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No place for financial creditors in CoC

Financial creditors will be excluded from CoC even if they cease to be related parties

THE Committee of Creditors (CoC) are widely recognised as the key decision makers in the resolution or liquidation process of the corporate debtor under the Insolvency and Bankruptcy Code, 2016 (IBC/Code). Owing to their pivotal role, the Supreme Court on February 1, 2021 in the case of Phoenix ARC Private Limited vs Spade Financial Services Limited and Ors notably excluded financial creditors from CoC even though they no longer were 'related parties' of the corporate debtor strict sensu. This judgment sheds light on the nuances of the constitution of the CoC, its role and function and the need to exclude related parties from the CoC.

ance the interest of the stakeholders, maximise value of the assets of the entity and to ensure that Corporate Insolvency Resolution Process (CIRP) of the corporate debtor does not unduly favour a class of stakeholders, overtly ben-

detriment of the genuine stakeholders. Hence, the first proviso to Section 21(2) explicitly disqualifies financial creditors and their authorised representatives that are related parties as under Section 21(6), (6A) or Section 24(5) from having any

to challenge the commercial wisdom of the CoC and this is made non-justiciable. This was further upheld by the Supreme Court later in the year in the case of Committee of Creditors of Essar Steel India Ltd vs Satish Kumar Gupta & Ors

Supreme Court's assessment

In order to assess the true nature of the relationship shared between the concerned parties and the corporate debtor, the Supreme Court in the judgment of Phoenix ARC Private Limited firstly, noted a deep entanglement in the business affairs of the corporate debtor. Secondly, in spite of the relationship having ended prior to the initiation of CIRP, significant reliance was placed on the statutory provisions of Section 5(24) and Section 5(24A) of the Code to evaluate and analyse the relationship shared between the parties and the corporate debtor. It was noted that the definition provided by the provisions describes a commutative relationship and that the definition of 'related party' under IBC was intentionally made to be considerably broad.

Deep entanglement between the entities

The facts of the case revealed that the concerned parties held positions

basis of directions of the board of the corporate debtor. This was further evidenced by the finding of collusive transactions. The submission that the transactions were of commercial nature was not accepted given the proximate relationship between the parties.

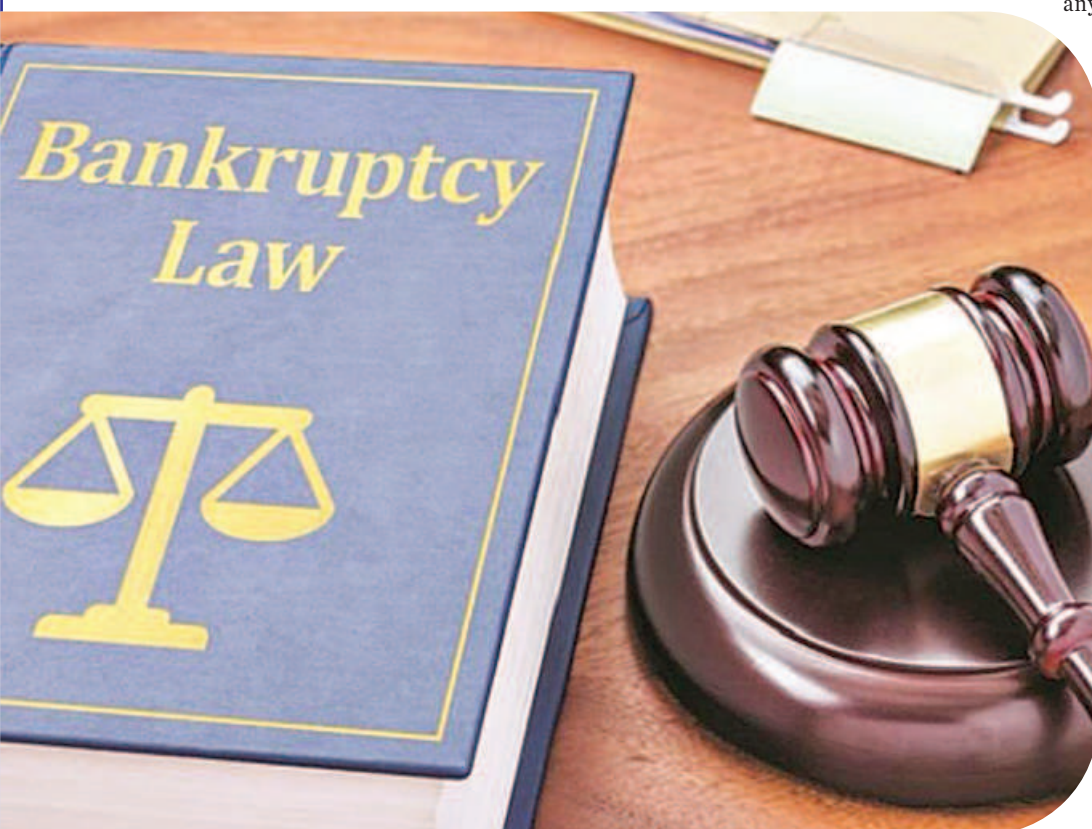
In light of these findings, the apex court clarified that the exclusion under the first proviso to Section 21(2) is related not to the debt itself but to the relationship existing between a related financial creditor and the corporate debtor. Thus, a financial creditor who in praesenti is not a related party would not be debarred from being a member of the CoC. However, in case where the related party financial creditor divests itself of its shareholding or ceases to become a related party in a business capacity with the sole intention of participating in the CoC and sabotage the CIRP by diluting the vote share of other creditors or otherwise, it would be in conformity with the object and purpose of the first proviso to Section 21(2) to consider the former related party creditor as one debarred under the first proviso.

Thus, it was held that while the default rule under the first proviso to Section 21(2) is that only those financial creditors that are related parties in praesenti would be debarred from the CoC, those related party financial creditors that cease to be related parties in order to circumvent the exclusion under the first proviso to Section 21(2), should also be considered as being covered by the exclusion thereunder. The bench further acknowledged that if this interpretation was not given to the first proviso of Section 21(2), then a related party financial creditor can devise a mechanism to remove its label of a 'related party' before the corporate debtor undergoes CIRP, so as to be able to enter the CoC and influence its decision making at the cost of other financial creditors.

Ultimately, even though the concerned parties are no longer qualified as related parties of the corporate debtor, given the deeply entangled relationship shared between the concerned parties and the corporate debtor, the Supreme Court bench excluded them from the CoC as they strongly asserted that the inclusion of the parties in the CoC would affect the other independent financial creditors.

Hence, the apex court has broadened the scope for exclusion of members from the CoC to preserve the intent of the Code.

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Who is a related party?

A related party in relation to a corporate debtor and in relation to an individual are defined in Section 5(24) and Section 5(24A) respectively. Such parties include and are not limited to director or partner or key managerial personnel of the corporate debtor, LLP or partnership firm in which a director or partner or manager of the corporate debtor or their relative is a partner; company in which a director, partner or manager of the corporate debtor is a director and holds along with his relatives more than two per cent of its share capital and, any person on whose advice, directions or instructions, a director, partner or manager of the corporate debtor is accustomed to act.

Why are related parties excluded from CoC?

CoC comprises all financial creditors who have a claim against the corporate debtor. In order to bal-

enefit the corporate debtor and prejudice the rights of the minority stakeholders, a collective process was deemed fair and appropriate.

In this regard, the NCLT, Jaipur Bench in the case of Sushant Aneja and Anr vs J D Aneja Edibles Private Limited dated June 7, 2019 recognised that any transactions between the related parties cannot be equated to the type of transactions with outsiders on an arm's length basis and hence there is bound to be a differential treatment for a related party to a corporate debtor irrespective of being secured or unsecured.

The inclusion of related parties in the CoC would result in sabotage of the CIRP. This would further prevent aggrieved creditors from being fairly represented thereby negating the purpose of IBC and effectively making the role of the CoC redundant. A related party being included in the CoC would likely result in abuse of the process of law as established by the Code to the

right of representation, participation or voting in a meeting of the CoC.

Remarkably, one of the key reasons for enforcing safeguards such as excluding related parties from CoC is owed to the fundamental principle that the decisions of the CoC have limited scope of review. The principle was cemented by Supreme Court in the case of K Sashidhar vs Indian Overseas Bank & Ors in 2019 wherein it was stated that the Adjudicating Authority does not have the jurisdiction to evaluate and undermine the commercial decision of the CoC except for instances of lack of jurisdiction where procedural irregularities or contravention of legal provisions has been observed. The Code and its regulations have deliberately not provided grounds

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which could have been used to guide the affairs of the corporate debtor. Furthermore, it was found that the parties entered into transactions on the