso to section 21(2).</p>	75/53

7	Interpreting the legislation	In interpreting the legislation, which represents a Parliamentary effort to bring about structural changes in the resolution of corporate insolvencies, the effort of the court must be to aid the fulfilment of the objects of the IBC.	77/54
8	Does disqualification in the first proviso of section 21 (2) of the Code attach in <i>praesenti</i> ?	<p>The use of the simple present tense in the first proviso to section 21(2) indicates that the disqualification applies <i>in praesenti</i>.</p> <p>The purpose of excluding a related party of a corporate debtor from the CoC is to obviate conflicts of interest which are likely to arise in the event that a related party is allowed to become a part of the CoC.</p> <p>The exclusion under the first proviso to section 21(2) is related not to the debt itself but to the relationship existing between a related party FC and the corporate debtor. As such, the Fc who in <i>praesenti</i> is not a related party, would not be debarred from being a member of the CoC. However, in case where the related party FC divests itself of its shareholding or ceases to become a related party in a business capacity with the sole intention of participating the CoC and sabotage the CIRP, it would be in keeping with the object and purpose of the first proviso to section 21(2), to consider the former related party creditor, as one debarred under the first proviso.</p> <p>While the default rule under the first proviso to section 21(2) is that only those FCs that are related parties in <i>praesenti</i> would be debarred from the CoC, those related party FCs that cease to be related parties in order to circumvent the exclusion under the first proviso to section 21(2), should also be considered as being covered by the exclusion thereunder. Otherwise, a related party FC can devise a mechanism to remove its label of a ‘related party’ before the corporate debtor undergoes CIRP, so as to be able to enter the CoC and influence its decision making at the cost of other FCs.</p>	<p>84/58</p> <p>90/63</p> <p>94/66</p> <p>95/65</p>
9	Decision	<p>(i) Due to the collusive nature of their transactions alleged to be a financial debt under section 5(8), Spade and AAA cannot be labelled as FCs under section 5(7);</p> <p>(ii) Spade and AAA are related parties of the corporate debtor under section 5(24); and</p> <p>(iii) Spade and AA are ineligible to be a part of the CoC in accordance with the first proviso of section 21(2) of the Code.</p>	97/67
