NATIONAL COMPANY LAW APPELLATE TRIBUNAL, NEW DELHI

Company Appeal (AT) (Insolvency) No. 557 of 2018

(Arising out of Order dated 5th July, 2018 passed by the Adjudicating Authority (National Company Law Tribunal), Allahabad Bench in C.P. No. 168/ALD/2017**)**

IN THE MATTER OF:

Shobhnath & Ors. **...Appellants**

Vs.

Prism Industrial Complex Ltd. **...Respondent**

Present: **For Appellant: - Mr. Ashok Kriplani with Mr. Hitesh, Advocates.**

For Respondent: - None.

J U D G M E N T

SUDHANSU JYOTI MUKHOPADHAYA, J.

The Appellant- Mr. Shobhnath filed an application under Section 7 of the Insolvency and Bankruptcy Code, 2016 ("I&B Code", for short) against 'Prism Industrial Complex Limited'- ('Corporate Debtor'). The Adjudicating Authority (National Company Law Tribunal), by detailed judgment dated 5th July, 2018 rejected the application under Section 7 with following reasons:

"Whether insolvency application can be entertained in a case where financial fraud exists?

Admittedly the corporate debtor company had raised deposits from retail investors, by instruments purporting to be debentures. The debentures were issued to more than 3000 investors.

In accordance with the provisions of sec. 67 of the Companies Act, 1956, these debentures were deemed to have been issued to public. - - - -

The debentures were issued in breach of the public issue norms, and therefore, the debentures must be redeemed immediately.

Additionally, some of the debentures were regarded to be "deposits", being unsecured debentures, and orders have been passed by the NCLT for immediate repayment of the said debentures.

Even while the said orders of NCLT are pending for execution, and have not been acted upon application has been made by some of the financial creditors for insolvency of the Corporate Debtor under sec. 7 of the IBC.

There are two essential reasons why such an application for declaration of insolvency and moratorium under sec. 7 cannot be granted.

First reason is purely a question of bonafide reasons for making the application, and the implications of the insolvency declaration and ensuing moratorium.

There is no doubt that the enactment of the insolvency resolution process under the IBC is a step towards resolution or rectification of an insolvency. There is a company which had run into financial problems; the creditors are proposing to collectively bail the company out. These provisions are intended for repairing a broken house that still can be repaired, and can avoid demolition. The intent of Insolvency resolution process cannot be to interfere in cases where there are financial irregularities, illegalities or indications of a financial fraud.

The present case is one where interests of a large number of retail investors, from whom money has been raised in the guise of debentures or deposits, is involved. None of these retail investors, who have been deprived of their life's savings, could be intending to be benevolent to think of resolution or revival of such a company. It is also evident that having raised money from numerous investors, the promoters/directors have siphoned the funds out into various affiliated companies. This is evident from a study of the balance sheet of the company.

Where the situation is reflective of a financial fraud, and orders of NCLT for immediate repayment of the debentures/deposits have remained unexecuted, what the ends of justice require is effective implementation of orders already issued, and sternest prosecution of an offender responsible for financial fraud. The benevolent scheme of IBC for a resolution of a company under distress is not meant for a case of a financial fraud or irregularity, where the directors/promoters have deliberately engaged in a scheme having striking similarity with the Infamous "chit funds" or Ponzi schemes. The promoters/directors face serious criminal implication for breach of the orders of SEBI as well noncompliance of provisions of sec. 73/74 of the Companies Act 1956. It is also notable that section 75 of the Companies Act provides that raising of deposits, or non-payment thereof, amounts to a serious corporate fraud, punishable under sec. 447 of the Companies Act. It can be no one's case that in such a murky scenario of corporate fraud, section 7, which is intended for a holistic collective healing process, could be rightly deployed.

The second reason why CIRP process cannot be initiated in a case such as the one in hand, is a combined reading of sec. 3(17) and sec. 3 (16) (a) of the Code. As per sec. 3(16) (a), the business of accepting deposits is included in the definition of "financial services". A financial services provider, as per sec. (17) is one who is engaged in the business of providing financial services, in accordance with authorization or registration granted under the law. Where an authorization or registration is required by statute, not obtaining the same cannot grant the entity the right to get out of the provisions which are intended to apply to an entity engaged in similar services.

It is notable that sec.3 (7) excludes a financial services provider from the ambit of the Code The intent of the exclusion is simple if an entity is engaged in financial services business, it has a systemic significance. It involves money belonging to public. If such a company is put into a situation of moratorium, and the payments made by such entity are halted, the financial system could get into a tail spin. Such a serious implication to the fact, keeping such entities outside a benevolent, remedial law such as IBC, is all the more important for such a truant

entity, which is sitting with public money, and that too, without any authorization.

The consequential impact of the commencement of CIRP will be moratorium. This will actually mean the orders made by SEBI or NCLT for immediate refund of the money raised from retail investors will not be implemented during the moratorium period. Also, the constitution of the Committee of Creditors and the system of voting there at, goes on the basis of majority by value. It is quite possible that the corporate person may have created creditors with high value, who may care feast for the interests of retail investors, from whom money has been. Hence, the so-called resolution plan may harm the interests of such investors.

Considering the Intent of the CIRP provisions, public interest involved and the ends of justice, we are of the view that in the present case, the application for CIRP deserves to be rejected.

The learned counsel for the financial creditor has emphasised on admitting the petition, for initiation of CIRP. Corporate debtor itself has filed its no objections in the form of affidavit, claiming that CIRP process will be in the interest of the debenture holders/ depositors and the

corporate debtor. The petition filed in the insolvency and bankruptcy code cannot be admitted only on the ground that corporate debtor has not opposed the petition Section 65 of The Insolvency and Bankruptcy Code 2016 provides that

> *"if any person initiates the insolvency resolution process or liquidation proceedings fraudulently with malicious intent for any purpose other than for resolution of insolvency, or liquidation, as the case may be, the adjudicating authority may impose upon such person a penalty which shall not be less than Rs. 1 lakh, but we may extend to one crore rupees."*

Thus it is clear that while a petition is filed under Insolvency and Bankruptcy Code 2016, fraudulently with malicious intention for initiation of CIRP, then in that case the petition cannot be admitted not be admitted and actions should be initiated under section 65 of the Code. This is a fit case where we find that this petition has been filed fraudulently for initiation of corporate, insolvency process, therefore petition deserves to be dismissed.

Order

The petition filed by the financial creditor under section 7 of the Insolvency and Bankruptcy code is dismissed for the reasons assigned in the body of the judgment. We further order that show cause notices under section 65 of The Insolvency and Bankruptcy Code against the petitioner/ financial creditors be issued. Reply against the notices may be filed within three weeks from today.

A copy of this order be communicated to the SEBI and to the Central Government through RD(NR).

List on dated 7th August, 2018 of further proceeding."

2. The Adjudicating Authority by impugned Judgment also directed for issuance of show-cause notice under Section 65 of the 'I&B Code' against the Appellants/ 'Financial Creditors' for further decision.

3. Learned counsel appearing on behalf of the Appellants submitted that the Adjudicating Authority is required to take into consideration the relevant facts as recorded in Form-1 to find out whether debt is payable

and the application is complete or not. If the debt is payable and default is of more than Rs.1 lakh and record is complete, the Adjudicating Authority is bound to admit the application.

4. In spite of service of notice and publication of advertisement in two Newspapers one in English- 'Times of India, Allahabad Edition' and another is Hindi- 'Hindustan, Allahabad Edition', the 'Corporate Debtor' has not appeared.

5. From the impugned order, we find that the Adjudicating Authority has allowed intervention applications filed by different creditors, which is not the requirement of the 'I&B Code'/ law.

6. In ***"Innoventive Industries Ltd. v. ICICI Bank & Anr.— Company Appeal (AT) (Insolvency) Nos. 1 & 2 of 2017"***, this Appellate Tribunal held that before admitting an application under Sections 7 or 9, a limited notice is required to be given to the 'Corporate Debtor' by the Adjudicating Authority.

7. The matter subsequently fell for consideration before the Hon'ble Supreme Court in ***"Innoventive Industries Ltd. v. ICICI Bank and Anr.— (2018) 1 SCC 407"*** wherein dealing with the provisions of Sections 7 or 9, the Hon'ble Apex Court observed and held as follows:

> *"27. The scheme of the Code is to ensure that when a default takes place, in the sense that a*

debt becomes due and is not paid, the insolvency resolution process begins. Default is defined in Section 3(12) in very wide terms as meaning non-payment of a debt once it becomes due and payable, which includes non-payment of even part thereof or an instalment amount. For the meaning of "debt", we have to go to Section 3(11), which in turn tells us that a debt means a liability of obligation in respect of a "claim" and for the meaning of "claim", we have to go back to Section 3(6) which defines "claim" to mean a right to payment even if it is disputed. The Code gets triggered the moment default is of rupees one lakh or more (Section 4). The corporate insolvency resolution process may be triggered by the corporate debtor itself or a financial creditor or operational creditor. A distinction is made by the Code between debts owed to financial creditors and operational creditors. A financial creditor has been defined under Section 5(7) as a person to whom a financial debt is owed and a financial debt is defined in Section 5(8) to mean a debt which is disbursed against consideration for the time value of money. As opposed to this, an

operational creditor means a person to whom an operational debt is owed and an operational debt under Section 5(21) means a claim in respect of provision of goods or services.

28. When it comes to a financial creditor triggering the process, Section 7 becomes relevant. Under the explanation to Section 7(1), a default is in respect of a financial debt owed to any financial creditor of the corporate debtor- it need not be a debt owed to the applicant financial creditor. Under Section 7(2), an application is to be made under sub-section (1) in such form and manner as is prescribed, which takes us to the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016. Under Rule 4, the application is made by a financial creditor in Form 1 accompanied by documents and records required therein. Form 1 is a detailed form in 5 parts, which requires particulars of the applicant in Part I, particulars of the corporate debtor in Part II, particulars of the proposed interim resolution professional in part III, particulars of the financial debt in part IV and

documents, records and evidence of default in part V. Under Rule 4(3), the applicant is to dispatch a copy of the application filed with the adjudicating authority by registered post or speed post to the registered office of the corporate debtor. The speed, within which the adjudicating authority is to ascertain the existence of a default from the records of the information utility or on the basis of evidence furnished by the financial creditor, is important. This it must do within 14 days of the receipt of the application. It is at the stage of Section 7(5), where the adjudicating authority is to be satisfied that a default has occurred, that the corporate debtor is entitled to point out that a default has not occurred in the sense that the "debt", which may also include a disputed claim, is not due. A debt may not be due if it is not payable in law or in fact. The moment the adjudicating authority is satisfied that a default has occurred, the application must be admitted unless it is incomplete, in which case it may give notice to the applicant to rectify the defect within 7 days of receipt of a notice from the adjudicating authority. Under sub-section (7), the

adjudicating authority shall then communicate the order passed to the financial creditor and corporate debtor within 7 days of admission or rejection of such application, as the case may be.

29. The scheme of Section 7 stands in contrast with the scheme under Section 8 where an operational creditor is, on the occurrence of a default, to first deliver a demand notice of the unpaid debt to the operational debtor in the manner provided in Section 8(1) of the Code. Under Section 8(2), the corporate debtor can, within a period of 10 days of receipt of the demand notice or copy of the invoice mentioned of a dispute or the record of the pendency of a suit or arbitration proceedings, which is pre-existing- i.e. before such notice or invoice was received by the corporate debtor. The moment there is existence of such a dispute, the operational creditor gets out of the clutches of the Code.

30. On the other hand, as we have seen, in the case of a corporate debtor who commits a default of a financial debt, the adjudicating authority has merely to see the records of the information utility

or other evidence produced by the financial creditor to satisfy itself that a default has occurred. It is of no matter that the debt is disputed so long as the debt is "due" i.e. payable unless interdicted by some law or has not yet become due in the sense that it is payable at some future date. It is only when this is proved to the satisfaction of the adjudicating authority that the adjudicating authority may reject an application and not otherwise."

8. In ***"Innoventive Industries Ltd. v. ICICI Bank and Anr."*** (Supra), it is made clear that the 'debt' means a liability of obligation in respect of a 'claim' and a 'claim' means a right to payment ***even if it is disputed***. The Code gets triggered the moment default is of rupees one lakh or more.

9. The Hon'ble Supreme Court specifically held that when it comes to a 'Financial Creditor' triggering the process, Section 7 becomes relevant. The application is made by a 'Financial Creditor' in Form 1 accompanied by documents and records required therein. Form 1 is a detailed form in 5 parts, which requires particulars of the applicant in Part I, particulars of the 'Corporate Debtor' in Part II, particulars of the proposed 'Interim Resolution Professional' in Part III, particulars of the 'Financial Debt' in Part IV and documents, records and evidence of default in Part V.

10. Thus, it is clear that once the record is complete, Code is to be triggered if there is a default of more than Rs. 1 lakh. The 'Corporate Debtor' can only point out that the debt may not be due in a sense it is not payable in law or in fact.

11. This Appellate Tribunal in numerous cases has stated that notice is to be given only to the 'Corporate Debtor' in an application under Sections 7 or 9 of the 'I&B Code'. The question of intervention by a third party before the admission of the application under Sections 7 or 9 does not arise.

12. It is a settled law that the Adjudicating Authority is only required to ensure whether there is a debt and default on the basis of record (Form 1). It cannot take into consideration any other facts which are irrelevant. The 'Corporate Insolvency Resolution Process' not being a litigation much less adversarial litigation or a recovery proceeding or a money suit, has been held by this Appellate Tribunal in ***"Binani Industries Limited vs. Bank of Baroda & Anr.– Company Appeal (AT) (Insolvency) No. 82 of 2018 etc."***. For the said reason, we hold that the Adjudicating Authority cannot notice to hold that owing to the financial fraud the amount was not paid by the 'Corporate Debtor'.

13. Section 65 of the 'I&B Code' provides *"Fraudulent or malicious initiation of proceedings"* which reads as follows:

> *"**65. Fraudulent or malicious initiation of proceedings.**—(1) If, any person initiates the insolvency resolution process or liquidation proceedings fraudulently or with malicious intent for any purpose other than for the resolution of insolvency, or liquidation, as the case may be, the Adjudicating Authority may impose upon a such person a penalty which shall not be less than one lakh rupees, but may extend to one crore rupees.*
>
> *(2) If, any person initiates voluntary liquidation proceedings with the intent to defraud any person, the Adjudicating Authority may impose upon such person a penalty which shall not be less than one lakh rupees but may extend to one crore rupees."*

14. From the aforesaid provision, it is clear that if, any person initiates the Insolvency Resolution Process or Liquidation Proceedings fraudulently or with malicious intent for any purpose other than for the resolution of insolvency, or liquidation, the Adjudicating Authority has power to impose upon such person penalty which shall not be less than one lakh rupees, and may extend to one crore rupees.

15. In the present case, the Adjudicating Authority has failed to show that the present proceeding under Section 7 was filed by the Appellant fraudulently or with malicious intention for initiation of the 'Corporate

Insolvency Resolution Process' against the 'Corporate Debtor'. Whatever the grounds shown for not entertaining the application are not related and beyond Form 1 and were not to be pleaded. In fact, nothing on the record to suggest that the Appellant filed application fraudulently with malicious intention for initiation of the 'Corporate Insolvency Resolution Process' against the 'Corporate Debtor'.

16. *Prima facie* no case was made out before the Adjudicating Authority for passing any observation under Section 65 of the 'I&B Code' merely on the ground that the Directors and Promoters have engaged in Scheme having striking similarity with the infamous chit funds or Ponzi Schemes. The Promoters/ Directors may face serious criminal implication for breach of the orders of SEBI, but that cannot be ground to reject the application under Section 7 against the 'Corporate Debtor', or to initiate any proceeding under Section 65 against the Appellants, who have no connection with the Directors or Promoters of the 'Corporate Debtor'.

17. For the reasons aforesaid, we set aside the impugned judgment dated 5th July, 2018 and remit the case to the Adjudicating Authority to admit the application after notice to the 'Corporate Debtor' so as to enable the 'Corporate Debtor' to settle the claim. No intervention application can be entertained by the Adjudicating Authority before admission of the application.

The appeal is allowed with aforesaid observations and direction. No costs.

(Justice S.J. Mukhopadhaya)
Chairperson

(Justice A.I.S. Cheema)
Member(Judicial)

(Kanthi Narahari)
Member(Technical)

NEW DELHI
6th August, 2019

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