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Avinash Kumar



Avinash Kumar has completed his Ph.D. in International Investment Law from the Dept. of Law & Governance, Central University of South Bihar. His research work is on "International Investment Agreement and State's right to regulate Foreign Investment." He qualified UGC-NET and has been selected for the prestigious ICSSR Doctoral Fellowship. He is an alumnus of the Faculty of Law, University of Delhi. Formerly he has been elected as Students Union President of Law Centre-1, University of Delhi. Moreover, he completed his LL.M. from the University of Delhi (2014-16), dissertation on "Cross-border Merger & Acquisition"; LL.B. from the University of Delhi (2011-14), and B.A. (Hons.) from Maharaja Agrasen College, University of Delhi. He has also obtained P.G. Diploma in IPR from the Indian Society of International Law, New Delhi. He has qualified UGC – NET examination and has been awarded ICSSR – Doctoral Fellowship. He has published six-plus articles and presented 9 plus papers in national and international seminars/conferences. He participated in several workshops on research methodology and teaching and learning.

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AN ANALYTICAL STUDY OF FRAUDULENT BANKRUPTCY IN INDIA

AUTHORED BY - SMITA R. NAIK

Semester - III, Secunder year LLM, PES' Modern Law College, Pune

ABSTRACT

The present study comprises of bankruptcy, its types, its advantages & disadvantages, legal framework for prosecuting fraud, Insolvency & Bankruptcy Code, provisions under IBC & IPC and landmark case laws have been discussed.

Key words: bankruptcy, IBC, legal framework under IBC

1. INTRODUCTION

'Bank fraud is use of potentially illegal means to obtain money or assets from financial institution whereas bankruptcy is legal relief to seek debts of financial institution'.

Fraudulent bankruptcy or bankruptcy fraud is a serious white-collar crime involving the manipulation of banking system to deceive creditors, Court or trustee. Crime challenges the integrity of the bankruptcy process that is designed to give honest debtors a fresh start by settling debts they cannot pay while ensuring that creditors receive as much compensation as possible. Bankruptcy fraud can be defined as 'purposefully and illegally acting in a way that leaves bankruptcy creditors of the bankrupt corporation financially disadvantaged'¹ It is crime that often has serious financial consequences for people involved with the bankrupted company. Former employees may be unsettled several months of salary arrears, creditors do not see payment for goods or services and taxes are no longer paid.

When bank or entity is finding itself unable to pay off all debts and meet its liabilities, then the entity may file for the process of bankruptcy. The process helps banker or entity free themselves off its outstanding debts and offer repayments to all the creditors. Process starts with petition to the court made by the entity that owes money to its creditors (debtor). The Officials investigate actual amount of outstanding debt and depending on type of bankruptcy and nature

¹ Available at: <http://www.radio1.nl/contents/22045-faillissementsfraude> Last seen on 3-8-2024.

of applicant's debts and business (firm, individual, company, public or private).

Via bankruptcy, the debts owed to creditors are forgiven and written off, either completely or in part or paid off by selling off the assets of company. It is natural for a bankruptcy filing to severely impact bank's credit rating negatively. This means that availing loans in the future will be difficult process. There are various kinds of bankruptcies that will affect the credit rating and bankruptcy process at an individual and national level. Bankruptcy has no positive highlights and is often considered as a last resort since the credit rating will fall low. Though the credit rating may dive low, bankruptcy is actually a resilience effort to stabilize the debt obligations and start afresh. It is thus not synonymous with insolvency. In India, Bankruptcy is carried out under Insolvency and Bankruptcy Code (2016), new code that seeks to provide relief to all suffering entities.²

2. INSOLVENCY AND BANKRUPTCY CODE (IBC)

IBC is the bankruptcy law which seeks to consolidate the existing framework by creating single law for insolvency and bankruptcy. Prime objectives behind this law are to consolidate and amend all existing insolvency laws; to simplify and expedite proceedings in time-bound manner; to protect interest of both creditors and stakeholders of company; to get necessary relief to creditors and consequently increase credit supply in economy; to work out timely recovery procedure to be adopted by banks; to set up Insolvency and Bankruptcy Board of India and maximization of value of assets of corporate company.

This Act provides time-bound process to resolve insolvency. Default in repayment when occurs, creditors gain control over debtor's assets and must make decisions to resolve insolvency within 180 days. To ensure uninterrupted resolution process, Act also provides immunity to debtors from resolution claims of creditors during this period. Act also consolidates provisions of current legislative framework to form common forum for debtors and creditors of all classes to resolve insolvency. In order to facilitates insolvency resolution Insolvency –professionals and –agencies; adjudicating authorities (National Companies Law Tribunal & Debt Recovery Tribunal), and Insolvency and Bankruptcy Board have been established. When default occurs, the resolution process is initiated by debtor or creditor. Thereafter, the committee consisting of financial creditors takes decision regarding future of

² Available at: <https://cleartax.in/glossary/bankruptcy> Last seen on 3-8-2024.

outstanding debt owed to them. Committee may choose to revive debt owed to them or sell (liquidate) the assets of debtor to repay debts owed to them. If decision is not taken in 180 days, debtor's assets go into liquidation. Then insolvency professional administers process of liquidation. This Act has been amended twice in the year 2018 and 2020. Insolvency and Bankruptcy Code (Amendment) Act Bill of 2021 is still pending.³

3. TYPES OF BANKRUPTCY FRAUD

- 1) Concealment of assets: It is the most prevalent form of bankruptcy fraud. It occurs when debtor intentionally hide assets to avoid liquidated to pay off creditors *e.g.* failing to disclose bank accounts, real estate or valuable personal property.
- 2) Fraudulent preferences: Fraudulent preference occurs when debtor prioritizes one creditor over others shortly before declaring bankruptcy; often happens when debtor repays loans to family members or close associates leaving other creditors unpaid.
- 3) Misrepresentation and filing false information: Providing false or misleading information in bankruptcy filings; another common form of fraud *e.g.* overstating liabilities; understating assets, income, debts etc. and omitting or hiding income sources or assets.
- 4) Fraudulent trading and wrongful trading: Directors and officers of companies may continue to trade even when they know that Company is insolvent, leading to further losses for creditors. Such actions may be termed as fraudulent or wrongful trading under Indian law.
- 5) Undervaluation of assets: Another form of bankruptcy fraud that involves undervaluing assets before declaring bankruptcy, either by selling them at lower price to related parties or through fraudulent appraisals.
- 6) Multiple filings: Debtors may attempt to file multiple bankruptcy petitions in different jurisdictions or under different names to take advantage of automatic stay provision, which temporarily halts collection efforts by creditors.
- 7) Bribery and corruption: Less common form, some bankruptcy fraud cases involve the bribery of court officials or trustees to obtain favorable outcomes.
- 8) Asset-stripping before bankruptcy: Some debtors engage in asset-stripping before filing for bankruptcy by selling or transferring assets at undervalued prices to friends or family, intending to reclaim them after the bankruptcy process.

³ Available at: <https://byjus.com/free-ias-prep/insolvency-and-bankruptcy-code-upsc-notes/> last seen 3-8-2024.

4. ADVANTAGES AND DISADVANTAGES OF BANKRUPTCY

Declaring bankruptcy can help relieve legal obligation to pay the debts and save your home, business or ability to function financially, depending on which kind of bankruptcy petition is filed. However, it lowers credit rating, making it more difficult to get bank loan, mortgage or credit card, buy home or business. If the entity is trying to decide whether it should file for bankruptcy, its credit is probably already damaged. Any creditors or lenders it apply to for new debt (*e.g.* car-loan, credit-card, line of credit or mortgage) will see the discharge on its report that can prevent it from getting any credit.⁴

5. LEGAL FRAMEWORK FOR PROSECUTING BANKRUPTCY FRAUD

Legal framework to address bankruptcy frauds is primarily governed by Insolvency and Bankruptcy Code (IBC) of 2016 along with other relevant laws *viz.*, Indian Penal Code (IPC) and Companies Act (2013).⁵

A) Provisions under IBC

1. Section-66: Section deals with fraudulent and wrongful trading; empowers Resolution professional to apply to National Company Law Tribunal to hold directors personally liable if business operations are carried out with intent to defraud creditors.
 - a) Subsection-1: In corporate insolvency resolution process (CIRP) or liquidation process if it is found that any business of corporate debtor has carried out with intent to defraud creditors, Adjudicating Authority, National Company Law Tribunal (NCLT) may hold persons who were knowingly parties to such conduct liable to contribute to debtor's assets.
 - b) Subsection-2: Persons responsible for wrongful trading i.e. continuing business operations even when insolvency was inevitable can be held personally liable for company's debts.
2. Section 67 (proceedings for fraudulent trading): Section empowers resolution professional to apply to NCLT to investigate and prosecute directors or partners who were involved in fraudulent trading.
3. Section-69 (punishment for transactions defrauding creditors): Section specifies

⁴ Available at: <https://www.investopedia.com/terms/b/bankruptcy.asp> Last seen on 3-8-2024.

⁵ Chatterjee, S., Shaikh, G. & B. Zaveri (2018). Empirical analysis of insolvency and bankruptcy code. National Law School of India Rev.: 30 (2), Pp. 89-110.

penalties for fraudulent or malicious initiation of insolvency proceedings. It states that any person who knowingly and fraudulently initiates bankruptcy proceedings with intent to deceive creditors can be penalized with imprisonment and fines. It prescribes penalty for persons who have entered into any transaction to defraud creditors during insolvency resolution or liquidation process, punishable by imprisonment of up to five years, or fine or both.

4. Section-70 (punishment for misconduct in corporate insolvency resolution process): Section deals with penalizing individuals who, during CIRP conceal property or information or intentionally alter documents with intent to defraud.
5. Section-71 (punishment for undue preferences/transactions): Section deals with individuals who give undue preference to certain creditors or engage in transactions intended to defraud creditors can face penalties.
6. Section-77: Section deals with punishment for furnishing false information; recommends imprisonment and fines for those who knowingly provide false information or omit material facts in bankruptcy filings.

B) Provisions under Indian Penal Code (IPC)

Various sections under IPC inclusive of those dealing with cheating, forgery and criminal breach of trust may be invoked to prosecute individuals for in bankruptcy fraud.

- 1) Section-24 (dishonesty): Section states the term dishonestly denoting any person who performs any activity with an intention to wrongfully gain by doing someone's wrongful loss. If offense committed is punishable with imprisonment for life or imprisonment for term of 10 years or more, the punishment will be imprisonment for term of 3 years with fine. If offense is punishable with imprisonment for term of less than 10 years, punishment will be imprisonment for term of up to 2 years or fine or both.
- 2) Section-25 (fraudulent): Section states the term word fraudulent denoting when person does any kind of activity with an intention to defraud not otherwise, the thing or activity is said to be illegal and fraud activity.
- 3) Section-405 (criminal breach of trust): Section deals with dishonest misappropriation or conversion of property for one's use and it is punishable with imprisonment, fine or both.
- 4) Section-415 (cheating): Section deals with anyone who deceives another to deliver any property or valuable security or to do or omit to do something that he/she would not do or omit if he/she were not deceived, commits cheating.
- 5) Section-420 (cheating): Section deals with cheating and dishonestly inducing delivery of

property and accused had intent to deceive or cheat someone to obtain property or cause loss.

- 6) Section-421: Section specifically deals with dishonest / fraudulent removal or concealment of property to prevent its distribution among creditors.
- 7) Section-422: Section deals with who dishonestly or fraudulently prevents any debt or demand due to them from being satisfied is punishable.
- 8) Section-423: Section deals with executing deed of transfer of property dishonestly or fraudulently with intention to defeat or delay creditors is punishable.
- 9) Section-463: Section deals with forgery, accused intent to deceive by making false document.

6. HOW BANKRUPTCY WORKS

Bankruptcy offers individual or business a chance to start fresh by forgiving debts that they can't pay. Meanwhile, creditors have a chance to get some repayment based on the individual's or business's assets available for liquidation. Ability to file for bankruptcy benefits overall economy by allowing people and companies a second chance to gain access to credit. It can also help creditors regain a portion of debt repayment. Administration over bankruptcy cases is often handled by trustee, an officer appointed by Tribunal to represent the debtor's estate in the proceeding. When bankruptcy proceedings are complete, the debtor is relieved of their debt obligations.⁶

7. DISCHARGED FROM BANKRUPTCY

When a debtor receives a discharge order, he/she is no longer legally required to pay debts specified in the order. Any creditor listed on the discharge order can't legally undertake any type of collection activity, such as making phone calls or sending letters against the debtor once the discharge order is in force. However, not all debts qualify to be discharged *e.g.* tax claims, anything that was not listed by debtor, child support or alimony payments, personal injury debts and debts to government. In addition, any secured creditor can still enforce a lien against property owned by debtor provided that the lien is still valid. Debtors do not necessarily have the right to discharge. When a petition for bankruptcy has been filed in court, creditors receive notice and can object if they choose to do so. If they do, they will need to file a complaint in court before the deadline which leads to filing of an adversary proceeding to recover money owed or

⁶ Available at: <https://www.investopedia.com/terms/b/bankruptcy.asp> Last seen on 3-8-2024.

enforce.⁷

8. JUDICIAL DECISIONS

In India, fraudulent bankruptcy cases often fall under the purview of the IBC and IPC. Certain key case laws related to fraudulent bankruptcy have been given below.

- 1) In case of SBI v. V. Ramakrishnan & Another (2018), the issue was addressed whether personal guarantors could be held liable when corporate debtor undergoes Corporate Insolvency Resolution Process. Corporate debtor's directors tried to avoid their personal liabilities by alleging that they were only guarantors. SC held that Section-14 of IBC which imposes moratorium on institution of suits, does not apply to personal guarantors of corporate debtor; significant ruling to prevent fraud by the guarantors to avoid their liabilities and thus preventing fraudulent attempts to escape personal liability during insolvency.
- 2) The case of Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors. (2019) involved challenge to constitutional validity of IBC. Petitioners argued that IBC allowed operational creditors to initiate CIRP in a way that could be misused and lead to fraudulent bankruptcies. SC upheld constitutional validity of IBC that sufficient safeguards to prevent its misuse for fraudulent purposes and ensure equitable treatment of all the creditors.
- 3) In case of RBI v. Vijay Mallya (2018), absconder businessman was accused of defaulting on loans worth over Rs. 9,000 crore. Enforcement Directorate (ED) and Central Bureau of Investigation (CBI) alleged that he had concealed assets by transferring them abroad and had misrepresented his financial situation to avoid repayment. Courts ruled that he was a willful defaulter. Case highlighted importance of transparency in bankruptcy proceedings under IBC.
- 4) In case of Phoenix ARC Pvt. Ltd v. Spade Financial Services Ltd & Ors. (2021), SC dealt with issue of fraudulent misrepresentation in bankruptcy proceedings and ruled out resolution plan of Corporate Debtor that was based on fraudulent misrepresentation of facts leading to rejection; reinforced need for transparency-honesty in insolvency process under IBC.
- 5) In case of ArcelorMittal India Pvt Ltd v. Satish Kumar Gupta & Ors. (2018), SC dealt with issue of fraudulent and wrongful trading. Court held that if Company's directors

⁷ Supra 6.

knowingly engage in activities that further deplete Company's assets after it has become insolvent, they can be held personally liable; case is significant in highlighting responsibility of corporate directors in preventing bankruptcy fraud.

- 6) In case of IDBI Bank Ltd v. Jaypee Infratech Ltd (2020), National Company Law Appellate Tribunal (NCLAT) found that corporate debtor had undervalued its assets in the plan submitted under IBC. Tribunal ordered fresh valuation and emphasized importance of accurate asset valuation in insolvency process. The case served as precedent for ensuring that assets are not undervalued to detriment of creditors.

9. CONCLUSION

Bankruptcy fraud in India poses significant challenges to legal and financial systems.

It is serious offense that undermines the fairness, effectiveness and integrity of bankruptcy system. It also imposes significant harm on creditors and the legal system. It not only harms creditors but also erodes public trust in the judicial system. Legal framework includes both Bankruptcy Code and Criminal Code ensures those who commit bankruptcy fraud which are held accountable. Through series of landmark cases, Courts have developed vigorous body of case laws that clearly defines what constitutes bankruptcy fraud and the consequences of engaging in such illegal activities and fairness in bankruptcy proceedings. These cases have played crucial role in shaping the jurisprudence around bankruptcy fraud in India, ensuring that the rights of creditors are protected and that fraudulent debtors are held accountable. Bankruptcy system functions crucially when act of honesty and transparency is expected from all the participants. Detection and prevention efforts must be healthy to ensure that the system is not abused by fraudulent actors.