

SECTION 66 OF THE INSOLVENCY AND BANKRUPTCY CODE - A BRIEF OVERVIEW

I. Introduction

The Insolvency and Bankruptcy Code, 2016 (“**IBC**”) has been a landmark legislation for systematic corporate debt restructuring in India. The main objects of the IBC were succinctly described by India’s former Finance Minister, late Mr. Arun Jaitley during his eloquent speech while introducing the IBC bill in the Rajya Sabha: “...*There is a reset and then after the reset the company is competitive once again and it goes forward, and it becomes successful. That is what happens consistently in the United States. They go into bankruptcy, the liabilities are reset, they become competitive again and then thereafter they do fine...*” During the course of its implementation, there have been a number of judgments that have analysed and given teeth to the various provisions of the IBC.

Unlike the prevailing scheme of winding-up petitions, which is focused on fishing out left-over monies from a sinking company, the IBC focuses more on restructuring the debt of the company and resurrecting it through the Corporate Insolvency Resolution Process (“**CIRP**”). The IBC also specifies that liquidation should be considered as a last resort in the event, all attempts at achieving a CIRP fail. During CIRP, one of the integral aspects for reviving a debt-ridden company is to ensure the reversal and avoidance of Preferential, Undervalued, Fraudulent and Extortionate Transactions (“**PUFE transactions**”). The aim is to ensure that a particular class of creditors are not given any undue advantage over the other creditors of the Corporate Debtor.

The UNCITRAL Legislative Guide on Insolvency Law defined avoidance provisions as “*provisions of the insolvency law that permit transactions for the transfer of assets or the undertaking of obligations prior to insolvency proceedings to be cancelled or otherwise rendered ineffective and any assets transferred, or their value, to be recovered in the collective interest of creditors.*” Since the concept of maximization of assets of the Corporate Debtor is key during the CIRP, the provisions pertaining to the avoidance transactions gain importance.

The IBC contains detailed provisions with respect to Preferential Transactions, Undervalued Transactions, Transactions to Defraud Creditors, Extortionate Credit Transactions and Fraudulent Transactions in Sections 43, 45, 49, 50 and 66 respectively. This news alert is limited to the latest jurisprudence on Fraudulent Transactions during CIRP.

With respect to Fraudulent Transactions, Section 66 of the IBC confers wide powers



on the Adjudicating Authority to pass appropriate orders and to do justice where, during the pendency of CIRP or Liquidation Process it suspects that the directors/partners or any other persons related to the corporate debtor, were involved in carrying out any business “*with the intent to defraud creditors of the corporate debtor or for any fraudulent purpose*”. Significant recent judgments have been discussed in this news alert which throw light on the manner in which Section 66 is practically understood and implemented.

II. The Provision

66 Fraudulent trading or wrongful trading. -

(1) If during the corporate insolvency resolution process or a liquidation process, it is found that any business of the corporate debtor has been carried on with intent to defraud creditors of the corporate debtor or for any fraudulent purpose, the Adjudicating Authority may on the application of the resolution professional pass an order that any persons who were knowingly parties to the carrying on of the business in such manner shall be liable to make such contributions to the assets of the corporate debtor as it may deem fit.

(2) On an application made by a resolution professional during the corporate insolvency resolution process, the Adjudicating Authority may by an order direct that a director or partner of the corporate debtor, as the case may be, shall be liable to make such contribution to the assets of the corporate debtor as it may deem fit, if-

(a) before the insolvency commencement date, such director or partner knew or ought to have known that there was no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process in respect of such corporate debtor; and

(b) such director or partner did not exercise due diligence in minimising the potential loss to the creditors of the corporate debtor.

(3) Notwithstanding anything contained in this section, no application shall be filed by a resolution professional under sub-section (2), in respect of such default against which initiation of corporate insolvency resolution process is suspended as per section 10A.

Explanation. – For the purposes of this section a director or partner of the corporate debtor, as the case may be, shall be deemed to have exercised due diligence if such diligence was reasonably expected of a person carrying out the same functions as



are carried out by such director or partner, as the case may be, in relation to the corporate debtor.

On plain reading of the provision, we understand that:

- i. Section 66 contemplates that during the CIRP or liquidation process if it is found that any business of the corporate debtor has been carried on with intent to defraud creditors of the corporate debtor or for any fraudulent purpose, the Adjudicating Authority may on the application of the resolution professional pass an order. The scope of Section 66 of Code requires the Adjudicating Authority to demonstrate that the business of the corporate debtor has been carried on with the “*intent to defraud*” its creditor or for “*any fraudulent purpose*” (“**fraudulent business**”). Further, Section 66(2) of the Code inter alia mandates that the director ought to have known that there was no reasonable prospect of avoiding the initiation of the CIRP and the directors did not exercise due diligence in minimizing the loss.
- ii. If it is established before the Adjudicating Authority that the directors/ partners or any other related persons of the corporate debtor were involved in fraudulent business, then the Adjudicating Authority shall pass Orders against such persons to contribute to the assets of the Corporate Debtor. Additionally, such persons shall also be liable for imprisonment for up to five years and fine of up to Rupees One Crore under Section 69 of the IBC.

III. Significant Judgments

Up until now only a handful of applications with respect to the PUFÉ transactions have been disposed of by the National Company Law Tribunals and few appeals have been filed against the orders passed. With this background, we have analysed some significant judgments in this section:

- i. **Restrictive Orders passed u/s 66 are not in violation of Article 21:** The NCLAT – New Delhi Bench in *Amandeep Singh Bhatia v. Vitol S.A.* passed a judgment dated 30 August 2018, holding that it will always be open to the NCLT to pass appropriate orders under Section 66 read with Section 67 of the IBC and any order passed under the law cannot be held to be violative of Article 21 of Constitution of India. In this case, the NCLT had imposed restrictions on the ex-director from leaving the country in an application under Section 66, due to the pendency of CBI investigations arising from allegations of serious fraud against him. This order was challenged before the NCLAT by the ex-director of the Corporate Debtor.



- ii. **Undervalued transactions by the corporate debtor to keep assets beyond the reach of creditors to be declared as null and void:** The NCLAT - New Delhi bench in *Edelweiss Asset Reconstruction Company Limited v. Net 4 India Limited* passed a judgment dated 29 April 2021, declaring certain transactions of the corporate debtor as null and void and directed the directors of the Corporate Debtor to compensate and pay for the loss suffered. The corporate debtor had executed a master reseller agreement and a trademark assignment agreement through which majority of the assets of the corporate debtor were transferred to its sister concern at a very meagre consideration which led to the Corporate Debtor suffering huge losses and subsequently pushed the corporate debtor into insolvency. In an application filed by the resolution professional under Section 66 of the IBC, the NCLAT held that the corporate debtor had entered into undervalued transactions with the sole intent to keep its assets beyond the reach of its creditors during CIRP; consequently, the said transactions were liable to be declared as null and void under Sections 66/67 of the IBC.
- iii. **After approval of resolution plan by the Adjudicating Authority, the resolution professional has no locus to maintain an application filed under section 43, read with section 66 of the IBC:** NCLT Ahmedabad Bench in *Vijay Lulla v. Technovaa Plastic* passed a judgment dated 9 February 2021, holding that once the CIRP ends with the approval of a resolution plan by the Adjudicating Authority, the resolution professional has no locus to maintain an application filed under Section 43 read with Section 66 of the IBC. Further, it observed that an application under Section 66, after the approval of plan can only be maintained by the successful resolution applicant or as per the mechanism adopted in the resolution plan. The NCLT noted that since the application was filed after the approval of the resolution plan, the role of the CoC and the resolution professional is limited to the implementation of resolution plan and they become functus-officio as soon as CIRP gets over.

IV. Pro Suspended Management Judgments

- i. Recently, the NCLT Mumbai Bench, in *RTIL Limited v. Nitin Kasliwal*, had the occasion to consider the provision of Section 66 in detail and passed a judgment dated 29 November 2021 which brought a much-needed relief to the management of the corporate debtor. The NCLT acknowledged that the management may have taken certain decisions which did not work out as intended by the management and eventually resulted into hefty monetary losses. Having acknowledged this, the Bench held that such bad commercial business decisions cannot be considered to be fraudulent or wrongful trading under the provisions of Section 66 of the IBC. The Bench also had the occasion



to consider topics such as write-off, interlinked entities, reduction in the carrying value of stock; and in doing so, analysed the documents on record and inter alia observed that write-offs are an internal accounting procedure which is necessarily to be followed by any corporate entity. The write-offs do not demonstrate any fraudulent intention. In the context of the facts of the case, the Bench also noted that mere common links between the corporate entities are not sufficient to conclude that there was a fraudulent intention.

- ii. In *R. Ramela Rangasamy v. Kandrikar Shahid Mansoor*, the liquidator in an application filed under Section 66 alleged that the actions of the erstwhile management were fraudulent since they diverted amounts received from LIC towards gratuity payment to employees/workmen, towards creditors. The erstwhile management also made payment of salaries and bonus to the very same employees. The NCLT Bench, Chennai observed that looking at the totality of the situation, it appears that the suspended directors have not utilised the money to defraud creditors or to defraud employees. Although, funds were diverted, but such diversion was not for fraudulent purposes. Further, it was also not the case of the liquidator that these transactions had been concealed from stakeholders.
- iii. In *Jayesh Sanghrajka v. Divine Investments*, the NCLT, Mumbai Bench dismissed the application filed under Section 66 of the IBC and observed that the forensic audit report is required to classify the transactions which fall under Section 66 of the IBC, highlight details and provide reasons for classifying the transactions as fraudulent. The onus is on the applicant to prove that there was an intent to defraud. In the instant case, there was a failure to establish a fraudulent intention. In fact, the respondents were able to establish that the transactions were not fraudulent, and every effort was taken to revive the Corporate Debtor. The Bench perused the certificates from the chartered accountant submitted by the respondent and concluded that the amounts were adjusted by the respondents. It was also observed that the applicant had literally construed the documents and balance sheets, and thus lacked research to suitably comprehend that the funds were being adjusted by the respondents.

V. No Look-back Period

One interesting and peculiar feature with reference to transactions under Section 66 of the IBC is the fact that the IBC does not provide for a look-back period for the purpose of examining and declaring transactions executed by the corporate debtor as fraudulent. This is in contrast to the provisions of Sections 43, 45, and 49 of the IBC which specify a look-back period. An observation to this effect was also recently made by the NCLT, Ahmedabad Bench in *Amit Patel v. Chandra Jain* on 16 February



2022. The Bench noted that there is no prescribed look-back period for transactions which are proposed to be termed as fraudulent under Section 66 of the IBC.

In addition to the above, the NCLAT – New Delhi Bench in *Aditya Kumar Tibrewal v. Om Prakash Pandey*– settled many significant questions of law with respect to Section 66 of the IBC vide its judgment dated 06 April 2022:

- A. **Timelines laid down in Regulation 35A are directory:** Regulation 35A of the Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (“**CIRP Regulations**”) prescribes that within the 115th day of the CIRP, the resolution professional has to form an opinion as to whether the Corporate Debtor has been subjected to any fraudulent transaction/ trading covered under Section 66; and within the 135th day of the CIRP, the resolution professional has to file an application under Section 66 seeking reversal of such a transaction. The NCLAT observed that timelines prescribed in Regulation 35A of the CIRP Regulations are directory and not mandatory and it shall depend on the facts of each case as to whether there are genuine reasons to consider the application on merits even if filed beyond the 135th day.
- B. **Pending Civil Proceedings would not cause impediment:** In the case before the NCLAT, the resolution professional had filed an application under Section 66 for declaring a lease transaction as fraudulent, which was dismissed by the Adjudicating Authority. In the appeal filed by the resolution professional, the respondents (i.e., ex-directors of the corporate debtor) took the stand that resolution professional could not be allowed to question the lease transaction as a civil suit with respect to the same transaction was pending before a civil court. The NCLAT observed that with respect to the proceedings under Sections 49 and 66, the civil proceeding in question cannot create any prohibition from consideration of the issues by the Adjudicating Authority which is competent under the Code to take a decision on fraudulent transactions. The IBC specifically empowers the Adjudicating Authority to take a decision regarding such transactions to ensure that undervalued and fraudulent transactions are unearthed, appropriate measures are taken, and directions are passed, in turn, leading to maximization of assets of the Corporate Debtor.

VI. The Report of the Insolvency Law Committee February 2020

The Report of the Insolvency Law Committee (“**Committee**”) of February 2020 discusses Section 66 at length and recommends many significant changes with respect to actions against avoidable transactions and improper trading in the corporate insolvency resolution and liquidation processes, which are briefly summarised



hereinbelow:

- a. ***Person Responsible for Investigation:*** The Committee Report observed that it may not be viable for the Insolvency and Bankruptcy Board of India ("IBBI") to undertake investigation of avoidable transactions and improper trading under the Code. The Committee concluded that only the Insolvency Professional would be in a position to investigate these transactions during a CIRP or liquidation process.
- b. ***Filing Of Applications to Avoid Transactions, etc.:*** Placing heavy reliance on the UNCITRAL legislative guide on Insolvency Law, the Committee Report recommended that, it may be beneficial to allow creditors (individual or in groups) and the CoC to file applications directly to the Adjudicating Authority in cases where the Insolvency Professional fails to do so. In this regard, the Committee suggested that the creditors should first approach the resolution professional or the liquidator and urgently request him/her to file an application before the Adjudicating Authority. In the event the resolution professional or liquidator fails to file an application, the creditor or the CoC may file the application directly before the Adjudicating Authority.
- c. ***Time Limit for Filing:*** The Committee Report observed that prescriptive timelines for initiating proceedings against avoidable transactions and improper trading during the CIRP or liquidation proceedings may not be necessary. As a general rule, these proceedings would have to be initiated by the resolution professional during the CIRP or liquidation process, within the timelines provided in the respective regulations. Nonetheless, the resolution plan in a CIRP can provide for preservation of claims and manner of pursuing these proceedings after the resolution plan is operational.

VII. Continuation of Section 66 Proceedings

The IBBI in its consultation paper published on 13 April 2022 with respect to the issues related to delays in the CIRP, observed that it is not always possible for the Adjudicating Authority to dispose of applications under Section 66 of the IBC during the tenure of CIRP or Liquidation process. Hence, in order to bring clarity regarding continuation of such applications the IBBI proposed an amendment to CIRP Regulations wherein it would be mandatory to include in the resolution plan, the manner in which such applications will be pursued after the approval of the resolution plan.

VIII. Conclusion



The IBC as a legislation is comparatively at a nascent stage. It is only in recent times, that significant judgments have been passed pertaining to Section 66 in particular. A perusal of the landmark judgments cited hereinabove indicates that increasing efforts are being made to interpret the provisions of the Code keeping in mind the commercial steps and transactions taken by entities in today's day and age. The Tribunals have been mindful to strike the right kind of balance to ensure that an extremely strict and straight-jacket interpretation is not lent to the statute, which frustrates transactions entered into during the ordinary course of business thereby, enhancing the chances of survival for the corporate entity. In line with the intent of the legislators, the Tribunals with every passing judgment are evaluating parameters that would result in a transaction being fraudulent as against a transaction arising from a commercial call taken by the promoters keeping in mind the economic reality at the time, for the company. In doing so, the Tribunals are also striving to ensure that the purpose of the provisions is given credence, thus maintaining the checks and balances required to ensure that the management acts within the contours of the law. Ultimately, this will create a fair playing ground for all the stakeholders of the corporate debtor pre and post CIRP.

DISCLAIMER

This alert has been written for general information of our clients and should not be treated as a substitute for legal advice. We recommend that you seek proper legal advice prior to taking any action pursuant to this alert. We disclaim all liability for any errors or omissions. For further clarifications you may write to Pooja Tidke (pooja.tidke@parinamlaw.com), Krushi N. Barfiwala (krushi.barfiwala@parinamlaw.com) and Rima Desai (rima.desai@parinamlaw.com).

MUMBAI

4th Floor, Express Towers, Ramnath Goenka Marg, Nariman Point, Mumbai – 400 021

Tel : +91 22 4241 0000

NEW DELHI

4 Todamal Lane, Bengali Market, New Delhi – 110 001

Tel : +91 98104 00283

PUNE

2nd Floor, Kundan Chambers, Thube Park, Next to Sancheti Hospital, Pune – 411 005

Tel : +91 20 2553 0711

WWW.PARINAMLAW.COM