

SAMVĀD: PARTNERS

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Insolvency and Bankruptcy Code

The Insolvency and Bankruptcy Code, 2016 (the “**IBC**”), that was passed by Parliament and received Presidential assent on May 28, 2016, aims at a significant overhaul of the existing legal framework of insolvency and bankruptcy resolution. The IBC seeks to consolidate the laws relating to insolvency and bankruptcy resolution for corporates, limited liability partnerships, partnership firms, individuals and other body corporates as may be notified by the Central Government from time to time. The Central Government now has much work to do in establishing the institutional framework required to implement the IBC before the new law can take effect. This period is also a good time for corporate debtors and creditors to prepare themselves for the new regime. In this Update, we discuss the key provisions of the new legislation that our corporate clients and lending institutions should be aware of in structuring and managing their financing arrangements.¹

I. History and Rationale for the IBC

Prior to the IBC being passed, India did not have a single law dealing with all aspects of a company in financial distress. Instead, there were multiple laws, each of which applied to a particular legal process, type of company or group of creditors. For example, the Sick Industrial Companies Act, 1985 (“**SICA**”) dealt with the rescue and rehabilitation of industrial companies only, while the Companies Act, 1956 provided a process for the liquidation and winding up of all types of corporate entities. There were also debt recovery laws such as the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (“**SARFAESI**”) and the Recovery of Debt Due to Banks and Financial Institutions Act, 1993 (“**RDDBI Act**”) that provided avenues for security enforcement and debt recovery, respectively, by banks and financial institutions.

The result of this fragmented legal framework was delays, confusion and conflicts between these multiples laws and legal fora. Further, many of these laws, such as SICA, had proved to be wholly ineffective in achieving a speedy restructuring that took into account the interests of both debtors and creditors. The World Bank’s *Ease of Doing Business Index 2015* ranked India 137 out of

¹ This Update is limited to the corporate insolvency resolution process. The resolution and bankruptcy process for individuals is not discussed.

189 countries on the ease of resolving insolvencies based on various indicators such as time, costs, recovery rate for creditors, the management of a debtor's assets during the insolvency proceedings, creditor participation and the strength of the insolvency law framework.²

Efforts at insolvency law reform began in late 2014 when the Ministry of Finance constituted the Bankruptcy Law Reform Committee (“**BLRC**”) under the chairmanship of Mr T.K. Viswanathan. The Finance Minister reiterated the Government's commitment to insolvency reform in his 2015-16 budget speech when he identified having a new insolvency law as one of the key priorities for the year. The BLRC submitted its report, including a draft of the Insolvency and Bankruptcy Bill, 2015 (the “**Bill**”) on November 4, 2015,³ which was introduced in the Lok Sabha in December 2015 with a few amendments. The Bill was subsequently referred to a Joint Parliamentary Committee, which submitted a detailed report, including a revised draft of the Bill.⁴ The IBC that was eventually passed was the version proposed by the Joint Parliamentary Committee.

II. The Insolvency and Bankruptcy Code – Key Terms

When a corporate entity enters into an insolvency proceeding, there are essentially two possible outcomes – the continuation of or sale of all or part of the existing business as a going concern (known as insolvency resolution) or the winding up and liquidation of the company and a distribution of its assets to creditors and other stakeholders. The IBC is a single consolidated law that provides for both insolvency resolution and, in the case of businesses that cannot be saved, their winding up and liquidation. The IBC envisages these processes to occur in a linear manner, i.e., an applicant cannot apply for the liquidation and winding up of a debtor without first going through the insolvency resolution process. However, a debtor can move into the liquidation phase soon after filing an application for insolvency resolution if the committee of creditors so decide.

The new legislation provides for the establishment of three new institutional structures whose functioning will be critical for the smooth implementation of the IBC – (i) a regulator, to be called the Insolvency and Bankruptcy Board of India, (ii) a new profession of insolvency professionals and insolvency professional agencies, and (iii) information utilities to collect and store

² World Bank Group, Ease of Doing Business in India, available at <http://www.doingbusiness.org/data/exploreeconomies/india>

³ The Report of the Bankruptcy Law Reforms Committee – Vol 1 and Vol. 2 are available at http://finmin.nic.in/reports/BLRCReportVol1_04112015.pdf and <http://finmin.nic.in/reports/DraftInsolvencyBankruptcyBil2015.pdf>

⁴ The Report of the Joint Committee on the Insolvency and Bankruptcy Code, 2015 is available at http://164.100.47.134/lssccommittee/Joint%20Committee%20on%20Insolvency%20and%20Bankruptcy%20Code,%202015/16_Joint_Committee_on_Insolvency_and_Bankruptcy_Code_2015_1.pdf

information on debts and defaults. The regulator's mandate is to regulate insolvency professionals, insolvency professional agencies and information utilities as well as to frame regulations under the IBC. Insolvency resolution cases will be heard by the National Company Law Tribunals (“NCLTs”), in the case of corporate debtors, and the Debt Recovery Tribunals (“DRTs”), in the case of individuals, partnerships and unincorporated entities.

A. The Insolvency Resolution Process (“IRP”)

The Trigger for Insolvency Resolution: Who and How?

Any creditor of the corporate debtor or the corporate debtor itself may file an application for insolvency resolution under the IBC. The trigger for filing an application is the occurrence of a payment default (defined as non-payment of a debt on its due date) of an amount of not less than INR 1,00,000. In the case of individuals and partnership firms, the minimum default amount is limited to INR 1,000.

In the case of financial debt, a financial creditor, such as a bank, a non-banking financial institution or a debenture trustee, may file an application immediately upon a default occurring, provided that the information on the default is available in the records of an information utility or the applicant provides some other acceptable proof of non-payment. In the case of operational debt – debt owed to suppliers, vendors, payments owed to employees, etc. – the operational creditor will need to deliver a demand notice to the debtor. If the debtor fails to either pay the unpaid dues or prove the existence of a dispute on the debt payment within 10 days of the demand notice, the operational creditor may file an application for insolvency resolution.

The IBC, thus, provides an early trigger for insolvency resolution with limited grace periods for payment delays, compared to earlier laws dealing with insolvency and debt recovery. SICA, for example, requires a 50% erosion in a company's net worth to trigger a requirement for the board of the company to monitor and report the erosion, while the RBI guidelines requires loans that are overdue for 90 days or more to be declared as NPAs. The rationale for having the occurrence of a payment default as the trigger is that the early detection of financial distress helps preserve value and increases the chances that a business can be saved.

However, these provisions that allow for early detection could potentially result in triggering insolvency resolution in situations where a corporate entity has inadvertently failed to satisfy a liability. Thus, corporates will need to be diligent in adhering to the payment schedules for all of their debts and liabilities, bearing in mind that any type of creditor, including a vendor or employee, could potentially trigger the insolvency resolution process.

What happens once the resolution process begins?

Once an application for insolvency resolution has been filed and accepted by the NCLT, two things happen:

(1) Moratorium:

A 180-day moratorium comes into place during which time all pending actions against the debtor are stayed and no new actions may be initiated. During the moratorium period, the debtor will also be prevented from disposing of its assets out of the ordinary course. The idea behind this moratorium is to provide a calm period for the debtor and creditors to discuss their future course of action, without having to deal with individual enforcement actions by creditors, which could lead to asset stripping and chaos.

The impact of such a provision on creditor rights is still to be examined and ascertained. An important point to note is that Section 14(1)(c) of the IBC makes it clear that during the IRP, the IBC takes precedence over debt recovery laws and security enforcement actions under SARFAESI. In other words, no new SARFAESI actions may be commenced and any existing ones would have to be suspended during the moratorium period.

(2) Insolvency Professional to Manage Debtor's Business:

The debtor ceases to have control of the business, which shifts to the committee of creditors. An insolvency resolution professional is appointed to manage the business of the debtor on behalf of the committee of creditors with a view to preserving its assets to the maximum extent possible and to coordinate the actions of the committee of creditors. The resolution professional will also need to prepare an information memorandum on the debtor's business and financial condition to assist creditors in drawing up a resolution plan.

This concept of an insolvency resolution professional running the business on behalf of the creditors is similar to the administrator-led regime in the U.K. and is in contrast to the U.S. Chapter 11 process where the debtor retains possession of the business under the supervision of the U.S. Bankruptcy Court. The history of abuse under SICA, where debtors and promoters tended to take shelter under SICA to siphon off their assets from creditors, has likely led to a more creditor friendly approach being adopted in the IBC. Having an insolvency professional run the business on behalf of the creditors, it is assumed, will ensure that

the debtor does not misappropriate funds or further mismanage the business to the detriment of creditors.

However, the success of this approach will rest on the effectiveness and experience of insolvency professionals in performing these functions. Insolvency resolution professionals do not currently exist in India and the IBC itself does not specify many points regarding their functioning, including their required skills and qualifications and how they will be regulated. Further, even if the regulations on insolvency resolution professionals are adopted in the near future, much will depend on developing a strong cadre of high quality insolvency professionals, which will take several years to develop.

How does the IRP come to an end?

Subject to a one time 90-day extension in exceptional cases, the IRP must end in 180 days. By the end of the 180-day period, the committee of creditors needs to have approved the resolution plan for the debtor, failing which the company goes into liquidation. Approval of the resolution plan requires the vote of 75% in value of the financial creditors (both secured and unsecured).

One of the key features of the IBC is the time-bound process that it offers for insolvency resolution, in contrast to the significant delays that occurred under SICA and the winding up process under the Companies Act, 1956. Delays are particularly important to guard against in insolvency resolution as the value of an insolvent debtor's estate depletes rapidly with time. However, it remains to be seen whether the strict timelines stipulated in the IBC will be followed by all parties concerned, including the NCLT.

Another feature to note is the IBC's attempt to limit the discretion and role of the NCLT in the insolvency resolution process. The contents of the resolution plan are left entirely up to the business decision of the committee of creditors, with the NCLT's role being limited to ensuring that the process for approval was followed and that the resolution plan does not violate the provisions of the IBC or other laws. Again, it remains to be seen whether the NCLT will, in practice, adhere to its limited mandate.

The time bound nature of the IRP should come as good news to creditors, including funds and other investors, looking to buy distressed assets. Purchasing such assets through an IRP is beneficial as buyers would then be able to purchase them free and clear of any liabilities. While in the past, potential buyers may have been reluctant to get embroiled in a long drawn out insolvency proceeding, the IBC's promise of a speedy resolution might make this route more attractive to them.

B. Liquidation

If 75% in value of the financial creditors do not approve the resolution plan or if they vote affirmatively to put the debtor into liquidation, the NCLT is required pass a liquidation order. The insolvency professional who managed the IRP or a new insolvency professional would then be appointed as liquidator to manage the winding up process and the distribution of assets to creditors. The liquidator has also been given powers to investigate into any fraudulent transactions of the debtor in the lead up to the insolvency filing and apply to have such transactions unwound. These provisions of the IBC are very similar to parallel provisions in the UK Insolvency Act and include provisions regarding preference transactions, extortionate credit transactions and undervalued transactions.

What are the rights of secured creditors in liquidation?

Unlike during the IRP, upon a liquidation order being passed, the moratorium is lifted and secured creditors may enforce their security interests under SARFAESI or other applicable laws. The IBC gives the secured creditor two options in a liquidation scenario:

- (a) The secured creditor can choose to relinquish its security interest and be part of the liquidation process, in which case its dues will rank high in the priority of distribution discussed below; or
- (b) The secured creditor can choose to stay outside the liquidation process and enforce its security interest, in which case, the secured creditor will lose its priority in the distribution of assets with respect to any portion of its debt that it could not recover on enforcement. (See priority rules below).

How will assets be distributed among different classes of creditors?

The priority of distribution among different classes of creditors is as follows:⁵

- (i) insolvency resolution costs, (ii) workmen's dues for 24 months and payments due to secured creditors who choose to relinquish their security interest; (iii) payments to employees in the preceding 12 months, (iv) dues to unsecured financial creditors, (v) government dues and payments to secured creditors for any unpaid amounts following enforcement of their security interest, (vi) all remaining debts and dues (including debts due to operational creditors) and (vii) any remaining amounts to equity holders.

This represents significant changes from the priority of distribution in the Companies Act, 2013, a few of which are worth highlighting. First, the costs of insolvency resolution (including the fees of insolvency professionals) are to be paid ahead of all other dues, perhaps as an incentive to attract individuals to

⁵Insolvency and Bankruptcy Code, 2016, Section 53.

the new profession. Another significant change is that government dues, such as taxes, have moved lower down in the priority chain, below the claims of unsecured financial creditors. This is contrast to the existing regime where government dues rank below the claims of secured creditors and workmen dues, but ahead of those of unsecured creditors. It is interesting to note that a similar change was made in the U.K. through the Enterprise Act 2002, which abolished crown preference in insolvency.

Finally, in a departure from legislation in other parts of the world, including the U.S. and the U.K. where all unsecured creditors are treated as a single class, the IBC treats unsecured financial creditors differently from operational or trade creditors. This last peculiarity represents an attempt to improve the position of unsecured financial creditors (such as bond holders) vis-à-vis secured financial creditors which have, up until now, been the main focus of law reform efforts in India. However, this does place operational creditors at a significant disadvantage as they also do not have any voting rights on the committee of creditors.

III. Challenges and Gaps in the IBC

The biggest challenge in getting the IBC off the ground would be to develop robust institutional framework and a strong cadre of insolvency professionals required to implement the new law. However, there are also some areas that the law fails to address:

- (a) Cross-Border Insolvency: The IBC does not adequately address the issues that would arise when a debtor has assets or creditors in jurisdictions outside India. The IBC does not discriminate between domestic and foreign creditors, and creditors who may be resident outside of India are permitted to commence and participate in proceedings under the IBC. However, the IBC does not provide any mechanisms by which an insolvency resolution professional or liquidator may access a debtor's assets located abroad other than to state that the Central Government may enter into bilateral agreements with other countries to deal with cross border insolvency issues. The new law also fails to address what happens if insolvency proceedings against a debtor are commenced concurrently in more than one jurisdiction. Ways of dealing with these challenges are provided in the UNCITRAL Model Law on Cross-Border Insolvency, which a number of countries have adopted into their domestic legislation. The next step would be a review of the UNCITRAL Model Law on Cross-Border Insolvency to determine what modifications would be necessary to make it suitable in the Indian context.

- (b) Inter-play with Debt Recovery Laws and the Corporate Debt Restructuring Process (“CDR”): The interplay of the IBC with debt recovery laws such as SARFAESI and the RDDBFI Act have not been fully addressed. There is an inherent tension between a statute that provides for collective insolvency resolution such as the IBC and debt recovery laws that enable individual creditors to enforce their security interests or recover their debt. However, for an insolvency regime to function effectively, there needs to be a clear delineation between these two types of laws. Amendments to the SARFAESI and RDDBFI Acts⁶ are currently being considered by the same Joint Parliamentary Committee that considered the IBC and it is hoped that these amendments would make the relationship between the IBC and debt recovery laws more seamless. Another issue on which the IBC is silent is the relationship of the IBC to out-of-court restructuring mechanisms such as CDR. For example, does an ongoing CDR process get suspended if an application for IRP is filed? While the IBC aims to be a comprehensive law dealing with all aspects of insolvency resolution and liquidation, the continued existence of other laws and processes means that their interaction with the IBC will need to be ironed out.

IV. Conclusion

In conclusion, the Insolvency and Bankruptcy Code, 2016, is a progressive legislation that is intended to improve the efficiency of insolvency and bankruptcy proceedings in India. The new legislation provides for the early detection of financial distress and a time bound process for resolution. However, many details on the IBC’s implementation need to be worked out in the regulations, and its success will depend to a large extent on how quickly a high quality cadre of insolvency resolution professionals will emerge and on whether the time bound process for insolvency resolution will be adhered to in practice.

This is an update for general information purposes only and does not constitute legal advice. Should you have any queries please write to us at infosamvad@samvadpartners.com.

BENGALURU CHENNAI HYDERABAI MUMBAI NEW DELHI

www.samvadpartners.com

⁶ The Enforcement of Security Interests and Recovery of Debts Laws and Miscellaneous Provisions (Amendment) Bill, 2016.