Can Protecting a Loan Make a Lender a Related Party?

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Key Takeaways

- The Supreme Court excluded ECL Finance from Palm Developers' CoC as a related party, not because ECL controlled the borrower, but because it participated in its policymaking. A role in navigating policy was enough
- Some of ECL's rights went further than a lender needs. Under the borrower's articles, no board meeting was valid without ECL's observer, and ECL decided any deadlock among the promoters. But the Court's test also reaches budget approvals, key-manager vetoes and step-in rights that private lenders routinely require, and the price is the lender's vote on the resolution plan
- ECL's sale of its facility after insolvency began did not help. The Court excluded the buyer too
- Lenders should drop quorum and deadlock rights and keep the rest as guardrails, with limits fixed at signing and enforcement tied to objective triggers rather than a default proved in court

ECL Was Excluded Not for Controlling the Borrower, but for Participating in Its Policymaking

ECL Finance holds Rs 110 crore of debentures issued by Saha Infratech, part of which funded Encore, a housing project in Greater Noida, and gave Saha Infratech a Rs 90 crore revolving credit facility. Palm Developers guaranteed both and later went into insolvency. The IBC bars a related party of the corporate debtor from its CoC. Two kinds of relationship in the definition of related party in Section 5(24) matter here.

The first is control. Section 5(24) catches a person who controls more than 20% of the voting rights, or can control the composition of the board, or whose instructions the directors are accustomed to follow.

Company law is to the same effect. Under Section 2(27) of the Companies Act, control "shall include the right to appoint majority of the directors or to control the management or policy decisions". Control is the power to make the decision.

The second is participation. Section 5(24)(m)(i) also catches "any person who is associated with the corporate debtor on account of … participation in policy making processes of the corporate debtor" (the ***Policymaking Bar***). It requires only a role in how decisions are made.

On 27 October 2026, the Supreme Court held that ECL was caught by the Policymaking Bar and excluded it and its debenture trustee from the CoC. A lender, it said, need not be "in the driving seat", and "a role of navigation would suffice". The Court also found that ECL had in fact supervised the borrower's policy and business. Exclusion carries a real cost. A lender off the CoC has no vote on the resolution plan, and the other creditors largely decide what it recovers.

Private Credit Lends Where Banks Will Not

RBI rules permit banks to finance land acquisition by public agencies, not private builders. Developers with land to acquire, unfinished projects or promoters under strain therefore turn to NBFCs and credit funds, which rely on their contracts for protection. Budget approvals, escrowed cash flows and step-in rights are standard terms, not overreach. The Court's reading of the Policymaking Bar falls hardest on the lenders who most need them.

The Policymaking Bar Was Never Meant for Genuine Lenders

The Policymaking Bar reaches related parties that fall outside the established heads of control and ownership. Its purpose is to prevent conflicts. In *Phoenix ARC*, the Supreme Court said insolvency is driven by external creditors, and related parties are kept off the CoC so they

cannot sabotage it to benefit the corporate debtor. A promoter that lends to its own company has interests beyond repayment. A third-party lender ordinarily wants only to be repaid.

In our view, the law was not meant to catch genuine third-party lenders. The IBC itself spares regulated lenders that became related parties only by converting debt into equity before insolvency, and Ind AS 110 treats a lender's right to restrict activities that affect a borrower's credit risk as protective, not as power. Courts should ultimately consider whether lender really shared the promoters' interest. A lender should lose its vote for governing the company, not for protecting its loan.

Protection Is Not Participation

Every covenant influences the borrower. If influence were the test, every secured lender would be a related party. A protective right lets the lender refuse, receive information or act when the borrower fails, while the borrower still decides. A participatory right makes the lender part of how the company decides in the ordinary course. Three questions separate them. Does the right let the lender refuse, or decide? Does it apply in the ordinary course, or only on failure? Does it protect the collateral and cash flows, or reach the business beyond them? The Court's navigation test asks only whether the lender had a role, not what kind.

Two of ECL's Rights Crossed the Line

Rights that amounted to participation

Observer as quorum. The observer had no vote. But under the borrower's articles, a clause the Court did not discuss, no board or shareholder meeting was valid without it unless its leave of absence was noted or the debenture holders had consented in advance. Circular resolutions needed the debenture holders' written approval, and ECL held all the debentures. Palm Developers could take no decision without ECL's presence or consent.

Deadlock referral. Any deadlock among the directors or promoters, on any matter, went to the lenders' nominee or the debenture holders for a binding decision. It did not depend on a default, and it gave ECL the decision itself. The promoters were two families, the Sahas and the Sirohis, so the clause made ECL the arbiter of their disputes. It may never have been invoked, but a lender that resolves disputes between owners participates in governing the company.

Rights that were protective

All project receipts went into an escrow account run on the debenture holders' instructions, which governs where the money goes, not how the company is run. A prior-approval list lets

the lender refuse, not direct. Inspection gives information. A veto on removing key managers protects continuity, and the right to require new staff applied only after missed milestones.

Rights that were necessary but drafted too broadly

Budget approval, a power of attorney and a say in sales are rights every real estate lender needs. The trustee could advise budget changes "as mutually decided", and the issuer had to revise the budget if so advised. Neither the judgment nor the documents we reviewed limit the power of attorney to default. The sales agent, by contrast, was fixed as a condition of disbursement, which is the appropriate approach.

The Court could have decided the case on the two rights that crossed the line. Its test does not distinguish them from the rest.

Two objections deserve an answer. The first is that ECL chose these rights and should bear the consequences. As to the quorum and deadlock rights, we agree. The second is that a forensic audit reported that Palm Developers was used to move funds from Saha Infratech to promoter companies whose assets were charged to ECL. If ECL benefited, it was no third-party lender. But the Court made no finding that ECL colluded with the promoters. Absent such a finding, ECL's exclusion can rest only on its rights, and only two of them, the quorum and deadlock rights, did more than protect the loan.

Selling the Claim After Insolvency Probably Complicated ECL's Case

As the Court summarised *Phoenix ARC*, an assignee escapes the bar if it has "legitimately taken over the debt of related parties" or the seller "had stopped being a related party 'long ago'". ECL might have stood on firmer ground had it sold the loan before insolvency.

ECL assigned the loan long after the insolvency began. The Court took up the point on its own, "Though not specifically argued". It found that the assignment "is not 'long ago' and is very recent" and "can only be considered as one intended to defeat the rigour of the proviso to Section 21(2)". It concluded, "The assignment hence fails the test of a bona fide assignment, and the 2nd appellant too cannot be participated."

How Lenders Can Protect the Loan Without Losing the Vote

The lender should set limits at signing and act when they are breached. The borrower should decide within them.

Drop quorum and deadlock rights. Give the observer notices, agendas, minutes and a right to attend, but its absence should not affect the meeting. Make an unresolved deadlock on a reserved matter an event of default, so the lender enforces rather than decides.

Fix the limits at signing. Agree the business plan, project cost, floor price, a panel of sales agents and milestones upfront. The lender approves or rejects each budget against the plan. The borrower picks agents and buyers within the limits, and all proceeds go to escrow, with an automatic sweep to fund the approved budget.

Trigger enforcement without a trial. A borrower can dispute a default for years. Use triggers that can be established promptly, such as a payment overdue by a set number of days, an escrow shortfall or a milestone missed as certified by an independent monitor. Make the trustee's notice of the event conclusive, save for manifest error. Graduate the remedies, so that early warning signs unlock a cash sweep or a monitoring agent and full step-in follows only a hard default. All of this must work before insolvency, because the moratorium then halts enforcement.

Take the power of attorney at signing, but condition its use. Promoters are unlikely to grant one after a default. Execute it at signing, irrevocable as a power coupled with the lender's interest, stamped, and registered where it covers property sales. Make it exercisable only when the lender serves notice of an objective trigger. Any earlier power should be narrow and mechanical, such as executing sale deeds for units the borrower has sold at approved prices into escrow.

Fix live documents and trades before stress. Amend quorum and deadlock rights while the borrower is performing. Assignments made very close to, or after, the start of insolvency could be read as attempts to avoid the bar, and buyers of claims should price that risk.

The IBC was designed to exclude conflicted parties. ECL's quorum and deadlock rights may have justified its exclusion, but the Court's test also catches lenders that did no more than protect their money.

References

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2. Insolvency Law Committee Report, March 2018, paragraph 1.24.

3. Insolvency Law Committee Report, February 2020, Chapter 1, section 11, paragraphs 11.1–11.3.

4. Phoenix ARC Private Limited v. Spade Financial Services Limited, (2021) 3 SCC 475.

5. Insolvency and Bankruptcy Code, 2016, Sections 5(24) and 21(2).

6. Ind AS 28, Investments in Associates and Joint Ventures, paragraph 6, and Ind AS 110, Consolidated Financial Statements, paragraphs B26–B28 (corresponding to IFRS 10).

7. Reserve Bank of India, Master Circular – Housing Finance (acquisition of land).

8. Companies Act, 2013, Section 2(27).

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