



DECODING THE JAYPEE JUDGMENT: PREFERENTIAL TRANSACTIONS

Dr. Binoy J. Kattadiyil

ICSI IIP, IPA of IBBI, New Delhi

Introduction

On February 26, 2020, the Supreme Court gave its verdict in the long-drawn litigation between JaypeeInfratech Limited (JIL) and Jaiprakash Associates Limited (JAL). These two entities had brought forth competing creditor claims. While deciding the case, Supreme Court held that the JIL claims were preferential transactions and that third party security does not amount to financial debt. Through this article, we shall analyse the judgment and its implications.

Background

The statutory appeal is made to SC from NCLAT order dated 01.08.2019 which set aside the order passed by NCLT, Allahabad Bench where the application was moved by IRP of JaypeeInfratech Ltd. (JIL) for setting aside the transaction of mortgage of certain properties made by the corporate debtor (CD) in favour of its holding company Jaiprakash Associates Limited (JAL), having 71.64% equity shareholding in JIL, as being preferential, undervalued and fraudulent, in terms of Sections 43, 45 and 66 of IBC. JIL was set up as a special purpose vehicle for construction of an expressway from Noida to Agra and finance was obtained from a consortium of banks (including Respondents) against the partial mortgage of land acquired and a pledge of 51% of the shareholding held by JAL. IDBI Bank Limited instituted CIRP against JIL alleging that it committed a default in repayment of its dues of Rs. 526.11 crores. After passing an order of moratorium and public declaration, IRP was permitted to take over management of JIL and in the process made an application u/s. 43 of IBC to NCLT which ordered the security interest was ordered to be discharged and the properties involved therein were vested in the corporate debtor, with release of encumbrances. NCLAT however overturned the order of NCLT holding that the transactions in question do not fall within the mischief of being preferential or undervalued or fraudulent; and that the lenders in question (the lenders of JAL) were entitled to exercise their rights. The Respondent banks namely, ICICI Bank Limited and Axis Bank Limited, sought inclusion in the category of FC of JIL but IRP declined to recognize them as such. Being aggrieved by the IRP decision it preferred separate applications u/s. 60(5) of IBC before NCLT asserting their claim on account of the securities provided by JIL for the facilities granted to JAL. NCLT rejected the applications. Aggrieved banks approached the NCLAT which didn't address the issues and has consequently appealed to SC.

Issues and Arguments

1. Whether the transaction of mortgage can be categorized as preferential, undervalued and fraudulent and consequently avoided?
 - (i) whether such transfer is for the benefit of a creditor or a surety or a guarantor?



- (ii) Whether such transfer is for or on account of an antecedent financial debt or operational debt or other liabilities owed by the corporate debtor?
 - (iii) Whether such transfer has the effect of putting such creditor or surety or guarantor in a beneficial position than it would have been in the event of distribution of assets being made in accordance with Section 53?
 - (iv) Whether the transfer was made during the period of two years preceding the insolvency commencement date?
 - (v) Whether such transfer is not an excluded transaction in terms of sub-section (3) of Section 43?
2. Whether the Respondents could be categorised as FC of JIL on the strength of the mortgage created by CD, as collateral security of the debt of its holding company for the purpose of CIRP?

Arguments by Appellants:

JAL would be preferred in the event of distribution of assets (waterfall mechanism) in terms of Section 53 of IBC due to the priority of interest created by way of security interest. The re-mortgage amounts to a fresh mortgage within the relevant time of two years before the date of commencement of CIRP and was not done in the ordinary course of business of JIL. The word “or” u/s. 43(3)(a) will have to be read as “and” otherwise it would mean that an overwhelming majority of transactions like the present one, whereby banks who would accept the security interest over properties belonging to a third party, after disbursing financial facilities to its loan, would get out of the net of “preferential transactions”, even if the transfer in question is not made in the ordinary course of business of the corporate debtor

Arguments of Respondents:

The impugned mortgages had not been created on account of any antecedent debt liability owed by the CD; they had been within the ordinary course of business of and were not within the statutory period of one year and, therefore, Section 43 of IBC would not apply. The ‘relevant time’ in the present circumstances could be only one year as Bank is an unrelated party as the land parcels were mortgaged on 24.02.2015, which is beyond even the two years formulation, the relevant time being from 10.08.2016 to 09.08.2017. The security was provided on account of the debt obligations of JAL, and not any antecedent debt obligations of the corporate debtor. The transfer has no effect whatsoever on the relative position of JAL in the distribution waterfall as it remains an operational creditor without any security interest. A mere transfer of the assets within the look-back period (relevant time period) would not make the transaction preferential except when it is coupled with the intent to prefer one creditor over the other.

The Judgment And Its Implications

1(i) The transactions had been of transfers for the benefit of JAL, who is a related party of the corporate debtor JIL as explained in 1(ii)

1(ii) CD has given a preference by way of the mortgage transactions for the benefit of its related person JAL for and on account of antecedent financial debts, operational



debts and other liabilities owed to such related person as JAL had entered into Promoter Support Agreement to the lenders of JIL to meet the obligation of JIL towards its lenders; and had further extended Bank Guarantees of Rs. 212 crores to meet the obligation of JIL.

1(iii) Evidently, by way of the impugned transfers, JAL is put in a much beneficial position than it would have been in the absence of such transfers as JAL received a huge working capital (approx. Rupees 30000 crores), by way of loans JAL's liability towards its own creditors shall be reduced, in so far as the value of the mortgaged properties is concerned. Other creditors and stakeholders of JIL shall have to bear the brunt of the corresponding disadvantage because such heavily encumbered assets will not form the part of available estate of the CD.

1(iv) Merely because look-back period is envisaged under IBC, for the purpose of finding 'relevant time', it cannot be said that the provision itself is retrospective in operation as contended by the Respondents. The concept of re-mortgage is equivalent to fresh mortgage and thus Respondent's contention that the mortgages were formed prior to commencement of IBC or were re-mortgaged falls flat.

1(v) With regards to the Respondent's contention of "*ordinary course of business*" in the landmark case of Downs Distributing Co. v. Associated Blue Star Stores, wherein it was held to mean "a transaction that falls into place as part of the undistinguished common flow business done". Relying on this, SC was of the opinion that the mortgages were not in the ordinary course of business of the CD as lending was not in the ordinary course of business of the CD.

Banks contention that they were unaware of third-party encumbrances was legally untenable as they are hit by doctrine of due diligence (notice) and should've inspected for any encumbrances.

2 The debts in question are in the form of third party security; said to have been given by the corporate debtor JIL so as to secure the loans/advances/facilities obtained by JAL from the respondent-lenders. Such a 'debt' is not and cannot be a 'financial debt' within the meaning of Section 5(8) of the Code; and hence, the respondent-lenders, the mortgagees, are not the 'financial creditors' of the corporate debtor JIL. As per ratio in Essar Steel and Swiss Ribbons, as being subsumed in financial creditors, is only that of such secured creditors who are directly engaged in advancing credit to the corporate debtor and not the indirect creditors who had extended any loan or facility to a third party but had taken a security from the corporate debtor, whose resolution is under consideration.

This decision of the Supreme Court will have a huge impact on how third party security transactions are viewed within the context of IBC. Classifying them as preferential transactions means that now insolvency professionals will have to re-think before approaching the NCLT for third-party security transactions. Moreover, the composition of committee of creditors would also have to undergo a change, as third-party security beneficiaries may not fall under the scope of financial creditors, post this decision.