

From Chairperson's Desk

Avoidance Transactions: Protecting Creditors' Interest under IBC

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) creates an ecosystem for maximizing the value of assets of the corporate debtor (CD) and balancing the interests of all stakeholders in a time-bound manner. A significant value of insolvent entities is often locked in assets underlying avoidance transactions which are undertaken by the CD prior to the initiation of the Corporate Insolvency Resolution Process (CIRP). The resolution professional (RP) or the liquidator is obliged to file applications, in respect of avoidance transactions (preferential, undervalued, extortionate and fraudulent transactions) found by him during CIRP and liquidation processes before the Hon'ble Adjudicating Authority (AA), seeking appropriate relief permissible under the Code.

As of end of September 2024, 1,326 avoidance transaction applications involving an amount of ₹ 3.76 lakh crore have been filed with the AA. The AA, after consideration, can order for the amount to be clawed back. The IBC has led to a direct recovery of about ₹ 3.55 lakh crore due to resolution and ₹ 10,446 crore due to liquidation till September, 2024. The recovery from avoidance transactions will add to this recovery to the creditors. Till September 2024, 338 avoidance transaction applications have been settled by the AA ordering a claw back of about ₹ 7,516 crore.

While the RP/liquidator may have filed an application with the AA based on his determination, it may not always be possible for the AA to consider and dispose of the application during the tenure of the CIRP or the liquidation process. Section 26 of the Code clarifies that the filing of an avoidance application by the RP shall not affect the proceedings of CIRP. Avoidance applications and CIRP are a separate set of proceedings and avoidance applications can be continued post-completion of CIRP. The IBC provides that the resolution / liquidation process should not be held up if avoidance transaction applications are pending. During CIRP, if the decision on avoidance transactions is pending before resolution is finalised, the amount would claw back to CD for the benefit of creditors. The CIRP Regulations mandate that a resolution plan should contain the details of the party/ person who will pursue these avoidance transactions after the approval of the resolution plan, who will get the proceeds and the manner in which the proceeds, if any, from such proceedings will be distributed. Consequently, after the resolution plan is approved, the RP has no role in pursuing these transactions and creditors/ successful resolution applicant (SRA) will have to make their own arrangements to pursue them before the AA.

The UNCITRAL Legislative Guide on Insolvency Law clarifies that any assets from avoidance proceedings transferred, or their value, to be recovered would be in the collective interest of creditors. The Insolvency Law Committee (ILC) in its 2020 report, noted that in most cases it may be better suited to distribute recoveries from avoidance transactions amongst the creditors of the CD.

The amount clawed back would reflect in higher bids. In cases where decision on avoidance transactions is not available, the avoidance transactions being assets of the CD, could be permitted by the CoC to be bid by prospective resolution applicants (PRAs) in the resolution plan. In case the CoC decides to assign the

avoidance transactions to a resolution applicant (RA), the specifics of avoidance transactions should be made explicit in the Information Memorandum (IM) and Request for Resolution Plan (RFRP), allowing prospective RAs to account for the value of avoidance transactions while submitting their plan. The CoC in the resolution plan should not give the proceeds of avoidance transactions to the RA without detailing such transactions in the IM or RFRP and without transparent bidding for such transactions. Another option could be to invite bids for avoidance transactions separately after obtaining the approval of AA and the amount recovered could be appropriated by the creditors post-approval from the AA.

Since avoidance transactions involve significant sums and potentially result in large recoveries, creditors should keep these avoidance transactions to themselves and benefit from the upside.

During liquidation, section 36(3)(f) of the Code provides that the liquidation estate shall comprise of any asset or their value recovered through proceedings for avoidance of transactions. The liquidator should invite bids separately for avoidance transactions and the amount recovered would be included in the recoveries of the liquidation estate.

In Personal Guarantors (PGs) to CD proceedings, sections 164 to 167 of the Code specify the transactions made by the PG/ debtor prior to bankruptcy that the AA may set aside to swell the asset pool available to creditors. The avoidance proceedings filed in the CIRP of the CD and PG proceedings are entirely distinct. Any order of the AA in the CIRP of the CD for claw back of the amount from the PG would entitle the creditors/ SRA to file a claim before the RP/ Bankruptcy Trustee (BT) in the PG proceedings.

Avoidance transactions carried out by erstwhile promoters and directors are one of the primary causes leading to financial distress and sickness of CD, and eventually entering the IBC. It is necessary to take these transactions seriously. The CoC should review the progress of these avoidance proceedings on a monthly basis and if required, create a mechanism to pursue these transactions before the AA. Recovery from avoidance transactions would play a vital role in reducing haircuts to creditors. On a conservative scale, decision on avoidance transactions would add recovery to creditors by at least 10%. In cases where avoidance transactions are approved by the AA for prosecution, creditors should approach the Ministry of Corporate Affairs (MCA) or the Insolvency and Bankruptcy Board of India (IBBI/ Board) and file a criminal complaint under section 236 of the IBC before the Special Court established under Chapter XXVIII of the Companies Act, 2013.

To conclude, the provisions for avoidance transactions aid in maximizing the value of the CD both *ex-post* (i.e., once the CD is in insolvency) and *ex-ante*. These provisions foster good corporate governance and deter solvent entities and market participants from engaging in activities involving diversion of funds from the CD. By annulling such transactions, the Code aims to prevent the depletion of the debtor's assets and protect the interest of creditors and other stakeholders. They would act as an additional source of recovery for the creditors.

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