INSOLVENCY PROFESSIONAL AGENCY
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Indian Institute of Insolvency Professionals
of ICAI (IIIPI)

STATEMENT OF BEST PRACTICES:

"ROLE OF INSOLVENCY PROFESSIONALS (IPs) IN AVOIDANCE PROCEEDINGS"

(Joint paper by all the IPAs)

This document has been prepared for the sole purpose of creating awareness and appreciation of the provisions of the Code and emerging jurisprudence. This is not a guide for taking or recommending any action, commercial or otherwise. The user must study the relevant provisions of law and / or seek professional advice if he wishes to take any action or decision in any matter covered in this document.

ABOUT THE DOCUMENT

The need for avoidance proceedings can arise in both Corporate Insolvency Resolution Process (hereinafter referred as **'CIRP'**) and Liquidation proceedings.

The Code, read with Regulations, has demarcated the responsibilities of an insolvency professional in CIRP and liquidation process. To enable the insolvency professional and the Committee of Creditors (hereinafter referred as 'CoC') to have a complete and clear understanding of their roles and responsibilities in a CIRP, the IBBI, on 1st March, 2019[1], issued an indicative Charter of their responsibilities, prepared in consultation with the three Insolvency Professional Agencies (IPAs). Since the CoC does not exist in the liquidation process, the Liquidator has independent and exclusive duties. The emerging jurisprudence is bringing further clarity about their roles in corporate insolvency proceedings.

It is understood that Insolvency Professionals (hereinafter referred as **'IPs'**) seem to be following different practices for identification of avoidance transactions and filing applications before the AA. Further, certain conflicts may still arise in the conduct of the proceedings due to perceived overlaps in the domain of the Resolution Professional (hereinafter referred as **'RP'**) and CoC.

Therefore, for having a systematic approach in the working of all the IPs, a thought of having a guidance and Statement of Best Practices (hereinafter referred as **'Statement'**) was inculcated.

A core committee of IPs having 6 members was formulated by ICSI Institute of Insolvency Professionals *(with other 2 IPAs)* who worked on developing this statement of best practices through various meetings with pre-defined questions. Mr. Vinod Kothari *(IBBI/IPA-002/IP-N00019/2016-17/10033)*, Ms. Ramanathan Bhuvaneshwari *(IBBI/IPA-002/IP-N00306/2017-18/10864)*, Ms. Pooja Bahry *(IBBI/IPA-003/IP-N00007/2016-2017/10063)*, Mr. Ashok Kumar Gulla *(IBBI/IPA-003/IP-N00024/2017-2018/10174)*, Mr. Anuj Jain *(IBBI/IPA-001/IP-P00142/2017-2018/10306)* & Mr. Abhilash Lal *(IBBI/IPA-001/IP-P00344/2017-18/10645)* were the members of the committee.

The same was subsequently put on website of all the 3 IPAs for public comments and later on reviewed and refined by other IPs, through the discussions and deliberations made at;

1. 1st Roundtable organised by ICSI Institute of Insolvency Professionals on 21st August, 2020
2. 2nd Roundtable organised by Indian Institute of Insolvency Professionals of ICAI on 26th August, 2020.

Consequently, the Statement of Best Practices was developed which may be useful for the insolvency professionals while handling Corporate Insolvency Resolution process/Liquidation.

The Statement of Best Practices is principles-based, and is recommendatory in nature leaving substantial discretion to RP/Liquidator dealing with the case in hand.

[1] https://ibbi.gov.in//uploads/legalframwork/58b3837f3e594c5ed43f5ffa54c7c270.pdf

STATEMENT OF BEST PRACTICES:1

"ROLE OF IPs IN AVOIDANCE PROCEEDINGS"

Sections 25 and Section 35 of the Insolvency and Bankruptcy Code, 2016 (hereinafter referred as **'IBC/Code'**) enumerate the duties of Resolution Professional (hereinafter referred as **'RP'**) and Liquidator, respectively. These duties include certain actions in respect of avoidance transactions and questionable conduct (*wrongful trading and fraudulent trading).* The avoidance transactions are divided into three categories: preferential transactions, undervalued transactions and extortionate credit transactions. However, references to avoidance transactions in this Statement include, unless excluded by context or otherwise, references to questionable conduct too.

Sections 43, section 45, section 49, section 50 and section 66 of the Code mandate the RP and the Liquidator to file applications with the Adjudicating Authority (hereinafter referred as **'AA/NCLT'**) seeking appropriate reliefs and directions permissible under the Code where the RP and Liquidator comes across any transactions that can be classified in the said provisions. Section 47 of the Code, inter alia, provides that the AA shall require the Insolvency and Bankruptcy Board of India (hereinafter referred as **'IBBI/Board'**) to initiate a disciplinary action against the RP or the Liquidator, as the case may be, where he has not reported undervalued transactions to the AA. Additionally, section 59(6) incorporates reference to section 43, section 45, section 49 and section 50 in context of voluntary liquidations as well. Hence, this Statement is intended to guide Insolvency Professionals in context of CIRP, liquidation as well as voluntary liquidation. Accordingly, references to Liquidation in the Statement, where appropriate, include references to voluntary liquidation as well.

Regulation 35A of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (hereinafter referred as **'CIRP Regulations'**) requires the RP to form an opinion whether the Corporate Debtor (hereinafter referred as **'CD'**) has been subjected to any avoidance transaction on or before the 75th day of the insolvency commencement date (hereinafter referred as **'ICD'**). Where he is of the opinion that the CD has been subjected to any transactions covered under the aforesaid sections, he shall make a determination, on or before the 115th day of the ICD, under intimation to the Board. The same is also required to be confirmed in Form H annexed to the CIRP Regulations. Further, he shall apply to the AA for appropriate relief on or before the 135th day of the ICD. These provisions aim to claw back the value lost through avoidance transactions, in sync with objective of maximisation of value of the assets of the CD.

Therefore, the following **six** types of transactions/conduct can be identified as covered under the Code, and related avoidance proceedings which are essentially aimed at **compensating** the estate of the insolvent company –

(i) Preferential transactions u/s 43
(ii) Undervalued transactions u/s 45
(iii) Transactions defrauding creditors u/s 49
(iv) Extortionate credit transactions u/s 50
(v) Fraudulent trading u/s 66(1)
(vi) Wrongful trading u/s 66(2)

It may be noted that each of the above are concerned with a distinctive behaviour. The features have also been discussed in UNCITRAL Guide and may be briefly discussed here for the purpose of clarity –

(i) **Section 43: Preferential Transactions** - Preference is about 'who'. If the debtor is being biased and is making payment to a creditor, to the exclusion of others, such that the creditor is wrongly benefitted, it amounts to a preference. Intention is not a factor in 'preferences' – under UK law, what matters is a 'desire to prefer'. However, avoidance is subject to transaction falling within look back period. The Hon'ble Supreme Court (hereinafter referred as **'SC'**) in the matter of ***Jaypee Infratech Limited***[2] has already dealt in detail the features of a preferential transaction.

(ii) **Section 45: Undervalued Transactions** – Undervalued transactions are about 'how much'. Where the value received by the debtor is less than the value compromised by the debtor, the same can be a targeted transaction under Section 45 of the Code.

(iii) **Section 49: Transactions defrauding creditors** – Scope of section 49 is different from that of section 43 and 45, in the sense that there is an element of deliberate intent, viz., the intent to defraud. For either section 43 or section 45, intent does not matter, but the moment an ulterior intent is added to a transaction covered by section 45, section 49 comes into picture. Thus 'intention to defraud' is an essential element in section 49. Though transaction defrauding creditors can be of varied types, however, section 49 makes reference to section 45. Based on the discussions and recommendations in para C (a) and (b) (Page 98-99) of the Interim Report of the Bankruptcy Law Reform Committee (hereinafter referred as **'BLRC'**)[3], it may be inferred that there is no look-back period for cases under section 49[4].

Section 49 may be connected to section 45, but is naturally different; otherwise, there was no need to create a different section at all. Section 45, per se, does not need an element of intent. If the transaction alleged under section 45 happened within the look-back period, it is deemed to be an undervalued transaction. However, where there was an ulterior motive, the transaction would fall under section 49. The intent of the debtor is to 'keep assets of the corporate debtor the reach of any person who is entitled to make a claim against the corporate debtor'. The UNCITRAL Guide on Insolvency Law clearly states that as the effect of these transactions will generally be to the disadvantage of all unsecured creditors, the transactions cannot be 'automatically' avoided by reference to an objective test of fixed period of time in which the transactions occurred because of the need to prove the intent of the debtor. The intent is proven by identifying circumstances that are common to these type of transactions. Detailed indicators are given in the UNCITRAL Guide.

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[2] Civil Appeal Nos. 8512-8527 of 2019- https://main.sci.gov.in/supremecourt/2019/35907/35907_2019_7_1501_20906_Judgement_26-Feb-2020.pdf

[3] https://www.finmin.nic.in/sites/default/files/Interim_Report_BLRC_0.pdf

[4] Reference may also be made to the order of the Hon'ble Supreme Court in the landmark Jaypee ruling (supra)- para 17.4 which states that "*separate provisions are made as regards the transactions intended at defrauding the creditors (section 49 of IBC) as also for fraudulent trading or wrongful trading (section 66 of IBC). It can thus be implied that the tenet of section 49 is different from sec 45, and deals with fraudulent trading- hence, will not attract a claw-back period."* However, the instant statement is subject to jurisprudence, as it evolves over time.

(iv) **Section 50: Extortionate credit transactions** – The same deals with transactions undertaken at unconscionable terms.

While the Sections as mentioned above deal with the types of transaction, the Sections mentioned below deal with the "conduct of business":

(v) **Section 66(1): Fraudulent trading** – The provision deals with fraudulent trading, therefore, 'intent to defraud' is essential. Here, what needs to be proved is that the business as such is conducted in a wrongful manner, whereas in section 49, it is the specific transaction which is undertaken to defraud creditors. This requires a broad understanding of how business is being run vis-à-vis how the business is to be run. The law does not prescribe any look back period for the same.

Therefore, it is felt that the scope of section 66 (1) is quite wide, and if there are definitive findings of conduct of business in a wrongful manner, with an intent to cause prejudice to creditors, the conduct of business may be brought under the section. IPs, therefore, have substantial flexibility, so as to accommodate their findings.

(vi) **Section 66(2): Wrongful trading** – The provision deals with wrongful trading, that is, the conduct might not amount to fraud, but if the directors have continued to trade, taking advantage of the limited liability of equity holders, exposing creditors to deeper losses, the conduct may fall short of principles governing duties of directors to act diligently in the vicinity to insolvency.

Hence, the point which is being emphasised is that there can be an array of transactions, which can escape the provisions of section 43, section 45 and section 49, however can only appropriately fall under section 66(1)/(2), as the sweep of the latter provisions is expansive provided one can prove the intent to defraud or wrongfully carry business. Also, while sections 43/45 have a look-back period criterion, there is no such criterion under section 66(1)/(2). Though, in section 66(2), the look-back period can be circumstantial. Therefore, while initiating the process for identifying the transactions, these points may be kept in mind.

(a) What parameters to be used to form an opinion and then to determine each kinds of avoidance transactions?

An Insolvency Professional during his initial 30 days of CIRP i.e. in the capacity of Interim Resolution Professional (hereinafter referred as **'IRP'**), should work more diligently and with utmost care because those initial days are very important to understand the reasons of failure of the Corporate Debtor, i.e., whether was it normal business failure or the present situation has been contributed by avoidance, preferential, or fraudulent transactions. The avoidance transactions may be of two types: where value is to be recovered ("recuperative transactions") or where there is an implication in form of fraud, breaches of law, alterations of books, etc. ("culpable transactions"). IP may focus on recuperative transactions. Culpable transactions may be referred for further investigation by appropriate authorities. The primary parameters to form an opinion may include:

1. Whether the transfer of property happened for the benefit of a creditor/surety and guarantor and whether such transfers have put him in beneficial position than what he would have received in the event of distribution of assets?

2. Whether a transaction/transfer is made in the ordinary course of business of the Corporate Debtor? *While transactions out of the ordinary course of business are especially gullible, there may be transactions superficially clothed as ordinary course transactions, though not having a genuine business purpose. These transactions are typically done involving either related parties, or where the effect/end-result of the transactions is to cause a benefit to related parties.*

3. Whether the transfer is made for a consideration which is significantly lower than the consideration that would have otherwise been received by the Corporate Debtor?

4. Whether the transactions require the Corporate Debtor to make exorbitant payment in respect of credit provided and whether the transactions are unconscionable under the prevailing circumstances of availing credit?

5. Whether the transfer of property affects the interests of the creditors and affects the resolution process in terms of value?

6. Whether funds have been raised to remit elsewhere, without any deployment towards the core business of the company?

The IP may also be benefited from the **'Red Flag Document on Avoidance Transactions**, issued by IBBI for facilitation of Insolvency Professionals on 07th August, 2020[5].

For determining the avoidance transactions,

[5] https://ibbi.gov.in/uploads/legalframwork/72438989cca02508e20db38d5f18958e.pdf

(i) The first and foremost act on the part of the IP should be to collect and start reviewing records and information. If he thinks fit, he may take custody of the required records to prevent any tampering or destruction of evidence. The IP should then collect as much information as possible regarding the alleged transactions/conduct. IP shall understand the nature of business of the Corporate Debtor and the circumstances leading to financial decline by communicating with customers, suppliers, employees, workers, creditors etc. IP may seek other entities under the control of promoters or persons in charge of the management of the CD, and invoke section 19 of the Code in case of any non- cooperation.

(ii) The IP may also take assistance from the financial creditors because in many cases the financial creditors conduct forensic audit of the CD before filing application with AA. The findings of the forensic audit may be of great help to the IP.

(iii) The assessment shall broadly be intended to check the following –

- Verification of end-use of funds granted by lenders
- Identification of cases involving siphoning of funds, misrepresentation of financial information
- Violation of RPT norms – this would cover verification of related party transactions (hereinafter referred as **'RPT'**) taken directly/indirectly, transactions done by with or by [subsidiaries, step-down subsidiaries, in India and overseas]. In reported transactions with "related parties", a liberal view is to be taken, such that transactions not adhering to arms-length basis are reported. However, there are quite often transactions with entities which are structured so as to avoid being treated as "related party transactions". There may be several approaches to identifying such transactions, including tracing the network of ownership structure of entities where promoters have shareholdings, or repetitive nature of transactions with certain entities with disproportionate size or terms, etc. IP may also carefully understand group structures/cross-holdings/box-structures.
- Verification and tracing movement of unsecured loans/inter-corporate deposits, especially those raised in group concerns
- Concentrating transactions
- Verification of ageing receivables, including advances given, debit balances with vendors, etc. and large amounts of write-off.

(iv) An indicative list of transactions/documents which may be reviewed (either through himself or by appointing a suitable professional) are –

- transactions with related parties.
- large transactions with unrelated parties.
- salaries/benefits to KMPs.
- movement of cash.
- transactions with group companies (to see the diversion of funds).
- sale of assets, transfer of contracts.
- investments made by the company.
- inventory details.
- suspicious movements in the financials.
- transactions routed through related parties and potentially linked parties and whether these were at arm's length and specific purpose.

- purchases and sales made from/ to relatively unknown parties at rates which are higher than market rate.
- perusal of payments made which prima facie indicate diversion of funds under different activities like selling and general expenses, repairs and maintenance, legal expenses, high salaries and other perks to Directors and KMP, high raw material costs and purchase of fixed assets etc.
- large amount of write off of account recoverable made without adequate justifications.
- misrepresentation in statements / data provided to banks for acquiring higher limits and availing withdrawals from banks.
- non-existence of parties from whom money is to be recovered/ outstanding.
- major change in accounting policies including revaluation of assets and in provisioning and depreciation. Impact of these on the financials of the corporate debtor.
- the transaction involved transfer of property or any other asset and investment of corporate debtor to third parties and terms of the said transaction.
- major liabilities including contingent liabilities, disputes, legal cases, tax liabilities, penalties that has not been adequately reported in financial statements and appropriate action not taken.
- bank statements of the CD.
- search from publicly available information i.e. details of charges, hypothecation etc.
- send letters to the debtors for account receivables because there may be chances that the debtors are only shown in the books of accounts to manipulate the books.
- verify the orders passed by authorities against Corporate Debtor which may help to identify the areas of concern.
- physical verification of assets.
- fixed Assets of substantial value sold or disposed off.
- tracing inventory towards invoicing or stock and in particular write off of inventory
- cash transactions.
- purchase from unregistered dealers / service providers, which may be fictitious parties.
- the gap between the value of the claims received and the value of assets available.
- reconciliation of financial statements with several quantitative parameters, such as raw materials, freight, power consumption, gate entries, etc.

If books of accounts are not available, the insolvency professional shall collect bank transactions and identify suspicious movements, search from publically available information i.e. details of charges, hypothecation etc.

(b) Time frame of scrutiny for avoidance transactions

The IP should exercise a well-considered call in deciding the period of time before initiation of insolvency proceedings that he will want to cover for scrutiny of avoidance transactions. While the claw-back period has been explicitly laid down for different sections, other sections do not have explicit clawback period. The absence of any avoidance transactions may only be concluded based on either a preliminary scrutiny by the IP or by a professional *(having experience in related domain and regulated by professional body)* as discussed later. The relevant factors in determination of the period for which the scrutiny of avoidance transactions may be:

(a) The "deflection point", that is, the approximate time when the business model of the CD started suffering financial decline, and therefore, the imminent insolvency may have become evident to the management;

(b) The number of years during which there were no substantial operations or financial transactions, and that such period is unlikely to reveal much relevant information;

(c) The period during which unusual transactions such as borrowings other than from regular lenders/FIs, unusual investments, etc. may have been done or begun;

(d) The period for any substantial remittances overseas (ODI, others) may have been done, which may have later become bad or infructuous;

(e) Other relevant factors, on assessment of financials of the CD.

While choosing the period for scrutiny, the difficulties in obtaining books/records and information from the CD or the promoters/management (say, period prior to 8 years) may be kept in mind. Also, the IP must do a cost-benefit analysis as the costs of the transaction audit may relate to the period covered by the exercise.

Based on circumstances, the IP may want to stretch his own preliminary scrutiny to 5 – 8 years before the initiation of insolvency, and then decide to have the transaction audit done, for relevant years, after getting some feelers from such preliminary scrutiny.

(c) What process to be followed to form an opinion if a CD has been subjected to any avoidance transaction, and make a determination of the same and then file an application?

The following procedure may be followed:

I. Collate records/information–

(i) Seeking information would be the first step – IP may invoke section 19 of the Code. The IP may also take assistance from the creditors because in many cases the financial creditors conduct forensic audit of the CD before filing application with AA. The findings of the forensic audit will serve great help to the IP. If required, IP can take information or discuss with statutory and internal auditors of the CD. Discussions with independent directors and audit committee members may also be of help.

(ii) Generally speaking, the IP may consolidate his findings about all the avoidance transactions so as to make a consolidated, single application, but where there are reasons for taking urgent action about some transaction and "stop losses" caused thereby, the IP may move for a particular transaction separately. Separate applications may also be done where further avoidance transactions come to light after filing application.

(iii) Going by general prudence, transactions in (ii) may require immediate interim relief to be prayed before the AA.

II. **Assessment**- (as stated above in point (a))

III. **'Sifting' –** this would involve studying various records, as above

IV. **Forming *prima facie* view –** sensing the depth

V. Short listing potentially vulnerable transactions

VI. Classification of transactions

VII. If required, seek professional expertise and arrange for transaction audit for the aforesaid process. *See later about the transaction audit and the approval of the costs by the CoC.*

While the preliminary study and examination may be done by the RP, where the RP is of the view that a transaction audit is warranted to identify further related transactions that may have been entered into, the RP may seek necessary professional assistance.

VIII. **Audit findings -** The RP/Liquidator should carefully see the observations of the professional *(having experience in related domain and regulated by professional body)* and juxtapose the same with his independent assessment, so as to frame the final view.

IX. **Discussion with CoC/creditors/statutory auditors/directors-** The findings of a transaction audit report may be discussed with the COC for their views/ comments/ opinions before filing the application with the NCLT, but the filing should not be dependent on the views of COC. RP should not be bound by the views of the COC, as it is the primary statutory duty of the RP to file the application for avoidance of vulnerable transactions.

It must be noted that the Regulation 39 (2) of the CIRP Regulations require the RP to submit the details of avoidance transactions identified. While Reg. 39 (2) requires the RP to submit such details, there is no bar in the Code and/ or regulations that restricts the RP from discussing a certain aspect of the resolution proceedings with the CoC. Nevertheless, so as to maintain confidentiality of the details, the CoC may be made to make an undertaking of confidentiality.

X. **Communicate the findings with the person in default and given an opportunity of being heard:** *the idea is to make the counterparty to the proceedings have his/their side of the story as well. The IP may be able to gather further facts during such interactions.*

XI. **Decision on application –** Respondents to the application to be decided appropriately.

(d) Should every RP in every CIRP examine and investigate if the CD has been subjected to any avoidance transaction?

Filing application against avoidance transactions is one of the *duties* of the resolution professional/liquidator, as mandated under law –

- Section 25(2)(j) stipulates that it is the duty of the resolution professional to file for avoidance of transactions, if any. Note that the RP has to confirm in Form H of the CIRP Regulations, as to whether the RP has made a determination if the CD has been subjected to any transaction of the nature covered under section 43, section 45, section 50 or section 66.

- Section 35(1)(l) enjoins upon the liquidator to investigate the financial affairs of the corporate debtor to determine avoidable transactions.

- Further, section 47(2) empowers the AA to require the Board to initiate *disciplinary proceedings* against a RP/Liquidator, if the said RP/Liquidator, *even after having sufficient information or opportunity to avail information of such transactions*, did not report such transactions to the AA.

Therefore, it is expected from the RP and the liquidator in every CIRP and liquidation to examine and investigate if the CD has been subjected to any avoidance transaction.

It has been noted above that the intent of the proceedings in avoidance transactions is recuperative; hence, if the IP considers that there are alternative ways of recovery of value that may have flown out, say by way of claim against the counterparty or any other proceeding, the IP may exercise discretion.

(e) Whether it is necessary to conduct / order a transaction audit or forensic audit for determination? If so, what are the responsibilities of the professional conducting audit and IP respectively?

The transaction audit may not be required in every case.

The RP/Liquidator may consider the following factors while deciding whether it is appropriate to conduct a transaction audit –

(i) Complexity of group architecture
   a. as in, how large the company is and how large the group is
   b. business of the corporate debtor – sometimes companies have sophisticated business models, to which the RP/Liquidator may not be well versed with.

(ii) Complexity of subject transactions such as :
   a. number of transactions, which prima facie, appear to be vulnerable.
   b. sweep of such transactions (such transactions would generally cover multiple entities).

(iii) Amount estimated to be recovered.

(iv) Relative costs (essentially 2 types – audit costs and litigation costs).

(v) RP/Liquidator's self-assessment as to whether the evidence collected by him will be sufficient to make a good case.

Generally, a distinction is drawn between transaction audit and forensic audit. Though transaction audit and forensic audit are inspired by same principles, but transaction audit has a specific purpose, that is, to determine existence of any of the six categories of transactions/conduct as noted above. Forensic audit is generally arranged by lenders with wide scope of work that includes end use of funds made available to corporate debtor. Forensic audit need not to be ordered by RP/ Liquidator. If lenders want to carry it, the same may be carried out at their own cost. While Forensic Audit is wider and the auditors have greater access to the data of the CD.

The RP is primarily responsible for bringing the avoidable transaction to the notice of CoC and Adjudicating Authority. The professional who is competent to conduct the audit is appointed to conclude on the findings, which shall help RP to enable filing application. It may be noted that the primary responsibility would lie with the RP/Liquidator; the professional appointed to conduct the audit, only facilitates the function of the RP/Liquidator. The duties of the professional may be, *mutatis mutandis* as per Section 143 of the Companies Act, 2013.

Responsibility of the professional conducting transaction audit:

- Analysing the financials statements of CD for the period covered for transaction audit in detail and in accordance with scope of work defined in appointment letter;
- Maintaining the confidentiality of the information collated during the audit;
- Properly classify in his/her report about the basis of classifying the transaction as avoidance and the same should be properly documented;
- The report should be conclusive classifying the transactions under relevant sections of IBC;
- He/She may be called in CoC Meeting or by AA for seeking any clarification on his/her report. He/She should be present at every such meeting/hearing.

Responsibility of IP:

- Providing assistance and information to the professional required for conducting audit;
- Studying and understanding the report submitted by the professional;
- Based on the transactions identified in the report, IP should identify the respondents to be made party;
- If deemed fit, IP can share the evidences as collected by him with the professional to be incorporated in the audit report.

A format detailing the scope of transaction audit is enclosed as **Annexure-A**

(f) Who can help an IP in detection of avoidance transactions? Is that person a professional? What should the amount of fee / expenses on such professional services? What care should be taken to avoid conflict of interests?

The IP may take assistance from a professional *(having experience in related domain and regulated by professional body)*, as per discussion above. Approval of CoC shall be taken by the RP regarding the fees of the professional. The RP may get the budget approved in the first CoC or can get the approval on each matter depending upon the case and the pertinent situations.

In some cases, where CoC does not approve the proposal for transaction audit or the fees, the resolution professionals shall record all the deliberations in the minutes.

To avoid conflict of interests, the following should be specifically noted –

(i) IBBI Circular No. IP/005/2018[6] dated 16th January, 2018 on "Disclosures by Insolvency Professionals and other Professionals appointed by Insolvency Professionals conducting Resolution Processes

(ii) Regulation 7 of the Liquidation Regulations;

[6] https://ibbi.gov.in//webadmin/pdf/legalframwork/2018/Jan/Disclosures-Circular-12.01.2018%20(1)-1_2018-01-16%2018:26:45.pdf

(iii) Para 23B of the Code of Conduct as under the Insolvency Professional Regulations.

As a matter of good practice, the following may also be noted –

(i) The RP/Liquidator should not appoint the professionals who have already conducted the audit of the same CD or those who have conducted forensic audit or have had any other engagement with the CD in the past.

(ii) Disclosures should be obtained from the professional appointed to conduct the transaction audit in accordance with IBBI Circular dated 16th January, 2018 (as mentioned above).

(iii) Suggestions from CoC members are commonly received about appointment of professionals. The RP may make an objective assessment based on the standing of the firm, fee quote, commitment of time, proximity to the place where the actual onsite work is to be carried, etc.

(g) Is detection of avoidance transactions a core function of an IP? Can it be outsourced to any other person?

Detection of avoidance transactions is one of the important functions of the Insolvency professional.

After forming a preliminary view as to the existence of suspicious transactions, the resolution professional/liquidator may appoint a professional who shall be independent to the RP/liquidator and to the CD to conduct transaction audit of the CD.

The primary responsibility shall be of the RP/liquidator; the professional conducting the audit will facilitate the RP. However, RP/Liquidator shall not be held liable for not being able to discover/unfold certain transactions which even the professional conducting the audit could not unfold by way of reasonable assessment and which can only be discovered through 'investigative powers'. *Bona-fide* actions of RP/Liquidator are protected under Section 233 of the Code.

(h) Whether the RP / Liquidator can himself be the professional conducting the audit? Whether the fee of RP / Liquidator includes the fee for determination and filing of application?

The RP / Liquidator cannot himself be the professional who conduct audit. After analysis of books of accounts, if the RP feels that there is a need to conduct the transaction audit he may appoint an independent professional to conduct the audit whose fees has to be separately approved by the CoC.

Further, the RP cannot charge separate fees for determination and filing of application. The professional fees he receives cover the entire work.

(i) Is it necessary to share and consult the CoC or promoters of the CD to order an audit or for taking follow up action on audit findings?

When one refers to section 20(2), it becomes clear that the 'authority' to appoint professionals lies with IRP/RP. The law has identified areas where CoC consent has to be obtained - Section 28 also does not talk about obtaining CoC approval for appointment of professionals.

In other jurisdictions too, especially UK, there is no requirement before the office-holder to obtain creditor approval for appointing professionals [see sections 238, 239, etc.].

It cannot be contended that there is no explicit reference to 'transaction audit" in the provisions pertaining to the powers/functions of the RP, and therefore, the RP is not entitled to exercise discretion in this regard. Transaction audit is an incidental requirement which enables the RP/Liquidator to perform his duties, hence, should not be denied by CoC on the above-stated ground.

However, CoC is required to approve the fees for such audit as per Regulation 34 of CIRP Regulations and hence the appointment needs to be discussed in meeting of CoC w.r.t. to the fixation of fees. *See below*.

In Liquidation, there is no concept of a CoC during liquidation. As we are aware, the law 'shifts' the control from creditors to the Tribunal, under whose supervision, the Liquidator works.

Section 35 entails 'powers and duties' of the liquidator to appoint professionals, look for avoidance transactions, etc. Hence, the role of creditors is limited and advisory in nature. However, as a matter of good practice, the liquidator should keep the creditors informed.

Moreover, as per IBBI facilitation letter[7] dated 1st March, 2019 regarding "**Charter of Responsibilities of IRP/RP and CoC in a CIRP"** it was clearly mentioned that (i) determination of transactions of the nature of preferential, undervalued, extortionate, fraudulent trading or wrongful trading; (ii) intimation to the IBBI; and (iii) applying to the AA for appropriate relief are the responsibilities of IRP/RP and CoC has no role into it.

The findings of the transaction audit may be discussed in the CoC meeting, but the same should not be a voting agenda. If some/all members of the CoC have any say in the matter, the RP shall record everything and go ahead with the filing, in case the RP is of the opinion that the application should be made. The CoC cannot direct the RP with respect to filings against avoidance transactions. CoC can contribute their views/opinions, but the final decision is to be taken by the resolution professional.

(j) Whether the approval of CoC is required for expenses to be incurred on audit /professional fee? Where the CD has resource constraint, should audit be avoided?

Regulations 31, 33 & 34 of CIRP Regulations provide details about the insolvency resolution process cost, cost of interim resolution professional and resolution professional costs as follows -

"Regulation 31: Insolvency resolution process costs

[7] https://ibbi.gov.in//uploads/legalframwork/58b3837f3e594c5ed43f5ffa54c7c270.pdf

"Insolvency resolution process costs" under Section 5(13)(e) means
.....

*(c) Expenses incurred **on or by** the interim resolution professional to the extent ratified under Regulation 33;*

*(d) Expenses incurred **on or by** the resolution professional fixed under Regulation 34.*

Regulation 33: Costs of the interim resolution professional.

1. *The applicant shall fix the expenses to be incurred on or by the interim resolution professional.*
2. *The Adjudicating Authority shall fix expenses where the applicant has not fixed expenses under sub-regulation (1).*
3. *The applicant shall bear the expenses which shall be reimbursed by the committee to the extent it ratifies.*
4. ***The amount of expenses ratified by the committee shall be treated as insolvency resolution process costs.***

Explanation- For the purposes of this regulation, "expenses" include the fee to be paid to the interim resolution professional, fee to be paid to insolvency professional entity, if any, and fee to be paid to professionals, if any, and other expenses to be incurred by the interim resolution professional.

Regulation 34: Resolution professional costs

The committee shall fix the expenses to be incurred on or by the resolution professional and the expenses shall constitute insolvency resolution process costs.

Explanation- for the purposes of this regulation, "expenses" include the fee to be paid to the resolution professional, fee to be paid to insolvency professional entity, if any, and fee to be paid to professionals, if any, and other expenses to be incurred by the resolution professional."

Accordingly, only the amount ratified by CoC will form part of insolvency resolution process cost. Therefore, RP shall put forward the agenda of transaction audit and subsequent proceedings for the approval of expenses. RP may get the budget approved in the very first meeting depending upon the situations. The RP shall make sure that the fees should be reasonable and proportional to the matter in hand.

The cases where CoC is not cooperative and does not ratify the fees of the legal counsels/advocates/other professionals, the RP shall record all the deliberations in the CoC minutes. The application shall be filed with all facts recorded therein, seeking appropriate directions from the AA.

(k) Whether the audit or audit findings are confidential? How long it should be confidential. Should it be disclosed under listing compliances?

The question of disclosure may arise at three stages: audit stage, application stage and decision (of the AA) stage. The decision of the AA is invariably in public domain – hence, the same is deemed publicly disclosed. Usually, the disclosure of any proceedings before

the AA is made only to the parties to the proceeding. Other interested persons may use the procedure given in NCLT Regulations for inspection of records of proceedings, if permitted by the Registry. Hence, there is no question of disclosure of the details of the pending application to the AA as well. That leaves the question of disclosure at the audit stage.

The audit stage, whether during its pendency or its findings, cannot be considered as a conclusive proof of any vulnerable transaction or fraud, hence, the audit findings should be kept confidential, subject to the following –

(i) **Disclosure to persons alleged in the audit findings –** The relevant audit findings may be shared with the concerned persons (potential respondents who may be directors, promoters, of the CD) as a part of natural justice, so as to allow them to offer explanations within a reasonable time.

(ii) **Disclosure to members of CoC –** Sharing audit findings with the members of CoC appears logical, since, during CIRP, the CD is under the control of the creditors. CoC members may have difference of views – the same may be recorded. It is not appropriate for the RP to screen or withhold important information from the CoC members. During liquidation proceedings, the Stakeholders Consultation Committee may be kept informed, for any contribution they may have to make.

(iii) **Disclosures to other creditors–** The scheme of the Code is to keep the proceedings under the functional supervision of the CoC members. CoC members mostly consist of financial creditors (and authorised representatives), and may, in limited cases, consist of operational creditors. Disclosure of information relating to avoidance transactions to any creditor, not being a member of the CoC, may amount to divulging sensitive information, and is, therefore, not recommendable.

(iv) **Disclosure to public or under listing compliances –** As stated, audit findings are not conclusive, and the mere audit finding or the filing of avoidance application is not a material information in terms of Reg. 30 of LODR Regulations for the CD. Whether such application constitutes a material information for the parties against whom the proceedings are made may be considered by the respective party.

(v) **Disclosure to resolution applicants –** Since the findings about avoidance transactions reflect the value that may have moved out of the CD, with a prospect of recovering the same through relevant proceedings, it is considered appropriate that details of such findings, and the intended recovery, should form part of the Information Memorandum. Here, also note that section 29(2) of the Code permits provision of access to RA to all relevant information subject to requirements as to confidentiality. This will also enable the RAs to make appropriate provisions about any clawback of the proceedings in their resolution plan.

Note that any disclosure or sharing of such audit findings/report should be done subject to a confidentiality undertaking (akin to regulation 5 of the Liquidation Regulations). *See*

also IBBI Circular No. IP(CIRP)/007/2018[8] dated 23rd February, 2018 on "Confidentiality of Information relating to Processes under the Insolvency and Bankruptcy Code, 2016".

(l) Whether the audit findings are conclusive about avoidance transactions? What makes a determination concrete?

The conclusiveness of audit can only be determined after the decision of Adjudicating Authority.

However, the transaction audit report should be concrete and specific. The report should conclude the findings on the basis of available information. The audit report shall be the supporting document when the RP files application with AA.

(m) Is RP bound to file an application if CoC passes a resolution to file avoidance application? Should he not file an application where the CoC resolves not to file an application?

As per section 25 of the Code, it is the duty of the RP to file application for avoidance transactions with Adjudicating Authority. The RP will conduct his preliminary assessment and will file application, wherever necessary after deliberations with the CoC.

As stated above, the findings of the transaction audit may be discussed in the CoC meeting and views of CoC members may be minuted. The CoC cannot, however, direct the RP with respect to filings against avoidance transactions. CoC can contribute their views/opinions and the final decision is to be taken by the resolution professional.

In the Code, there is no requirement of taking approval from the CoC for filing the application determining avoidance transactions. The RP is required to only inform the CoC about filing of such transactions with the AA.

Here, it might be important to note that Para 16 of the IBBI (Insolvency Professionals) Regulations 2016, which states that an IP must ensure that he maintains written contemporaneous records for any decision taken, the reasons for taking the decision, and the information and evidence in support of such decision. This shall be maintained so as to sufficiently enable a reasonable person to take a view on the appropriateness of his decisions and actions.

(n) Should there be a format of the application to be filed with the AA and the details to be provided for each kind of avoidance transaction to facilitate quick disposal by the AA?

The basic and minimum details should be similar in all applications to ease the working of Adjudicating Authority. The details are:

- Executive summary.
- Relevant sections under which the application is filed.

[8] https://ibbi.gov.in//webadmin/pdf/legalframwork/2018/Feb/Confidentiality%20of%20Information%20relating%20to%20Processes%20under%20the%20IBC,%202016-R_2018-02-24%2010:19:37.pdf

- Amount of default.
- Persons responsible.
- Nature of transactions.
- Details.
- Documents to support the transaction.
- Relief/guidance sought.

(o) Should CIRP/liquidation conclude when an application for avoidance transactions is pending before the AA?

The pendency of proceedings will not bar the resolution/liquidation or voluntary liquidation of the CD. The application for avoidance transactions is against the promoters/directors/related parties, however the resolution/liquidation is for the CD. Therefore, these two should be treated separately and even if the CD is resolved/ liquidated, the application of avoidance transactions may continue to be prosecuted.

However, this leads to a number of questions, illustratively:

- Who will handle the proceedings, including engaging with legal counsel, ensuring appearance and information?
- Who will bear the cost of the proceedings?
- How long the proceedings will be undertaken? Can the proceedings prolong beyond dissolution, and if so, how long?
- If the IP/liquidator proceeds on these, in what capacity and for what remuneration the IP/liquidator will be working and who will pay the remuneration?
- How the value clawed back will be utilised?

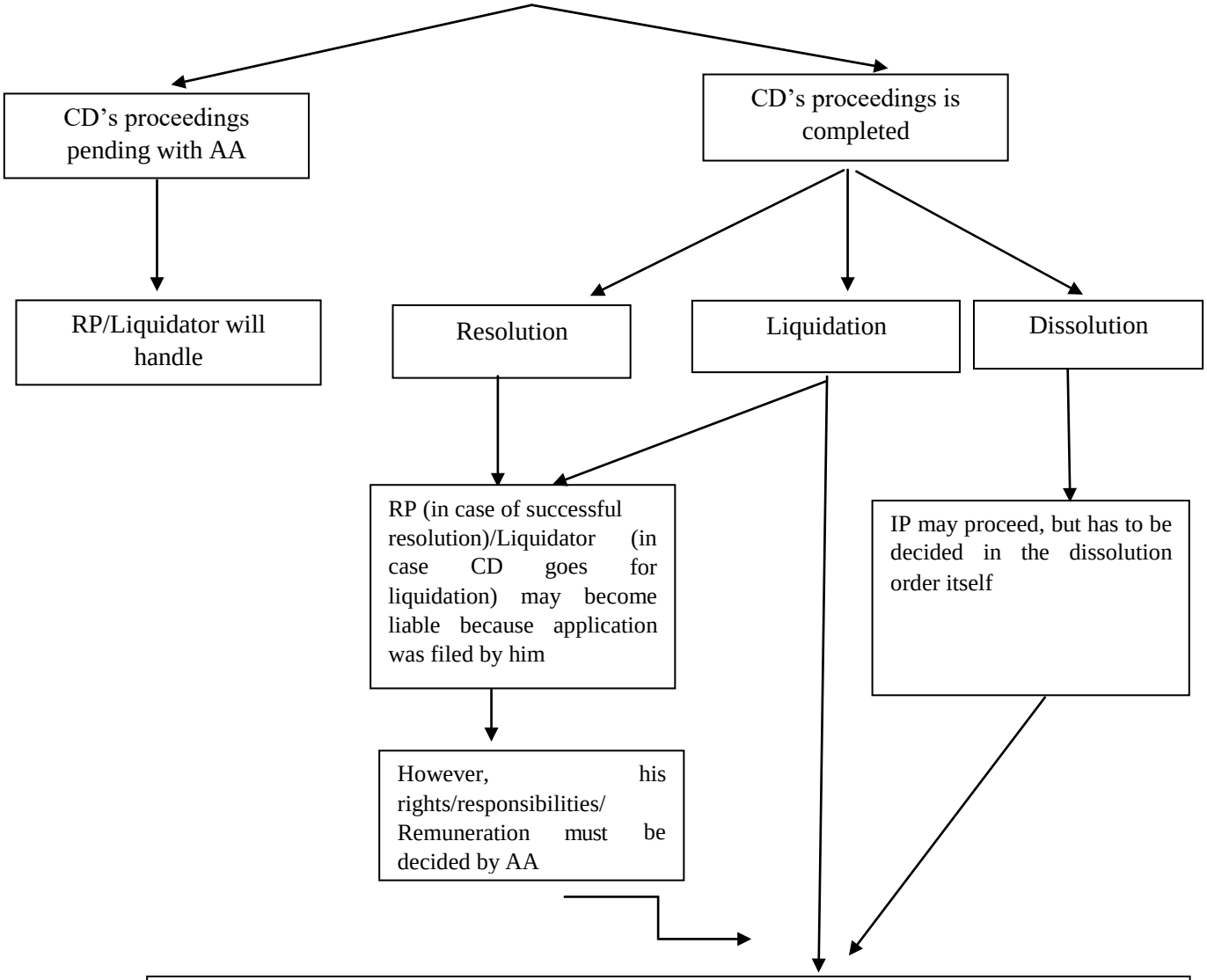
Essentially, the questions above may logically be connected with the beneficiary of the clawback. The pursuit and the costs of proceedings are logically linked with the beneficiary. As mentioned above the details of avoidance proceedings should appropriately be a part of the Information Memorandum (hereinafter referred as **'IM'**). Therefore, it is presumed that the potential Resolution Application (hereinafter referred as **'RA'**) knows about the proceedings. Hence, we may expect that the resolution plan, which is a contract between the RA and the creditors/CD may contain the manner of treatment of any clawback. That is, the resolution plan may provide for the extent, and the manner, in which the clawback will go to the benefit of the CD/RA.

If the resolution plan is silent specifically on the matter, it may be construed from the language of the plan whether the plan passed on the benefits of all properties, claims, receivables, etc. of the CD to the RA. It may be felt that the clawback from the avoidance transactions is a manner of recovery, akin to proceeds of other civil proceedings, say, arbitration, claims, etc. If those recoveries go to the RA, the recovery from the proceedings may also be treated similarly.

If the resolution plan makes provisions about the beneficiary of the clawback, the plan may also provide for the continuation of the proceedings and the cost for the same. If the plan is silent, the AA may decide on the continuation and the costs.

As regards liquidation, it is clear from section 36 (3) (f) that the proceeds of avoidance proceedings are a part of the liquidation estate. However, the dissolution application u/s 54 predicates the completion of distribution. Hence, if liquidator makes dissolution application before conclusion of the avoidance proceedings, the liquidator may also seek orders from the AA on the manner of distribution of the same. Section 53 will certainly apply to such distribution, and the costs of proceedings may be akin to the costs of liquidation, with the top priority in the waterfall.

A snapshot of the way forward is produced below:



(a) Considering that it is expected that the IM shall contain details about the pending proceedings, the resolution plan may provide for the extent, and the manner, in which the clawback will go to the benefit of the CD/RA.

(b) If the resolution plan is silent specifically on the matter, it may be construed from the language of the plan whether the plan passed on the benefits of all properties, claims, receivables, etc. of the CD to the RA. If those recoveries go to the RA, the recovery from the proceedings may also be treated similarly.

(c) If the resolution plan makes provisions about the beneficiary of the clawback, the plan may also provide for the continuation of the proceedings and the cost for the same. If the plan is silent, the AA may decide on the continuation and the costs.

(d) In case of liquidation, section 36 (3) (f) states that the proceeds of avoidance proceedings are a part of the liquidation estate.

(e) When the liquidator makes dissolution application before conclusion of the avoidance proceedings, the liquidator may also seek orders from the AA on the manner of distribution of the same.

As regards, the disposal of avoidance transaction, the Tribunals will dispose of as per its schedules. As such no time frame can be set.

(p) In what circumstances and who should appeal against the order of the AA?

Generally an appeal is made when the applicant/respondent/interested party is not satisfied with the decision of the Adjudicating Authority.

The resolution professional, the committee of creditors, liquidator, respondents, etc. have the right to appeal against the order of Adjudicating Authority.

IP has to take a view based on the merits on the case. Aggrieved party will file appeal.

(q) Who will pursue the application where the term of RP/Liquidator is over, or the CD is dissolved?

Please see point (o) table.

(r) How the value clawed back should be used?

Please see point (o) table.

(s) Should Liquidator necessarily investigate if the CD has been subject to any avoidance transaction where the RP has already filed an application during CIRP? Should Liquidator examine if the RP has done a good job. What should he do if he finds that RP did not do a good job?

The Liquidator need not necessarily investigate if the CD has been subject to any avoidance transaction where the RP has already filed an application during CIRP. However, if the Liquidator finds some transactions of considerable value which is not covered in the application filed by RP, the Liquidator can collate his findings and file additional application. It is not the duty or function of the Liquidator to examine the performance of the RP.

Further, as regards examining whether the RP has done a good work, since decision- making is a subjective area, it is not recommended that the liquidator questions/examines the conduct of the RP. The Liquidator should continue with his job as required and not spend time evaluating actions of the RP. The role of the RP would have been evaluated by the CoC (before liquidation) and the AA. It is not in the jurisdiction of the liquidator to comment on the role/ work of the earlier RP.

However, the Liquidator shall have the right to ask information/cooperation from the RP. In any case, IBBI has the right to seek explanations from the RP, if in the opinion of IBBI, the RP should have made the application.

Annexure A

Transaction Audit: Scope and approach of work [Indicative]

The following shall be the scope of work for transaction audit of_____[Name of CD] to be carried out by _____ [Name of professional].

The period of review shall be _____ to_____['Review Period'].

(i) Verification of end use of funds granted by lenders (including working capital loans during the specified period).

(ii) Verification of revenue from operations, sales returns including order, invoices and controls in the billing process. The focus should be on inflated/ deflated billings.

(iii) Verification of purchases / major expenses during the audit period.

(iv) Identification of cases, if any, of:

a. Diversion / mis-utilisation of bank funds.

b. Siphoning of funds.

c. Suspected/ padded up expenditures.

d. Misrepresentation of financial information submitted to various banks from time to time as per terms of loan agreement.

(v) Verification of major transactions with related parties, or two-way deals of Rs._____and above with the same party or indirect payments made by customers of the borrower to the vendors of borrower. This would include the transactions done with or by the downstream entities [subsidiaries, step-down subsidiaries, in India and overseas] to report if, for investments, loans or facilities obtained on the credit of the Company [guarantee, letter of credit, etc.], there is evidence of siphoning off of funds, etc., as referred to above. In reported transactions with "related parties", please take wide definition, such that transactions not adhering to arms-length basis are reported.

(vi) Verification of receivables with focus on receivables from related parties/ group companies *(more focus on receivables written off without substantive background).*

(vii) Vanishing Inventory.

(viii) Review and map transactions related to new addition/deletion of fixed assets (above Rs. _____) purchased during Review Period.

(ix) Review and comment transactions of substantial amount (Rs._____and above) which seems not to be normal transactions at arms' length.

(x) Verification of movement in unsecured loans during the Review Period.

(xi) Verification of substantial debts raised in sister/associate/group companies.

(xii) Adherence to Escrow / Trust and Retention Account (TRA) arrangements made with lenders / consortium. Details of all transactions with banks outside the consortium.

(xiii) Commenting on concentrating transactions, that is, where the transactions are concentrated to sole customers/sole suppliers.

(xiv) Review of minutes of Board Meetings and Internal Audit System.

(xv) Any fraud or any malfeasance committed by the company, pertaining to willful defaulter guidelines.

(xvi) Identifying and classifying each Transaction, on the basis of available information, audit findings and provisions of the Code, as –

a. Preferential transaction u/s 43.

b. Undervalued transaction u/s 45.

c. Transaction defrauding creditors u/s 49.

d. Extortionate credit transaction u/s 50.

e. Wrongful trading u/s 66(1).

f. Fraudulent trading u/s 66(2).

(xvii) The Transaction Audit Report shall have an executive summary of the said transactions so as to enable the RP/Liquidator to appropriately make references, wherever required.

It shall contain details of related / unrelated party name, nature of transaction, amount of transaction etc.

(xviii) It shall contain:

Timelines	
Payment terms	

**for professional conducting audit.*