

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 6 | Issue 4

2023

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Role of Resolution Professional in Reporting Fraudulent & Avoidable Transactions under the Insolvency and Bankruptcy Code, 2016

SHILPA NEWATI DHEER¹

ABSTRACT

The Insolvency and Bankruptcy Code, 2016 (IBC) has revolutionized India's insolvency resolution process, providing a robust legal framework to address financial distress and protect the interests of stakeholders. This research paper aims to delve into the critical concepts of fraudulent and avoidable transactions within the ambit of IBC and the role, powers and duties of interim resolution profession/ resolution profession in relation to identification and reporting of fraudulent and avoidable transactions.

Keywords: Resolution Professional, Fraudulent Transaction, Avoidable Transaction, IBC, 2016.

I. INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 (IBC) marks a significant milestone in India's financial landscape, consolidating various laws related to insolvency and bankruptcy into a single comprehensive legislation. The Code aims to enhance the ease of doing business, facilitate faster resolution of insolvency cases, and promote entrepreneurship. Central to its objectives, the concepts of fraudulent and avoidable transactions also play a pivotal role in identifying and addressing financial improprieties that could undermine the insolvency resolution process.

Fraudulent transactions refer to those transactions undertaken with the intent to defraud creditors or divert assets from the reach of the insolvency resolution process. These transactions are often a last-ditch effort by debtors to conceal assets and evade rightful creditors. Avoidable transactions are those which might have been avoided then they would not cause unfairly prejudice the interests of creditors or are preferential in nature.

This research paper seeks to shed light on how fraudulent and avoidable transactions are determinantal for carrying out honest business affairs as well as its resolution and liquidation if that business undergoes insolvency and bankruptcy proceedings. Also, what steps are to be taken by

¹ Author is a Ph.D. Research Scholar at Faculty of Law, University of Delhi, Delhi, India.

resolution profession in order to identify and reporting these transactions.

II. UNDERSTANDING FRAUDULENT TRANSACTIONS

(A) The Nature and Characteristics of Fraudulent Transactions

Fraudulent transactions often involve complex financial manoeuvres aimed at concealing assets or manipulating financial records. This section will delve into the various types of forensic transactions, such as asset transfers, preferential payments, and undervalued transactions. By understanding the characteristics of these transactions, individuals and businesses can identify potential red flags and take preventive measures.

(B) Analysing the Intent behind Fraudulent Transactions

Proving the intent behind a Fraudulent transaction is crucial for establishing its validity.² As per section 66 of IBC, any transaction is a fraudulent or wrongful transaction done during resolution or liquidation process if

“It is done with the intent to defraud creditors of the corporate debtor or for any fraudulent purpose, before the insolvency commencement date, director or partner of company have duty to know about this transaction and, they haven’t taken any steps to avoid or minimize the potential loss to the creditors of the corporate debtor.”

Thus, it gives clarity, that there are two things required for putting liability of transaction as wrongful or fraudulent, where there is intent to do fraud and if it is in the knowledge of company’s director or any partner or any person of authority, they haven’t taken steps to rectify or mitigate the situation.

In case of Mr. Shibu Job Cheeran Vs. Mr. Ashok Velamur Seshadri³ Held that, Section 66 to apply, it is crucial to prove that the former directors of the corporate debtor were aware of its insolvency but still engaged in business with dishonest intentions. In essence, the directors must have knowingly committed fraudulent acts to deceive creditors and stakeholders. Also, the concealment of the actual financial standing of the corporate debtor could also fall under the scope of Section 66.⁴

Other important provision that should be read while dealing with fraudulent or wrongful transaction is Section 43⁵, which talks about preferential transactions or avoidable transaction,

²Section 420 of the Indian Penal Code, 1860 (Act No. 45 of 1860)

³Ashok Velamur Seshadri Liquidator of M/s. Archana Motors Pvt. Ltd. Vs. Mr. Shibu Job Cheeran (2022) ibclaw.in 561 NCLAT

⁴Section 66 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

⁵ Section 43 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

which are done without any requirement or done by going out of way of natural course of business or done at exceptionally high price or lower price as compare to current market rate. The tracing of this transaction is done from one year prior to the insolvency commencement date, while if the related party involved in the transaction, then this date would be two years prior to the insolvency commencement date.

As per Sec 43, it involves transactions done by corporate debtor as

“To give special benefit to any creditor, surety, guarantor in the name any debt or liability.”

Also, transaction will not be considered as preferential if they are done

1. transfer made during the ordinary course of the business.
2. any transfer creating a security interest in property acquired by the corporate debtor.

There is no question of intention while fixing the penalty under this section. Which was cleared by NCLT in case of GVR Consulting Services⁶ stating “Transaction entered by Corporate Debtor voluntary or due to pressure or threat has no relevance while coming to the conclusion whether the transaction is preferential or not, the intent of Corporate Debtor is not relevant since Section 43 of IBC envisages statutory/deeming fiction”. Similarly held in case of Shibu Job.⁷

The AA had allowed the application under sections 66, 43 and 45 of the Code and ordered that the mortgaged properties be vested with the CD. On appeal, the NCLAT noted that the mortgages were made in favour of the banks and financial institutions by the CD in the ordinary course of business. Further, in absence of any contrary evidence to show that they were made to defraud the creditors of the CD or for any fraudulent purpose, it set aside the order of the AA.⁸

III. AVOIDABLE TRANSACTIONS AND THEIR IMPLICATIONS

(A) Identifying Avoidable Transactions

Avoidable transactions can significantly impact the outcome of insolvency proceedings. The foremost goal of IBC is to maximize the assets value, keep the enterprise going on and equitable asset distribution to all stakeholders. When we talk about equitable asset distribution, then it is inherent in the process (CIRP or Liquidation) to be honest and working the favour of all stakeholders. But in some cases, creditor or debtor act determinantal to creditors or give favour to one or more creditors over others. As a result, this will hamper the process of recovery in

⁶ GVR Consulting Services Pvt. Ltd. Vs. Pooja Bahry (2023) ibclaw.in 261 NCLAT

⁷ Supra 3

⁸ Anuj Jain IRP for Jaypee Infratech Ltd. Vs. Axis Bank Ltd. (2020) ibclaw.in 06 SC

case of liquidation and get the fair value while enterprise goes into resolution process

(B) Different Types of Avoidable Transactions

IBC, 2016 discussed different types of avoidable transactions under section 43 to 51. These are

- a) Preferential transactions (Section 43)
- b) Undervalued transactions (Section 45)
- c) Transaction's defrauding creditors (Section 49) and
- d) Exorbitant credit transactions (Section 50)

a. Preferential Transactions⁹

As per Sec 43, it involves transactions done by corporate debtor as "To give special benefit to any creditor, surety, guarantor in the name any debt or liability." This also includes the case of liquidation under sec 53. Also, transaction will not be considered as preferential if they are done

1. within usual business activities of the corporate debtor.
2. it gives fresh value for the corporate debtor

The tracing of this transaction is done from one year prior to the insolvency commencement date, while if the related party involved in the transaction, then this date would be two years prior to the insolvency commencement date.

In the recent Jaypee Infratech case,¹⁰ the Supreme Court provided clarity on the conditions and recognition of preferential transactions. In this case, "the corporate debtor had pledged its property as collateral security for its holding company's debt. The Court ruled that this transaction could be avoided since it benefited a related party and occurred within the two-year look-back period." The Hon'ble Supreme Court gave following observations in this judgment:

- A transaction qualifies as a preferential transaction if it passes the three-level test. This includes meeting the requirements of Section 43(4) and 43(2), and not falling under the exceptions of Section 43(3). The parties' intent or awareness of the preferential nature of the transaction doesn't matter.
- The look-back period begins from the insolvency commencement date, not from the date when Section 43 came into effect.
- Section 43(3) stipulates that a transaction won't be considered preferential if it takes

⁹ Section 43 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

¹⁰ Supra 8

place within the ordinary course of the 'corporate debtor's or the transferee's' business or financial affairs.

- The Supreme Court interpreted this phrase as 'corporate debtor and the transferee,' to maintain focus on the corporate debtor's affairs and prevent shifting attention to the transferee's affairs.

The Resolution Professional of M/s Shivkala Developers Pvt. Ltd.,¹¹ filed three applications under various sections of the Insolvency and Bankruptcy Code, 2016, seeking to set aside transactions as preferential transfers intended to defraud creditors. The Adjudicating Authority rejected all three applications, stating that no case was made for preferential, undervalued, extortionate credit, or fraudulent transactions. The transactions in question were made several years before the insolvency proceedings, and the Adjudicating Authority found no evidence of fraudulent intent. As a result, the appeals against the rejection of the applications were dismissed.

Also, in case of *Tata Steel BSL Ltd. v Venus Recruiters*,¹² brought about a change in the adjudication of avoidance transactions. The Delhi High Court held that avoidance applications initiated by the Resolution Professional (RP) shall continue even after the conclusion of CIRP, contrary to a previous decision in *Venus Recruiters v Union of India*.¹³ The change in the legal stance adopted by the Delhi High Court is perceived as a favourable stride towards achieving the goals of the IBC. This decision is likely to support potential Resolution Applicants in submitting their plans to take over the company and decrease the financial burden on creditors who have suffered losses in previous insolvency cases. Before the *Tata Steel* case, the law on avoidance transactions was uncertain. Section 26 of the IBC clarified that such applications filed by the RP would not affect the CIRP. However, the *Venus* decision contradicted this and limited the adjudication of avoidance transactions within the CIRP, causing delays and hindering creditors' recovery. The complex nature of these transactions requires a thorough assessment, and resolving them within the CIRP timeline posed challenges. Overall, the *Tata Steel* case's ruling is seen as a positive development in the insolvency process, promoting the interests of creditors and facilitating a smoother resolution for distressed companies.

¹¹Anup Kumar Resolution Professional of M/s Shivkala Developers Pvt. Ltd. Vs. BDR Builder & Developers Pvt. Ltd. (2019) ibclaw.in 68 NCLAT

¹²*Tata Steel BSL Ltd. Vs. Venus Recruiter Pvt. Ltd. & Ors.* (2023) ibclaw.in 09 HC

¹³*M/s Venus Recruiters Pvt. Ltd. Vs. Union of India and ors.* (2020) ibclaw.in 41 HC

b. Undervalued Transactions¹⁴

Undervalue literally means exceptionally lower price as compare to current market rate. Whenever corporate debtor transfers its property to other by the way of gifts or other named transaction, where no value or undervalue have been recovered. Such transaction under company and insolvency law is called undervalue transaction. The provision related to this given under section 45 (2)¹⁵.

The key ingredients of undervalue transaction are

a) When the corporate debtor gives a gift, or transfer one or more of its assets to a person at substantially lower price as compare to current market rate and

b) The transactions fall outside usual business activities of the corporate debtor.

These transactions also have tracing period or look back period, which is similar to the preferential transaction i.e., one year prior to the insolvency commencement date, while two years for if the related party involved in the transaction. If such a case encountered or came into the knowledge of RP is duty bound to file a petition to the tribunal for declaring these transactions null and void.¹⁶

c. Transaction's Defrauding Creditors¹⁷

Section 49 is an aggravated situation where corporate debtor with knowledge and intention done act of transfer of property undervalued with intention to defrauding the creditors. This transaction is called transactions defrauding creditors.

The main ingredients of this section are

a) Transfer of property at low value

b) Intentionally putting the corporate debtor's assets beyond the reach of creditors

or

c) Intentionally prejudicing the interests of the person making a claim against the corporate debtor

d) Irrespective of time line

Voluntary intention to defraud the creditor is the key to fix penalty under section 49. This section

¹⁴Section 43 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

¹⁵Section 45(2) of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

¹⁶The Resolution Professional (RP) of Talwalkars Better Value Fitness Ltd. (Mr. Saurabh Kumar Tikmani Vs. Talwalkars Club System Pvt. Ltd. (2023) ibclaw.in 424 NCLT

¹⁷Section 49 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

also applicable in case, where claim is not made today, but might made in future. This is a unique section in the IBC who predominantly work on time line, is not a time bound act. This way protection of claimant right is made. And, if a Resolution professional or liquidator notices this type of transaction, he can file a complaint with the adjudicating authority, which, if satisfied, would issue an order restoring the situation to the way it was before the transaction, and make it as if the transaction never happened, by protecting the interests of those who are victims of such transactions as well. There is protection to all the transaction done under good confidence with good confidence or without knowledge or notice of the corporate debtor's relevant conditions.

By plain reading section 45 and section 49 seem to be same. But in reality, they are different on the basis of requirement of both the sections (Table 1). Under section 45 only undervalue transaction is done within one year of from date of commencement of insolvency commencement date, read two years in care of related party so that creditors won't get their due debt and there is no question of intention, while intention to defraud the creditor is the main purpose of dong undervalue transaction is explained in section 49.

Table 1: - Difference between Section 45 and 49

Subject	Section 45	Section 49
Intention	Not required	Required
Time Lapse	Yes	No
Protection available	Transaction done Normal course of business & interest acquired by debtor	To the other party who acted on good faith without having notice of position of corporate debtor

d. Extortionate Transactions¹⁸

These are diagonally opposite to undervalued transaction. Undervalued transaction¹² has main ingredient i.e., exceptionally low-ticket transaction of high valued assets, while in extortionate transaction the transaction value become extraordinarily high. For example, if the rate of interest on loan is 10 % in the market, then this rate of interest is being increased say 25% or higher and corporate debtor accepted it. The provision for is given under Section 50 of the IBC talks about extortionate transaction. This transaction includes, any exorbitant or unconscionable payments

¹⁸Section 50 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

done by the corporate debtor to his creditors whether it is financial or operational two years preceding the insolvency commencement date. At the same time, it will not include the exorbitant payments by the corporate debtor, on the orders or direction of NCLT or like authority.

In the case of *Anamika Singh Vs. Shinhan Bank*¹⁹ as per decision of Delhi Bench of NCLT, it was determined that an interest rate of 65% P.A. is unreasonably high, leading to nullification of the debt. The court ruled that since the interest rate significantly exceeded the customary business norms in the market, it qualified to consider it as an extortionate or exorbitant transaction.

e. Defences against Avoidable Transactions

Creditors and stakeholders have the right to defend themselves against avoidable transactions. This section will explore the defences available to parties involved in such transactions, highlighting their legal basis and effectiveness. Defence against the avoidable transaction is available itself under sec 43 of the code where, it protects all the transactions done during ordinary course of business. By relying on case of *Anuj Jain*¹⁴ reiterated that, “The expression “ordinary course of business or business affairs has to be read “ejusdem generis”. The expression “financial affair” should not be given extended meaning. Thus, transaction must fall into place as part of the undistinguished common flow of the business done to be considered under ordinary course of business⁵.

(C) Reporting of Fraudulent & Avoidable Transactions: Role of the Insolvency Resolution Professional

The insolvency resolution professional plays a pivotal role in CIRP of the corporate debtor. There are various duties, powers and responsibilities given to the RP in IBC and they all are aimed to ensuring time bound resolution of corporate debtor while taking care of balancing of interests of both the parties. Under Chapter II of IBC described appointment, duties, powers, responsibilities and various other aspects of the interim resolution professional (IRP)^{20,21,22,23,24}

¹⁹*Anamika Singh Vs. Shinhan Bank & Ors.* (2020) ibclaw.in 107 SC

²⁰Section 16 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

²¹Section 17 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

²²Section 18 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

²³Section 19 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

²⁴Section 20 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

and resolution professional (RP).^{25,26,27,28,29,30,31}

In the interim resolution professional (IRP) is a critical figure in the resolution process, as they take charge of managing the corporate debtor from the insolvency commencement date until the appointment of a RP. Their responsibilities encompass collecting information, constituting a committee of creditors, managing assets, and ensuring the company continues to function as a going concern. Cooperation from corporate debtor personnel is vital for the IRP to carry out their duties effectively. Thereafter appointment of resolution professional, he is responsible for conducting smooth process of corporate insolvency resolution process and along with balancing the rights of corporate debtor and creditors.

In order to safeguard property in hand of corporate debtor that won't be wasted and cause in non-availability or inadequacy of it during resolution process, IBC put mandatory duty on RP to report fraudulent and avoidable transactions to the Adjudicating Authority (AA) and seek appropriate relief and directions. If they failed to do so then IBC empowers the AA to initiate disciplinary action against RPs or Liquidators.^{32,33}

As per Regulation 35A of the IBBI (CIRP) Regulations, 2016³⁴ requires the RP to form an opinion

- whether the corporate debtor (CD) has been subjected to any avoidance transaction on or before the 75th day of the insolvency commencement date (ICD).
- Once he made positive opinion regarding avoidable or preferential transactions then he should intimate to the Board (IBBI) on or before the 115th day of the ICD.
- Further, he shall apply to the AA for appropriate relief on or before the 135th day of the ICD.

The main purpose of these provision is to recover the value lost through such transactions and maximize the assets' value. Thus, RP and liquidators should be vigilant and take prompt action whenever they found such situation during the process. In addition to this, the Adjudicating

²⁵Section 22 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

²⁶Section 23 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

²⁷Section 26 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

²⁸Section 27 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

²⁹Section 28 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

³⁰Section 29 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

³¹Section 25 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

³²Section 47 of The Insolvency and Bankruptcy Code, 2016 (Act No. 31 of 2016)

³³Circular No. FACILITATION/001/2020, dated 8th May 2020, Regulation 35A of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016,

³⁴Supra 31

Authority in ensuring compliance with the IBC and taking disciplinary action against professionals who fail to fulfil their duties, thereby promoting transparency and integrity in the insolvency process.

There two important judgments that offer guidance to insolvency professionals and stakeholders regarding fraudulent or avoidable transactions reporting. These judgments provide a framework for handling avoidance transactions during insolvency and liquidation, helping to protect the interests of stakeholders and ensure a fair distribution of assets: -

1. In the case of Mr. Ram Ratan Kanoongo,³⁵ certain transactions during the Corporate Insolvency Resolution Process (CIRP) of Saana Syntex Pvt. Ltd. appeared to be fraudulent or preferential. As a result, the Resolution Professional (RP) filed an application under Sections 19, 45, and 66 of the Insolvency and Bankruptcy Code, 2016. Since the company could not be revived, it went into liquidation. The court held that avoidance or preferential transactions can be addressed even during the liquidation stage, based on Sections 43 and 45, which indicate that the liquidator or the RP can handle such transactions.
2. In the case of Anuj Jain (Interim Resolution Professional for Jaypee Infratech Limited) vs. Axis Bank Limited, the Supreme Court clarified the duties of the RP concerning avoidance transactions.
 - i. The RP must examine all transactions related to the assets of the Corporate Debtor (CD) starting from the Insolvency Commencement Date (ICD) up to the preceding two years. Transactions involving related parties and unrelated parties within one year from the ICD are scrutinized further.
 - ii. The RP needs to assess if the transactions involve transfers of CD's property or interest, and whether the beneficiaries are creditors, sureties, or guarantors. If the transactions preferentially benefit the beneficiaries, they will be considered as preferential transactions unless excluded under Section 43(3).
 - iii. The Court emphasized that once a transaction is deemed preferential, there is no need to investigate if it is undervalued or fraudulent, as the intent is not relevant in preferential transactions. Undervalued transactions require separate scrutiny under Sections 45 and 46 to assess fraudulent intent.

³⁵Mr. Ram Ratan Kanoongo vs. Mr. Sunil Kathuria & Others

(D) Suggested guidelines and red flags by The Insolvency and Bankruptcy Board of India (IBBI)

The Insolvency and Bankruptcy Board of India (IBBI) had vide its communication³⁶ provided some guidance on the role of RP in respect of Avoidance Transactions for the purpose of educating the IPs and other stakeholders of corporate insolvency resolution and liquidation processes.

The various Red Flags have been collated and placed under the following six broad categories, namely, Red Flags related to –

- Entity, Group and Operations
- Maintenance of Books and Records
- Regulatory Compliance and Litigation
- Independent Auditor Reports
- Financial Statements and Board Reports, and
- Classification and Reporting of Frauds (as covered under RBI Master Directions).

a) Entity, Group and Operations

This provides some guidance to an IP in understanding certain Red Flags emanating from the entity, nature and scale of an operations, presence and predominance of related and connected entities, and management of the entity. To determine whether there is any preferential or avoidable transaction occur, Insolvency Professional (IP) should thoroughly understand the entity's business nature and should be vigilant about the following: -

- In some industries like Trading Infrastructure, Construction, EPC Contracts, Real Estate Power, and Steel are more prone to avoidance transactions.
- The IP should analyse the Control Document (CD) considering industry, operations, market, and financial pressures.
- Changes in operations, like acquisitions, divestitures, or investments in other entities, should be carefully examined as potential red flags.
- The Annual Financial Statements' Segment Reporting can offer insights into business segments.

³⁶IBBI Communication bearing reference no. Facilitation Note / 001 / 2020] dated 8th May, 2020.

- The IP should review the Balance Sheet, Profit & Loss Account, and Cash Flow Statements for unusual variances across years. Attention should be given to prior period items, transaction reversals, inventory write-offs, and large provisions.
- Complex transaction structures, sole arrangements, import-export activities, and excessive cash transactions are entity-level red flags. Claims based on cash transactions require review.
- Confirming the Registered Office's presence at the Ministry of Corporate Affairs (MCA) address is crucial. Lack of presence is a red flag.
- Entities or related parties in foreign locations are red flags.
- Transactions with such units and compliance with Foreign Exchange Management Act (FEMA) need scrutiny.
- The IP should assess whether competent teams managed the Company's financial and operational affairs. Inadequate or absent teams might signal Avoidance Transactions due to a lack of checks and balances.
- Directors disqualified under Sec 164(2) of the Companies Act, 2013, due to non-filing of CD's Annual Financial Statements, are a Red Flag.
- Directors disqualified for not filing financial statements of connected entities raise a Red Flag, especially if these entities engaged in significant transactions.
- Frequent changes in Directors and Key Managerial Personnel are suspicious and require investigation for underlying reasons.
- The IP should evaluate directors' independence, capability, and the individuals they act under.
- Name-only directors are concerning.
- In group setups, director appointments should align with competence.
- Frequent changes in auditors should be noted, considering audit firm size and CD's operations.
- Auditor independence under Companies Act, 2013, matters. Discussion with auditors may reveal Avoidance risks.
- The presence of many related/connected entities indicates a Red Flag, demanding a review for Avoidance transactions. IP should summarize such data from MCA, considering director connections and entity status.
- The entity's financial statements should reveal Related Party transactions. Unusually high transactions are Red Flags.

- Verification with CD's records are important. Dormant or inactive connected entities should be examined, including fund movements with the CD from a Red Flag perspective.
- Adverse Public Domain Information and Wilful Default Status. IP should search for adverse public information that may raise concerns. Check if promoters/entities are Wilful Defaulters per RBI guidelines; this is a significant Red Flag.
- Inquire with past lenders about CD's issues discussed in meetings. Impact on Red Flag assessment. Review earlier Avoidance/Forensic reports for Red Flag indicators like inadequate data, incomplete circulation, inconclusive findings, or disclaimers. Inconclusive forensic audits due to data gaps should be considered as Red Flags and their impact evaluated.
- Issuing Corporate/Bank Guarantees unrelated to CD's business is a Red Flag. Significant BG invocations and creditor claims need scrutiny.
- Unconfirmed balances of debtors, creditors, etc., may signal Red Flags, as they could be fictitious. High-value transactions, legal fees, and professional payments warrant review for Avoidance Transactions.
- Assess claims vs. available assets. Large unrecorded transactions raise Red Flags.

b) Maintenance of Books and Records

This describes various red flags to be check, which are associated with Maintenance of Books and Records, aspects connected to Accounting Systems and Internal Control framework of the Company.

- All Companies must maintain proper Books of Accounts. Failure to do so or not producing them to the IP may necessitate applications to the Adjudicating Authority under Sec 19(2) of the Code. This is a Red Flag. Exploring alternative methods like reviewing bank statements through direct lender communication may help identify Avoidance transactions.
- Non-maintenance of Secretarial records, including registers and minutes, by the CD is significant.
- Cases of CD reporting lost records due to natural disasters should be verified against Board and AGM minutes, tax filings, and subsequent financial statements.
- Absence of essential registers like Fixed Assets and Inventory registers is a Red Flag for potential Avoidance transactions.

- Understanding the Accounting System's robustness, transaction integrity, and unalterable nature is vital. Controls to prevent transaction backdating and audit log absence signal Red Flags.
- The IP should comprehend the entity's Internal Controls framework established by management to prevent and uncover frauds and errors.

c) Regulatory Compliance and Litigation

This chapter covers various red flags as given below, which are identifiable based on the status of various regulatory compliances to be made by the CD under various statutes and litigations involving the CD. Some illustrations of major Regulatory Compliances are as under: -

- For Companies where, certain audits such as Secretarial Audit, Cost Audit etc. are mandatory under Companies Act, 2013, IP should verify if such audits were conducted and inquire with the auditor about the need for Avoidance Review. Absence of audits or qualifications in audit reports are Red Flags.
- In cases without mandated Secretarial Audits, Cost Audits etc., attention should be given to past processes ensuring Board and Shareholder approvals for transactions like Loans, Investments, and dealings with Related Parties, as required by Companies Act, 2013. Also check whether, internal audits have been conducted or not? Lack of such audits is a Red Flag.
- Non-registration of CD or connected entities with tax authorities and not filing necessary returns is concerning. Filed returns should be reviewed for potential Avoidance Transactions.
- Regulatory cases by authorities like SEBI, SFIO, CBI, Police, RBI, FEMA, along with IT/GST/VAT search and seizure outcomes should be examined. Payments to legal professionals should also be reviewed.
- Consistently high legal and professional fees might indicate potential litigation requiring investigation.
- CD-involved arbitrations with material amounts are Red Flags. Corroborating them with awarded claims, related party disputes, and arbitral awards is essential. Details of all CD-related arbitration proceedings must be obtained and reviewed.

d) Independent Auditor Reports

The various red flags which may be associated with Annual Audited Financial Statements and Disclosures, Remarks, Qualifications, Matters of Emphasis, Key Audit Matters etc are

following: -

- Preferential, undervalued, fraudulent, or extortionate transactions can appear across financial statement components, including off-Balance Sheet items like Contingent Liabilities. IP needs a deep understanding of Balance Sheets, Profit and Loss Accounts, Cash Flow Statements, Notes to Accounts, Auditors' and Independent Auditors' reports, and Auditors' reports on internal financial controls over the last 8 years prior to the Insolvency Commencement Date (ICD) for identifying unusual and significant items.
- The Companies Act, 2013 mandates submitting Audited Financial Statements to the MCA annually. Failing to do so is a Red Flag.
- Instances where Audited Financial Statements were not prepared are concerning. These statements reflect financial position and affairs, ensuring accurate disclosure and presentation by management and audit opinion. Non-preparation or audit is a Red Flag.
- Certain Companies must prepare Consolidated Financial Statements for Subsidiaries, Joint Ventures (JVs), and Associates. Omission of these or non-audit of entity books is suspicious.
- Comparing Standalone vs. Consolidated Financials for scale differences can reveal Red Flags.
- IP should approach Auditors for other reports (Management Letters) issued during the audit.
- Adverse remarks in these communications are significant.
- Clean audit reports don't negate Avoidance Review need, as audits have specific purposes.
- Significant audit report qualifications raise Red Flags and warrant immediate CD Avoidance reviews.
- Full audit reports
- Independent Auditors' Report, CARO, and ICOFR should be considered.

e) Financial Statements and Board Reports

This covers various red flags as given below, which are associated with Financial Statements and Board Report of CD: -

General Red Flags

- Non-preparation of current and past financial statements.
- Failure to file financial statements with MCA.
- Submitting unsigned financial statements to comply superficially.
- Financial statements not approved by Board of Directors & Shareholders.
- Financial statements signed by disqualified Directors under Companies Act, 2013.
- Incomplete Board Reports not aligned with Companies Act, 2013.
- Repeated Auditor qualifications across multiple years.
- Specific concerns like frequent changes in accounting policies
- High-value, related Party Transactions.

Red Flags in Fixed Assets and Capital Work in Progress

- Lack of approval process for asset acquisition/alienation.
- Assets not transferred to IP after reconciliation.
- Substantial variance between Registered Valuer reports and actual asset status.
- Listing assets on Balance Sheet without entity ownership.
- Absence of proper Fixed Assets register.
- No periodic asset verification by management.
- Assets in transit/not cleared from port for long durations.
- Assets used by others for free/low cost.
- Aged Capital Work in Progress compared with Registered Valuation Reports.
- High Revaluation Reserves.
- Sale and Leaseback of assets pledged to lenders.
- Unauthorized security interest creation.
- Assets utilized for promoter personal use with CD cost.
- Undervalued asset sales without valuation reports or competitive process.

Red Flags in Special Purpose Vehicles (SPVs) and Investments

- SPV incorporation and fund transfer without genuine business purpose.
- Substantial investments in partnerships and unincorporated entities.
- Strike-off of Indian SPVs, leading to fund trail loss.
- Closure of foreign SPVs without lender notice or fund traceability.
- Creating assets abroad and in related entities.
- Selling/transferring key revenue-earning business segments.
- Investing funds in connected/related entities without lender consent.
- Purchasing investee entity shares at high/unjustified premiums.
- No returns on investments in terms of dividends or capital refunds.
- Large value investments written off without clear rationale, eroding net worth.
- Shareholding diluted by fraudulent/collusive rights issues.

Inventory and Purchases

- Inventory not transferred to IP.
- Inadequate or missing inventory registers.
- Weak internal controls over inventory processes.
- No proper physical verification and reconciliation protocols.
- Discrepancies between Stock reports to lenders and books.
- Unusual inventory sales.
- Significant returns enabling preferential payments.
- Notable write-offs of inventory.
- Substantial provisions for obsolete/slow-moving inventory.
- Inventory used for promoter/personal purposes with CD cost.
- Inflated stock and book debts reporting.
- Inability to perform Registered Valuation of inventory.
- Major differences between Registered Valuer and actual inventory reports.

Revenues and Receivables

- Incomplete/incorrect customer master data.

- Fraudulent sales reporting and receivables inflation.
- Selective high-value customer discounts.
- Collections via unauthorized bank accounts or cash.
- Direct customer payments to vendors/promoters, unreconciled receivables.
- Aging Receivables balances.
- Assigning receivables to third parties/related entities.
- Large receivables written off without proper legal steps, eroding net worth.
- Fictitious bank receipts (in books but not bank statements).
- Rapid unbilled revenue increase.
- Receivables written off based on arbitral awards.
- Audit qualifications on Revenue recognition, balance confirmations.
- Unreconciled inflated book debts reporting to banks.

Bank Transactions

- High number of bank accounts and fund transfers.
- Funds diverted to non-business parties.
- Round tripping of funds among different cash credit accounts.
- Fund movements not via designated consortium accounts.

Loans and Advances

- Loans without agreements/legal basis.
- Loans to directors/entities without business purpose, including related entities.
- Aging loan balances.
- Interest-free loans with CD paying interest.
- Large value loan write-offs without legal action.
- Loans to entities under MCA 'strike-off'.

Share Capital/Premium and Proceeds Use

- Share Capital received through non-bank adjustments.
- Incorrect/missing return of allotment filings.

- Exorbitant Share Premium not from bank sources.
- Fictitious shareholding.
- CD funds used to purchase its shares by directors.

Loan Transactions

- Mere book entry loans without bank inflows.
- Diverted loans without business purpose.
- Round tripping loans for fund diversion.
- Loans without No Objection from existing lenders.
- Unsecured to secured loan without new value.
- Cash-received loans.
- Prioritized settlement of certain loans.
- Loans from under 'strike-off' entities.

Payable Accounts

- Fictitious purchases and resulting liabilities.
- Non-arms-length transactions, especially with Related Parties.
- Aging Payables balances.
- High-value sole agents or related parties.
- Creditors paid directly but still shown as outstanding."

f) Classification and Reporting of Frauds (as covered under RBI Master Directions)

The RBI has issued Master Directions³⁷ to banks, aiming to establish a framework for early fraud detection and reporting. This enables timely actions and facilitates rapid information dissemination by RBI to banks about frauds, unscrupulous borrowers, and related parties. The goal is to enhance banks preventive measures through internal checks and procedures when dealing with such parties. The Master Directions encompass about 42 signals known as Early Warning Signals (EWS). The presence of any of these EWS can indicate possible fraudulent activity in a loan account. They alert banks to potential weaknesses or misconduct that could

³⁷Reserve Bank of India, Master Directions on Frauds – Classification and Reporting by commercial banks and select FIs - RBI/DBS/2016-17/28 - DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 dated 1st July, 2016 (Updated as on 3rd July, 2017).

lead to fraud.

IP can appoint auditor for conducting transaction audit and the professional auditor should be duty bound of following: -

Responsibility of the professional conducting transaction audit:

- Analysing the financial statements of the corporate debtor (CD) for the specified audit period, following the defined scope of work mentioned in the appointment letter.
- Ensuring the confidentiality of the information gathered during the audit process.
- Clearly indicating the criteria for classifying transactions as avoidance in the audit report and properly documenting this rationale.
- Providing a conclusive report that categorizes transactions under relevant sections of the Insolvency and Bankruptcy Code (IBC).
- Being available for CoC meetings or hearings if required, and actively participating in such interactions.

While the Insolvency Professional (IP) is responsible for the following during audit :-

- Offering necessary assistance and information to facilitate the audit conducted by the professional.
- Carefully reviewing and comprehending the audit report submitted.
- Identification of respondents in the report by the IP.
- If deemed appropriate, the IP has the authority to share collected evidence with the professional to be included in the audit report.

In situations where the Committee of Creditors (CoC) does not endorse the proposal for a transaction audit or the associated fees, the resolution professionals are required to document all discussions in the meeting minutes. To prevent potential conflicts of interest, the following key points need to be highlighted:

1. Reference should be made to IBBI Circular No. IP/005/2018 dated 16th January, 2018. (Reference should be made to IBBI Circular No. IP/005/2018 dated 16th January, 2018, outlining "Disclosures by Insolvency Professionals and other Professionals appointed by Insolvency Professionals conducting Resolution Processes.")
2. Emphasis should be placed on Regulation 7 of the Liquidation Regulations.
3. Attention should be drawn to Para 23B of the Code of Conduct mentioned within the

Insolvency Professional Regulations.

As a highly advised, the following aspects should also be considered:

1. It's advisable for the RP or Liquidator not to engage professionals who have previously conducted audits for the same CD, or who have been involved in forensic audits or any other engagements with the CD in the past.
2. The appointed professional responsible for conducting the transaction audit should provide necessary disclosures as per the IBBI Circular dated 16th January, 2018 (mentioned above).
3. CoC members frequently suggest potential professionals for appointments. The RP should make an impartial evaluation based on the firm's reputation, fee quotation, availability for onsite work, and geographic proximity to the work site.

IV. CONCLUSION

The Insolvency and Bankruptcy Code 2016 represents a paradigm shift in India's financial landscape, offering a robust framework for addressing insolvency and bankruptcy cases. Corporate Debtors are managed by individuals known as directors, collectively forming the Board of Directors. During insolvency, the management, having insider knowledge of the company's financial state, might attempt to redirect assets through various agreements or transactions to minimize their losses during liquidation. This often involves transferring company assets at significantly reduced values, leaving creditors with minimal recovery prospects. To safeguard lenders' interests, the IBC includes provisions to address various types of detrimental transactions: Preferential (Sections 43 and 44), Undervalued (Section 45 to 48), Extortionate (Sections 50 and 51), and Fraudulent (Section 49 and 66) transactions. These provisions serve the key purpose of ensuring that the assets of the corporate debtor remain available for resolution, sustaining its operations, or being liquidated. Additionally, these provisions prevent any individual creditor from gaining undue advantage over others.

Understanding the nuances of various types of potentially fraudulent and avoidable transactions is crucial in maintaining the integrity of resolution and liquidation proceedings. The article provided valuable insights into the timelines, criteria, and considerations involved in evaluating transactions, offering a comprehensive perspective for Insolvency professionals and liquidators dealing with insolvency and liquidation cases. By adhering to timelines, considering relevant criteria, and seeking expert assistance, resolution professionals can effectively address potentially fraudulent activities, ensuring fair and transparent resolution proceedings. Vigilance

and attention to detail remain paramount in safeguarding the integrity of the insolvency process and protecting the interests of all stakeholders involved. resolution professionals taking help of forensic experts, auditors etc can meticulously analyse financial records, transaction histories, and other relevant documents to expose any irregularities or red flags.
