



भारतीय दिवाला और शोधन अक्षमता बोर्ड  
Insolvency and Bankruptcy Board of India

# INSOLVENCY AND BANKRUPTCY CODE A MISCELLANY OF PERSPECTIVES





## *About the Publication*

**I**n the words of philosopher Sir Francis Bacon, '*Scientia potentia est*'– knowledge is power. This publication, being released on the occasion of the Third Annual Day of the Insolvency and Bankruptcy Board of India, puts together a miscellany of perspectives on the journey of the landmark Insolvency and Bankruptcy Code, 2016 from the viewpoint of practitioners, policymakers, lawyers, subject experts, and academicians. The articles in the publication unearth the hits, the misses, the challenges, the promises, the hopes and the silver linings of the path-breaking reform in the form of the Code. Hailed as a progressive and dynamic economic legislation, the Code is the true embodiment of time bound justice-oriented reforms, providing the much needed 'freedom to exit' to failing businesses. It is a paradigm shift from the erstwhile insolvency regime in terms of its design and architecture, professionalisation of insolvency services and delicately balancing the interest of all stakeholders.

Putting together a selection of articles that elucidate and stimulate thought around this theme, the publication is an attempt to contribute to the scholarly and policy discourse. It is a systematic response to accelerate the pace of research and scholarship in the evolving area of insolvency and bankruptcy laws.



**INSOLVENCY AND BANKRUPTCY CODE  
A MISCELLANY OF  
PERSPECTIVES**

**2019**

[www.ibbi.gov.in](http://www.ibbi.gov.in)

Insolvency and Bankruptcy Board of India

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*'None of us got to where we are alone. Whether the assistance we received was obvious or subtle, acknowledging someone's help is a big part of understanding the importance of saying thank you.'*

Harvey Mackay

**T**he Insolvency and Bankruptcy Code, 2016 is a deep structural reform with far-reaching implications for the Indian economy. It has been crafted with extreme care, after extensive consultation with stakeholders, to ensure that it delivers on its stated objectives on a sustained basis, *sans* any unintended consequences.

The Code has been developed in the context of life. It is continuously evolving to address the deficiencies arising from its implementation, in sync with emerging market realities. This obviously requires a healthy debate, discussion and dialogue among all concerned to chart out the best course for the Code and allow it to make swift course corrections, on learning from experience. Recognising this, the Insolvency and Bankruptcy Board of India (IBBI) has been engaging directly, and in association with various stakeholders, in generation of ideas and knowledge having a bearing on the insolvency and bankruptcy landscape of the country.

This publication is an endeavour to capture the contemporary discourse which is shaping the course of insolvency reforms and perhaps serve as a harbinger of future reforms.

Putting together the publication would not have been possible without its contributors, who have been very closely associated with implementation of the Code in some capacity or the other. They promptly responded to IBBI's call for their contributions and spared their invaluable time from their respective busy schedules to enrich this publication. We are deeply indebted to them.

Usually, regulators do not come up with publication such as this in early years of their existence. It could not have been possible but for commitment and enthusiasm of a small team at IBBI comprising Dr. Mukulita Vijayawargiya, Dr. Anuradha Guru, Ms. Medha Shekar, Ms. Surbhi Kapur and Ms. Pihu Mishra. We owe much gratitude to Ms. Harini Srinivasan, Founder and Director, Lekhana Communications Consulting Pvt. Ltd., for her guidance and help in the editing of this publication. We thank the printers, Degree 360 Solutions Pvt. Ltd., for bringing this publication out in just two weeks.

**Dr. M. S. Sahoo**

Chairperson

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## *Preface*

India moved from state provision of goods and services to regulation for provision of goods and services. This allowed freedom to firms to undertake business on their own terms subject to meeting with the regulatory norms. This carried two potential concerns. First, the regulatory norms, either because of inadvertence or in public interest, at times restricted freedom of firms to do business or not to do business. Second, the freedom promoted intense competition at marketplace leading to stress in some firms requiring a market mechanism to facilitate their revival or seamless closure. Legislations such as Sick Industrial Companies (Special Provisions) Act, 1985 did not prove effective in resolution of stress, either through revival or closure, primarily because it was not a market mechanism where the stakeholders had incentive to resolve stress in a time bound manner. This necessitated a major institutional reform of the insolvency regime, which came through the Insolvency and Bankruptcy Code, 2016 (Code).

The Code is a landmark piece of legislation which provides for institutionalised creditor-in-control mechanism for reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit, while balancing the interests of all the stakeholders. Many milestones, in achieving these goals, were crossed rather quickly, with various provisions of the Code being implemented at an unprecedented pace. The entire regulatory framework for corporate insolvency resolution process, fast track insolvency resolution process, corporate liquidation and voluntary liquidation were put in place within a short span of time. The regulations pertaining to insolvency professionals, insolvency professional agencies and information utilities were rolled out swiftly to build a strong professional and technology-driven bedrock of service providers under the Code.

The success of the Code hinges upon its dynamism and responsiveness to the emerging requirements of the market and various stakeholders. The Code has been amended thrice to facilitate the stakeholders. Several contentious issues have been settled by the courts of law through landmark judgments. In its journey, the Code has taken along with it a whole milieu of stakeholders. Policy makers, legal experts, subject experts, academicians and practitioners, have fiercely debated at each step of this journey on its hits and misses, on its challenges, its hopes and its despair. The World Bank's Doing Business Report has also taken cognisance of the path-breaking reform, in the form of the Code, and has improved India's ranking in the 'Resolving Insolvency' parameter from 136 in 2016 to 108 in 2018.

This publication is a conscious effort on our part to bring together the views of a number of distinguished contributors with diverse persuasions. The contributions have been sought to be arranged into different parts thematically for the purpose of practical convenience. Part I of this publication deals with the architecture of the Code. The discourse in this Part becomes paramount since insolvency legislation in India has become a vitally important mechanism for

sustainable resolution of distressed corporates and fostering corporate governance. The articles in this part veer around the institution of a robust insolvency regime in India and its evolving nexus with corporate frontiers, including both procedural and substantive themes.

The Code has been a paradigm shift from the past insolvency and bankruptcy regime in India. It cannot be gainsaid that a strong insolvency regime underpins stability and certainty of insolvency processes, practitioners, debtors and creditors. In this vein, Part II examines various aspects of the processes under the Code, assesses how they are functioning on the ground and suggests what changes may be required towards achievement of the objectives of the Code.

Having set the discussion, Part III focuses on the insolvency ecosystem in terms of its regulatory apparatus and the professionals involved in the implementation of the Code. These are the pillars of the new law, holding it in good stead and ensuring the delivery of its key objectives. There is an intense element of 'public interest' in the outcome of the processes under the Code. In this regard, Part IV scrutinizes the impact of insolvency law on the economy in general and on corporate governance structures and processes.

We have added many feathers to our cap in the area of a new and modern insolvency and bankruptcy regime in the country. However, a lot more remains to be achieved. It is perhaps now time to talk about new domains, while further consolidating the progress made so far. Part V explores the emergent themes in the insolvency regime.

We are grateful to each one of the eminent contributors for making our venture a success. I would, however, like to emphasise that views expressed in the articles are those of individual authors. We are confident that this publication will provide much food for thought to the readers to mull over and draw lessons for the road ahead.

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# Part I

## The Architecture



# 1

## *A Journey of Endless Hope*

M. S. Sahoo

A dialogue between two characters in a novel<sup>1</sup> goes like this: 'How did you go bankrupt?' Bill asked. 'Two ways,' Mike said, 'Gradually and then suddenly.' Most bankruptcies happen that way. The insolvency reforms in India also happened in the same way. While in the works for many years, the insolvency reforms suddenly took shape with the enactment of the Insolvency and Bankruptcy Code, 2016 (Code) on May 28, 2016. In no time, it became a reform by the stakeholders, of the stakeholders and for the stakeholders.

Prior to the enactment of the Code, India did not have any experience of a proactive, incentive-compliant, market-led, and time-bound insolvency law. Many institutions required for implementation of a state-of-the-art insolvency law, did not exist. The Code and the underlying reform, in many ways, was a journey into an uncharted territory- a leap into the unknown and a leap of faith. The entire regulatory framework in respect of corporate insolvency, both resolution and liquidation, and the entire ecosystem for corporate insolvency were put in place by the end of 2016, and provisions relating to corporate insolvency process came into force on December 1, 2016. The first corporate insolvency resolution process (CIRP) commenced on January 17, 2019. There is, perhaps, no parallel anywhere in the world to the swift enactment and implementation of the Code.

The Government led the reform from the front and demonstrated the highest commitment to the insolvency reform. It subordinated its dues to claims of all stakeholders except equity. It made the resolution plan binding on itself. It pushed very large corporates with high non-performing assets (NPAs) into the resolution process in the early days. It made changes in banking law, revenue law, company law, etc. to facilitate the processes under the Code. The regulators did their bits too: the Securities and Exchange Board of India (SEBI) exempted resolution plans from making public offers under the Takeover Code; the Reserve Bank of India (RBI) allowed external commercial borrowings for resolution applicants (RAs) to repay domestic term loans; and the Competition Commission of India devised a special route<sup>2</sup> for swift approvals for combinations envisaged under resolution plans. There have been quite a few regulatory interventions from the Insolvency and Bankruptcy Board of India (IBBI) in the last three years. These years witnessed an unprecedented co-operation and partnership among authorities and stakeholders, to implement the Code in letter and spirit to fully realise its objectives.

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<sup>1</sup> Ernest Hemingway (1926), *The Sun Also Rises*. Scribner

<sup>2</sup> Additionally, regulation 5A of the Competition Commission of India (Procedure in regard to the transaction of business relating to combinations) Regulations, 2011, which came into force on August 15, 2019, enables parties to avail of a "green channel" for approval of certain categories of combinations.

A dynamic law is one which is crafted in the context of life. Given that life is ever evolving, the Code underwent prompt course corrections, to address deficiencies arising from implementation of the Code, in sync with the emerging market realities, to further its objectives. It has witnessed three major legislative interventions<sup>3</sup> in as many years and dozens of subordinate legislations. The Adjudicating Authority (AA), the National Company Law Appellate Tribunal (NCLAT) and the Supreme Court (SC) have been in the forefront of the implementation of the Code. They have delivered numerous landmark orders to explain several conceptual issues and settle contentious issues and resolve grey areas with alacrity. These orders have imparted clarity to the roles of various stakeholders in the resolution process and as to what is permissible and what is not, thereby streamlining the process for future. The insolvency regime now boasts of, probably, the single largest body of case laws. The Insolvency Law Committee continuously reviews the implementation of the Code to identify issues impacting the processes under the Code and make recommendations to address them, in true spirit of the adage 'the road to success always remains under construction'.

The insolvency journey has weathered several storms on the way. Besides the usual challenges of building institutional capacity and developing the markets and practices to implement the reform, there was scepticism if the Code can be implemented at all and if it would meet the same fate as many such reforms had in the past. There was also reluctance to accept the reform and, at times, vigorous efforts, to cling<sup>4</sup> on to the old order. The resistance came in different forms from different quarters and continues even today. Some naysayers wanted implementation of the Code only after India had a world class ecosystem, including insolvency professionals (IPs) who can conduct the most complicated insolvency resolution processes. They essentially expected Olympic swimmers on the scene, without ever diving into a swimming pool! A few big fish preferred to watch from the sidelines till commoners tried their hands and emerged successful. Some condemned the reform as the first resolution plan<sup>5</sup> approved under the Code returned about 6 per cent of the claims of the creditors, disregarding the fact that the creditors got about 600 per cent of the liquidation value from the revival of the firm which had been sick for decades. Some promoters waited for the outcomes of the Code to pan out. As they saw many firms moving away from the hands of extant promoters through the process under the Code, they intensified their efforts to challenge the provisions of the Code.

Almost every provision in the Code in respect of corporate insolvency has been challenged on grounds of constitutional validity. The experiment contained in the Code, judged by the generality of its provisions and not by so-called crudities and inequities, passed the constitutional muster.<sup>6</sup> The Code prevails over every other law in case of any inconsistency between the two.<sup>7</sup> Section 29A, which was introduced by the Insolvency and Bankruptcy Code (Amendment) Act, 2018 to prohibit persons with certain disabilities to submit resolution plans,

<sup>3</sup> The Insolvency and Bankruptcy Code (Amendment) Act, 2018; the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018; and the Insolvency and Bankruptcy Code (Amendment) Act, 2019.

<sup>4</sup> One fails to notice changes in the environment and strives hard to cling on to the old order, best illustrated in Spenser Johnson, Who Moved My Cheese (1998).

<sup>5</sup> Resolution plan of Synergy Dooray Automotive Limited approved by AA on August 2, 2017.

<sup>6</sup> *Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.*, (2019) 4 SCC 17 (hereinafter 'Swiss Ribbons').

<sup>7</sup> *M/s. Innoventive Industries Ltd. v. ICICI Bank & Anr.*, (2018) 1 SCC 407 (hereinafter 'Innoventive Industries Ltd. '); *Pioneer Urban Land and Infrastructure Limited and Anr. v. Union of India & Ors.*, [Writ Petition (Civil) No. 43 of 2019].

was upheld.<sup>8</sup> Section 5(8), which was introduced by the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018 to treat home buyers as financial creditors (FCs), was upheld.<sup>9</sup> While upholding various provisions in the Code, the SC has accorded certain degree of deference to the legislative judgment in economic choices, apart from the presumption of constitutionality in economic legislations<sup>10</sup>. Section 30(2)(b), which was introduced by the Insolvency and Bankruptcy Code (Amendment) Act, 2019 to provide a waterfall for resolution plans, is under challenge. With every judgement delivered by the courts of law, the insolvency reforms have developed deeper and stronger roots.

The speed and challenges of implementation of the Code did not come on the way of innovation. One such innovation is the information utility (IU). India has the unique distinction of having an IU to cater to the informational needs of stakeholders under the insolvency and bankruptcy regime. Another innovation is the launch of a two-year Graduate Insolvency Programme, the first of its kind in the world, aimed at producing a cadre of top-quality IPs who can deliver world-class insolvency resolution services. The IBBI itself is also an innovation: there is no exact parallel organisation either inside or outside the country. It develops and regulates the insolvency profession and lays down the rules of the game for professionals and the market.

Matured over the last three years, the ecosystem now comprises 27 benches of NCLT, 2800 IPs, 3 insolvency professional agencies, 54 insolvency professional entities, one information utility, 2300 registered valuers and 11 registered valuer organisations. The professionals and market participants are learning on the job and are evolving best market practices. Debtors and creditors alike are undertaking corporate processes. About 2000 corporates, some of them having very large non-performing assets, have been admitted into corporate process. About 600 of them have completed the process either yielding resolution plans or ending up with liquidation. Details are presented in the Table below. Another 500 firms have commenced voluntary liquidation.

The resolution plans have yielded about 188 per cent of liquidation value for FCs.<sup>11</sup> They are realising on an average 43 per cent of their claims through resolutions plans under a process which takes on average 340 days and entails a cost on average of 0.5 per cent, a far cry from the previous regime which yielded a recovery of 25 per cent for creditors through a process which took about 5+ years and entailed a cost of 9 per cent. It is important to note that this realisation, not being an objective of the Code, is only a bi-product of revival of failing firms. Beyond revival of firms, the Code has ushered in significant behavioural changes resulting in substantial recoveries for creditors outside the Code and improving performance of firms. Therefore, it is important to consider what happens in the processes under the Code and what happens on account of the Code.

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<sup>8</sup> *Chitra Sharma and Ors. v. Union of India and Ors.*, [WP (C) Nos. 744, 782, 783, 803, 860 & 950-2017; 511-2018 & SLP (C) Nos. 24001, 24002, 36396 & 33267-2017]; *Arcelor Mittal India Private Limited v. Satish Kumar Gupta and Ors.*, (2019) 2 SCC 1 (hereinafter "Arcelor Mittal"); *Swiss Ribbons*

<sup>9</sup> *Pioneer Urban Land and Infrastructure Limited and Anr. v. Union of India & Ors.*, [Writ Petition (Civil) No. 43 of 2019].

<sup>10</sup> *Ibid.*

<sup>11</sup> Quarterly Newsletter of the IBBI-, April-June, 2019, Vol. 11.

**Table : Corporate Insolvency Resolution Processes****(Number)**

Quarter	CIRPs at the beginning of the Quarter	Admitted	Closure by				CIRPs at the end of the Quarter
			Appeal/ Review/ Settled	Withdrawal under Section 12A	Approval of Resolution Plan*	Commencement of Liquidation	
Jan- Mar, 2017	0	37	1	0	0	0	36
Apr-Jun, 2017	36	129	8	0	0	0	157
July-Sept, 2017	157	233	18	0	2	8	362
Oct-Dec, 2017	362	147	38	0	7	24	440
Jan-Mar, 2018	440	195	20	0	11	59	545
Apr-Jun, 2018	545	247	20	1	14	52	705
Jul-Sept, 2018	705	241	29	27	31	86	773
Oct-Dec, 2018	773	275	8	36	16	78	910
Jan-Mar, 2019	910	372	20	19	17	81	1145
Apr-Jun, 2019	1145	286	12	18	22	87	1292
<b>Total</b>	<b>NA</b>	<b>2162</b>	<b>174</b>	<b>101</b>	<b>120</b>	<b>475</b>	<b>1292</b>

\* These exclude 3 resolutions which have since yielded into liquidation

#### FREEDOM TO EXIT

Mainstream economic thought believes that at any point of time, human wants are unlimited while the resources to satisfy them are limited. The central economic problem, therefore, is inadequacy of resources vis-à-vis ever-increasing, unlimited wants. Mainstream legal thought believes that as a person moves from natural state to economic state, it loses some degree of freedom. The central legal problem, therefore, is inadequacy of freedom to pursue economic interests meaningfully. Thus, there are twin inadequacies of resources and freedom: resources are limited, so also is freedom. There are twin adequacies too: resources have alternative uses, and firms pursue self-interests. An economy thrives when the self-interested firms have maximum possible freedom to shift resources to more efficient uses continuously and seamlessly.

Freedom unleashes and realises the full potential of every firm and every resource in the economy. It is well established that economic freedom and economic performance have a very high positive correlation. Countries having a high level of economic freedom generally outperform the countries with not-so-high level of economic freedom. It has, therefore, been the endeavour of countries all over the world to provide the right institutional milieu that (a) provides, promotes and protects economic freedom, and (b) regulates such freedom only to the extent it is necessary for addressing market failure(s). In other words, the endeavour is to have better business regulations that make it easier for firms to do business in the economy.

A firm needs freedom broadly at three stages of a business - to start a business (free entry), to continue the business (free competition) and to discontinue the business (free exit). This enables new firms to emerge continuously; and they do business while they are efficient and vacate the space when they are no longer efficient. The first stage ensures

allocation of resources to the most efficient use, the second stage ensures efficient use of resources allocated, and the third stage ensures release of resources from inefficient uses. This ensures the most efficient use of resources and consequently optimum economic well-being. The economic reform typically endeavours to provide economic freedom at these three stages.

The reforms in India in the 1990s focused on freedom of entry. It ushered in liberalisation, privatisation and globalisation. It dismantled the *license-permit-quota Raj*,<sup>12</sup> when discretionary license gave way to an entitlement of registration. It allowed firms meeting the eligibility requirements to raise resources, without requiring any specific approval from the State, to facilitate freedom of entry.

The reforms in the 2000s focused on creating a free and fair market competition. It moved away from control of monopoly of firms to promote competition among firms at marketplace. Size or dominance, *per se*, was no longer considered bad, its abuse was. The reforms provided a level playing field and competitive neutrality and prohibited firms from restricting the freedom of other firms to do business.

The index of economic freedom, which measures the degree to which the policies and institutions of an economy are supportive of economic freedom, has substantially improved for India since the 1990s. The outcome has been astounding. The average growth rate in the post reforms period since 1992 has been more than double of that in the pre-reforms period. Today, India is the fastest-growing, trillion-dollar economy and the sixth largest in the world.

The Indian economy moved from socialism with limited entry to '*marketism*' without exit, leading to substantial cost of impended exit<sup>13</sup> After having commenced business, a firm in a market economy fails to deliver, as planned, mostly on account of competition and innovation: (a) The firm belongs to an industry where business is no more viable for exogenous reasons such as innovation. Most such firms have economic distress and are generally unviable. The only option available is to release the resources of the firm for other competing uses and the entrepreneur to pursue emerging opportunities. A few of these firms may, however, have resources to change the business and become viable.

(b) The firm belongs to an industry where other firms in the industry are doing well, but the firm in question is not doing well for endogenous reasons such as inability to compete at marketplace. Most such firms have only financial distress, not being able to meet financing costs and are generally viable. It is necessary to rescue the firm well in time from the clutches of current management and put it in the hands of a credible and capable management to avoid liquidation. A few of these firms may have significantly depleted resources and become unviable.

The World Economic Forum identifies three broad sources of growth, namely, (a) factor endowments and institutions, (b) competition, and (c) innovation, while classifying economies into five classes according to their stages of development<sup>14</sup> Where the reliance on competition and innovation is relatively less, say less than 40 per cent, the economy is in the first stage of development, typically yielding a per capita GNP of less than USD 2000 and where the reliance on competition and innovation is significant, say more than 80 per cent, the economy is in the fifth stage of development, typically yielding a per capita GNP of at least USD 17000. The level of

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<sup>12</sup> A term coined by C. Rajagopalachari for bureaucratic system of granting licences and permits for new commercial ventures.

<sup>13</sup> Economic Survey, Ministry of Finance, Government of India, 2015-16.

<sup>14</sup> The Global Competitiveness Report, World Economic Forum, 2017-18.

competition and innovation explains much of the distance in per capita GNP from USD2000 to USD 17000. Competition helps efficient firms to drive out inefficient firms; innovation helps new order to drive out old order. Thus, competition and innovation both carry the germs of firm failure. The higher the intensity of competition and innovation, the higher is the incidence of firm failure. Since competition and innovation are two main sources of growth in a market economy, it is necessary to have a mechanism to smartly deal with the failures.

In case of failures arising from either competition or innovation, the resources at the disposal of the firm are underutilised and the management / entrepreneur has failed. Where a firm remains in such a state for long, its balance sheet gets stretched. Such failure by many firms, particularly large ones, impacts the balance sheets of creditors, particularly banks. This reduces the availability of funds with the creditors, limiting their ability to lend for even genuinely viable projects, thus restricting credit growth. The impact is pronounced where some firms deliberately fail to repay loans. Thus, what emerged in the middle of this decade, popularly referred to as the *Twin Balance Sheet* problem<sup>15</sup>, where both the banks and firms were reeling under the stress of bad loans, thereby, hindering overall economic growth.

Given that the resources are scarce, and failures are routine in a dynamic market economy, India needed a codified and structured market mechanism to put the underutilised resources to more efficient uses continuously and free entrepreneurs from failure. The Code provides such a market mechanism for (a) rescuing a failing, but viable firm; and (b) liquidating an unviable one and releasing its resources, including entrepreneur(s), for competing uses, and thereby provides the freedom to exit, the ultimate freedom.

#### THE INSOLVENCY AND BANKRUPTCY CODE, 2016

The objective of the Code is time-bound reorganisation and insolvency resolution of firms for maximisation of value of assets of the firm concerned, to promote entrepreneurship and availability of credit and balance the interests of all its stakeholders. The first order objective is resolution. The second order objective is maximisation of value of assets of the firm and the third order objective is promoting entrepreneurship, availability of credit and balancing the interests. This order of objectives is sacrosanct<sup>16</sup>. The Code bifurcates and separates the interests of the firm from that of its promoters / management with a primary focus to ensure revival and continuation of the firm by protecting it from its own management and from a death by liquidation.<sup>17</sup> It is the mandate of the nation<sup>18</sup>. It is a paradigm shift in the law<sup>19</sup>.

The CIRP under the Code endeavours to achieve its stated objectives. A threshold amount of default entitles a stakeholder to trigger CIRP of the firm and if triggered, the firm moves away from 'debtor-in-possession' to 'creditor-in-control'; management of firm and its assets vest in an IP, who runs the firm as a going concern, and a committee of creditors (CoC) is constituted to evaluate options for the firm. The IP invites feasible and viable resolution plans from eligible and credible resolution applicants for resolution of insolvency of the firm. If the CoC approves a resolution plan within the stipulated time with 66 per cent majority, the firm

<sup>15</sup> *Supra* note 13

<sup>16</sup> *Binani Industries Limited v. Bank of Baroda & Anr.*, [CA (AT) No. 82,123,188,216 & 234-2018] (hereinafter "Binani Industries").

<sup>17</sup> *Swiss Ribbons*, *supra* note 6.

<sup>18</sup> *DF Deutsche Forfait AG and Anr v. Uttam GalvaSteel Ltd.*, [C. P. No. 45/1&BP/NCLT/MAH/2017]

<sup>19</sup> *Innoventive Industries Ltd. supra* note 7.

continues as a going concern. If the CoC does not approve a resolution plan with the required majority within this period, the firm mandatorily undergoes liquidation. The Code tries, by divesting the erstwhile management of its powers and vesting it in a professional, to continue the business of the firm as a going concern until a resolution plan is drawn up. Then the management is handed over under the plan so that the firm can pay back its debts and get back on its feet. All this is done within a period of six months with a one-time extension of up to 90 days or else the chopper comes down and the liquidation process begins<sup>20</sup>

### **Strategy of the Code**

The strategy under the Code includes the following elements:

**A. The Code has strong focus on prevention.** It requires that only credible and capable persons can submit resolution plans. This means that persons having any of the specified ineligibilities cannot submit resolution plans. India has a unique concept of promoter who also controls management. Some of them may have specified in eligibilities and hence may not be eligible to submit resolution plans. Even if one is eligible, it may not submit the most competitive plan or the CoC may opt for liquidation. In such cases, the existing promoter and management may lose the firm for ever. With the Code in place, ownership of firms is not a divine right.

The credible threat of a resolution process that may shift the control and management of the firm away from existing promoters and managers, most probably, for ever, deters the management and promoters of the firm from operating below the optimum level of efficiency and motivates them to make the best efforts to avoid default. Further, it encourages the debtor to settle default with the creditor(s) at the earliest, preferably outside the Code. There have been thousands of instances where debtors have settled their debts voluntarily or settled immediately on filing of an application for CIRP with the AA before the application is admitted. There are also settlements after an application is admitted<sup>21</sup> The Code has thus brought in significant behavioural changes and thereby redefined the debtor-creditor relationship. With the Code in place, the defaulter's paradise is lost<sup>22</sup> Repayment of loan is no more an option; it is an obligation.

On the other hand, the creditor knows the consequences of default by a debtor, if insolvency proceeding is not initiated or the insolvency is not resolved. It is motivated to resort to more responsible (meritocratic) lending to reduce incidence of default. Further, although a creditor has the right to initiate a proceeding under the Code as soon as there is a default of the threshold amount, it is not obliged to do so at the first available opportunity, if it has reasons for the same. It cannot, however, defer the initiation of proceeding indefinitely, allowing ballooning of default. It needs to explain to itself and its stakeholders why it initiated an insolvency proceeding or why it did not, in case of a default, and suffer consequences of its actions of omission or commission. Consequently, there would never be a high value default if this law exists on the statute book. This is another dimension of prevention. The scheme of

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<sup>20</sup> *Ibid.*

<sup>21</sup> *Lokhandwala Kataria Construction Private Limited v. Nisus Finance and Investment Managers LLP*, (Civil Appeal No. 9279/2017)

<sup>22</sup> *Swiss Ribbons*, *supra* note 6.

incentives and disincentives under the Code has brought in behavioural changes which would minimise the incidence of default in the days to come and most defaults would be resolved outside the Code. Going forward, the use of the Code would be minimal.

**B. The Code envisages a market mechanism** to rescue a failing, viable firm as it may not always be possible to prevent genuine failures in the face of competition and innovation, despite the best efforts and the most desirable behavioural changes. If there is a resolution applicant who can continue to run the firm as a going concern, every effort must be made to try and see that this is made possible.<sup>23</sup> The Code is a beneficial legislation which puts the Corporate Debtor (CD) back on its feet, not being a mere recovery legislation for creditors.<sup>24</sup> It envisages resolution of insolvency and not a recovery proceeding to recover the dues of the creditors.<sup>25</sup> It does not envisage sale or liquidation of the firm for recovery of loan.<sup>26</sup> In fact, it attracts penalty if the process under the Code is abused for purposes other than the purposes of the Code.<sup>27</sup>

(i) The Code endeavours resolution of insolvency at the earliest, preferably at the very first default, to prevent it from ballooning to un-resolvable proportions. In early days of default, enterprise value is typically higher than the liquidation value and hence the stakeholders would be motivated to resolve insolvency of the firm rather than liquidate it. Therefore, it entitles the stakeholders to initiate CIRP as soon as there is threshold amount of default. It also requires the AA to commence a CIRP within 14 days of receipt of an application for the same.

(ii) The Code mandates resolution in a time-bound manner, as undue delay is likely to reduce the enterprise value of the firm. When the firm is not in sound financial health, prolonged uncertainty about its ownership and control may make the possibility of resolution remote. Time is the essence of the Code. It is mandatory to complete a CIRP within 180 days, extendable by a one-time extension of up to 90 days.<sup>28</sup> The regulations provide a model time line for each task in the process, which needs to be followed as close as possible.<sup>29</sup> The Code requires that a CIRP shall mandatorily be completed within 330 days, including any extension of time as well as any exclusion of time on account of legal proceedings.

(iii) The Code envisages resolution of the firm as a going concern, as closure of the firm destroys organisational capital and renders resources idle till reallocation to alternate uses and makes the possibility of resolution remote. It, therefore, facilitates continued operation of the firm as a going concern during CIRP. It makes available a cadre of competent and empowered IPs to manage the affairs of the firm under resolution as a going concern, to protect and preserve the value of its property, help in retrieval of value lost through fraudulent and preferential transactions and assist the CoC to arrive at the best resolution plan. It mandates the firm, its promoters and any other person associated with its management to extend all assistance and cooperation to the IP. It envisages information utilities to make available authentic information required for completing the process expeditiously. It enables raising interim finances and includes the cost of interim finance in insolvency resolution process cost,

<sup>23</sup> Arcelor Mittal, *supra* note 8.

<sup>24</sup> Swiss Ribbons, *supra* note 6.

<sup>25</sup> Prowess International Pvt. Ltd. v. Parker Hannifin India Pvt. Ltd., [CA (AT) No. 89-2017].

<sup>26</sup> Binani Industries, *supra* note 16.

<sup>27</sup> Unigreen Global Private Limited., [CP No. IB- 39 (PB)-2017].

<sup>28</sup> M/s. Surendra Trading Company v. M/s. Juggilal Kamalapat Jute Mills Company Limited & Ors., [CA No. 8400-2017].

<sup>29</sup> Arcelor Mittal, *supra* note 8.

which has super priority. It envisages moratorium on institution or continuation of suits or proceedings against the firm during the resolution period. It prohibits suspension or termination of supply of essential services to the firm to keep it going. It prohibits any action to foreclose, recover or enforce any security interest during CIRP and thereby prevents a creditor(s) from maximising its individual interest.

(iv) The Code envisages a collective mechanism for resolution of insolvency. It enables any FC to initiate CIRP even when the firm has defaulted to another FC. This prevents the debtor from granting preferential treatment to a more vocal creditor, while ignoring the less vocal ones. It does not envisage termination of the process even if claims of the creditor concerned are satisfied. Once admitted into CIRP, other creditors have a right to file their claims. Thereby, the nature of insolvency proceeding changes to a representative suit and it is no more a *lis* between a creditor and the firm.<sup>30</sup> Therefore, they alone do not have the right to withdraw the insolvency petition even if the dues of the creditor concerned have been settled. The law, however, allows withdrawal with the approval of the CoC by 90 per cent of voting power.

(v) The Code calls for a team effort to resolve insolvency. There are many players having defined, complementary roles for completion of the process. It is a team responsibility to complete the process in time, though one has the prime responsibility for a task in the process. The insolvency proceeding is not an adversarial proceeding. There is no pleading or defending party, and the terminologies like petitioner, respondent, plaintiff, and defendant are not present under the Code.<sup>31</sup>

(vi) The Code provides for the best sustainable resolution. It requires the IP to provide complete, correct and timely information about the firm to resolution applicants for design of resolution plans and to detect avoidance transactions. It envisages only credible and capable persons to propose competing, viable and feasible resolution plans and empowers the CoC to choose the best of them. It envisages limitless possibilities of resolution through a resolution plan, including restructuring by way of merger, amalgamation or demerger. A resolution plan may entail a change of management, technology, or product portfolio; acquisition or disposal of assets, businesses or undertakings; restructuring of organisation, business model, ownership, balance sheet; strategy of turn-around, buy-out, acquisition, takeover; and so on.

(vii) The Code segregates commercial aspects of insolvency resolution from judicial aspects and empowers the stakeholders of the firm and the AA to decide matters within their respective domain expeditiously. It puts the entire process at the disposal of the stakeholders and motivates them with incentives and disincentives to complete the process at the earliest. The consideration of resolution plans and approval of the best of them requires two abilities, namely, the ability to restructure the liabilities and the ability to take commercial decisions. In contrast with the operational creditors (OCs), the FCs generally have the resilience to wait for realisation of their dues post reorganisation and the ability to determine if a resolution plan will achieve the objectives of the Code. In view of their abilities, the CoC comprises FCs. The commercial decisions of the CoC are not generally open to any analysis, evaluation or judicial review by the AA or the appellate authority.<sup>32</sup> The commercial aspects include the manner of

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<sup>30</sup> *Parker Hannifin India Private Limited.*, [CP (IB) No. 150-KB-2017].

<sup>31</sup> *Supra* note 18.

<sup>32</sup> *K. Sashidhar v. Indian Overseas Bank & Ors.*, 2019(3) SCALE 6.

distribution of realisations under the resolution plan.<sup>33</sup>

(viii) The Code balances the interests of stakeholders in the resolution process. It assumes significance as the firm undergoing CIRP may not have enough at the commencement of CIRP to satisfy the claims of all stakeholders fully. It provides specific balances, such as minimum payment to OCs in priority over FCs and for dissenting FCs. It aims to balance the interests of all stakeholders and does not maximise value for FCs.<sup>34</sup> It incorporates the principle of fair and equitable dealing of OCs' rights.<sup>35</sup>

(ix) The Code requires the resolution plan to be in compliance with all applicable laws of the land and it must be implementable. The IP needs to certify this, and the AA needs to be satisfied. Otherwise, the plan may not be implementable, and the purpose of resolution is defeated. The Code provides severe penal consequences if an approved resolution plan is not implemented.<sup>36</sup>

(x) A resolution approved by the AA is binding on all stakeholders, including central government, state governments and any local authority to whom the CD owes debt under any law.

**C. The Code facilitates creative destruction.** For a market economy to function efficiently, the process of creative destruction should drive out failing, unviable firms continuously. It was not happening hitherto in the absence of an effective mechanism. Quite a few firms got stuck up in '*chakravyuha*'<sup>37</sup> of unsustainable business or with idle assets and no business. The Code provides a mechanism whereby a failing, unviable firm exits with the least disruption and cost and releases idle resources in an orderly manner for fresh allocation to efficient uses.

Although a default of a threshold amount enables initiation of resolution process, it does not imply that the firm has failed, or that it is unviable. There is no precise mathematical formula to identify a firm as an unviable one. The market may wrongly punish a viable firm, by mistaking it as unviable and vice versa, because of market imperfections. Accordingly, it may push a viable firm to closure and conversely, allow an unviable firm to survive. Rescuing an unviable firm may not be of great concern as it would be a matter of time before it is closed. Closing a viable firm, on the other hand, is of grave concern as it impacts the daily bread of its stakeholders and it cannot be revived later. Similarly, there is no mathematical formula to identify a resolution applicant as credible and capable and a resolution plan as viable and feasible. Based on this premise, the Code has adopted a very cautious approach and provides an opportunity to the market to rectify a mistake where it has made a wrong assessment or decision.

The Code provides for initiation of a process for resolution; it does not enable initiation of liquidation process directly. It promotes resolution over liquidation.<sup>38</sup> After CIRP is initiated, if the market discovers that the process should not have been initiated, the Code allows termination of process with the approval of the CoC by 90 per cent of voting power before constitution of CoC, after constitution of CoC but before invitation of Expression of Interest, or

<sup>33</sup> Section 30(2)(b), as amended by the Insolvency and Bankruptcy Code (Amendment) Act, 2019.

<sup>34</sup> Binani Industries, *supra* note 16.

<sup>35</sup> Swiss Ribbons, *supra* note 6.

<sup>36</sup> *Corporation Bank v. Amtek Auto Ltd. & Ors.*, [CP (IB) No. 42-Chd-Hry-2017].

<sup>37</sup> It is a mythological multi-layer formation from which it is difficult to get out., Economic Survey, Ministry of Finance, Government of India, 2015-16.

<sup>38</sup> Preamble to the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018.

after invitation of Expression of Interest in exceptional cases, on an application made by the applicant.<sup>39</sup> During the process, the stakeholders endeavour to rescue the firm through a resolution plan. The CoC may at any time decide to liquidate a CD, even before preparation of information memorandum, where running the entire CIRP is an empty formality and liquidation maximises the value. Liquidation process commences only on failure of resolution process to revive the firm.

Even after an order for liquidation is issued, the law enables compromise or arrangement based on an application of a member, a creditor or the liquidator. In several matters, the NCLAT has directed to attempt a compromise or arrangement.<sup>40</sup> Many recent orders of the NCLAT have directed the liquidators to make efforts to sell the firm as a going concern or the business of the firm as a going concern to protect the interests of stake holders.<sup>41</sup> On failure of compromise or going concern sale, the liquidator may proceed to sell the assets in bits and pieces.

### CONCLUSION

The Code is still at its nascent stage. The work relating to individual insolvency, cross border insolvency, group insolvency, and valuation profession has begun in right earnest. As the process matures in the days to come, the insolvency regime is expected to impact not only 'ease of doing business', but also overall economic growth. The Code would boost economic growth through three main routes.

Firstly, the failure of business dampens entrepreneurship if it is onerous for an entrepreneur to exit a business. By rescuing viable businesses through CIRP and closing non-viable ones through liquidation, the Code releases the entrepreneurs from failure. It enables them to get in and get out of business with ease, undeterred by genuine business failures. As more and more potential entrepreneurs recognise this, the Code would promote entrepreneurship.

Secondly, when a firm fails, it typically defaults in service of debt obligations. As many firms default, the availability of funds with the creditor declines, limiting thereby its ability to lend for even genuinely viable projects. On the other hand, low and delayed recovery pushes up the cost of lending, and consequently, credit becomes available at a higher cost at which many projects may become unviable. Through provision for resolution and liquidation, the Code reduces incidence of default, and enables creditors to recover funds either through revival of the firm or sale of liquidation assets. It incentivises creditors - secured and unsecured, bank and non-bank, financial and operational - to extend credit for projects and thereby enhances availability of credit.

Thirdly, default typically reflects relative under-utilisation of resources at the disposal of the firm as compared to other firms in the industry. The Code ensures optimum utilisation of resources at all times by preventing use of resources below the optimum potential, ensuring efficient use of resources within the firm through a resolution plan; or releasing unutilised or under-utilised resources through closure of the firm and thereby maximising the value of the firm and in turn. The resources, that are currently unutilised or underutilised or rusting for

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<sup>39</sup> Swiss Ribbons, *supra* note 6.

<sup>40</sup> *Y. Shivram Prasad v. S. Dhanapal & Ors.*, [CA (AT) (Insolvency) No. 224 & 286-2018].

<sup>41</sup> *Edelweiss Asset Reconstruction Company Ltd. v. Bharati Defence and Infrastructure Ltd.*, [CP-292-I&B-NCLT-MAH-2017]

whatever reason, can be put to more efficient uses, enabling the growth rate to move up by a few percentage points.

By liberating the entrepreneur from failure and releasing resources from *chakravyuha* of inefficient or defunct firms, for continuous recycling, coupled with improved availability of credit, the Code has changed the narrative from 'Hopeless End' to 'Endless Hope'.

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## 2

# *Efficiency of Bankruptcy Institutions*

Shubhashis Gangopadhyay<sup>1</sup>

**B**anks' willingness to lend depends on their ability to get back the money that they have lent out. Banks lend to risky projects that are able to meet the debt repayment schedule when they are successful but are unable to meet the banks' claims when they fail. In classical economics, the rate of interest is sufficient to handle the riskiness of projects with those that have a higher probability of failure being asked to pay a higher rate of interest compared to a project that requires the same amount of loan but has a lower probability of failure. The fundamental assumption here is one of symmetric information - the bank and the debtor have the same knowledge about the probability of failure associated with the project.

However, in real life and financial markets in particular, information asymmetries are more the norm than the exception. The debtor has more knowledge of the project than the bank has. Consider project A and project B where B has a higher probability of failure. Owner of project A should pay a lower rate of interest than that of project B for the same amount of loan. Even if the bank is aware of the two types of projects it may not be in a position to know who owns project A and who owns project B. The two project owners, however, know what type they own. In such a situation, owner of B may want to masquerade as owner of project A. Since the bank knows this it plays safe and makes sure that it hands out contracts that assume all projects are of type B. Or, it demands a greater exposure of the owner, more owner funds or equity involvement, by restricting its own loans to the project. In other words, fearing project owner B, the bank gives less loans than it would have if *B-type* projects were not around. In such situations, the rate of interest alone is not the relevant factor in loans. The economics literature on adverse selection (Stiglitz and Weiss, 1981)<sup>2</sup> studies this in great detail.

Any project that a lender lends to goes through three broad phases - investment and creation of assets with initial investment, cash flows resulting from the operation of the asset thus created and, finally repayment of all outstanding non-shareholder claims. The problem with lending is that banks lend at the beginning of phase one and get back their full loan repayment at the end of phase three. The operational decisions in the second phase of the project are under the control of the management chosen by the shareholders. One part of the literature on credit rationing shows how moral hazard (Holmstrom and Tirole, 1997<sup>3</sup>, Tirole,

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<sup>1</sup> The paper has benefitted greatly from comments and suggestions by Dr. M. S. Sahoo, on an earlier draft. All remaining errors are mine.

<sup>2</sup> Stiglitz, Joseph and Weiss, Andrew (1981). Credit Rationing in Markets with Imperfect Information. *The American Economic Review*, 71(3), pp. 393-410

<sup>3</sup> Holmstrom, Bengt and Tirole, Jean (1997). Financial Intermediation, Loanable Funds and the Real Sector. *The Quarterly Journal of Economics*, 112(3), pp. 663-91

2006<sup>4</sup>), or opportunistic behaviour by the debtor in the second phase, is an important determinant of banks' willingness to lend. More is the ability of banks to anticipate and prevent moral hazard greater will be the bank's willingness to lend. By opportunistic behaviour we mean actions taken by the debtor, in the second phase of the life-cycle of a project, that transfer value away from the lender to the shareholders.

In addition to probability of default on loans and the presence of asymmetric information, there is a third factor that determines the terms and conditions under which a bank lends. This is the set of rules that govern the distribution of assets in a failed project. The rules and the procedures implementing them constitute the bankruptcy institution. This kicks in only when a project becomes insolvent and enables the bank to anticipate the extent of default when the debtor is unable to pay the full outstanding claim.

Bankruptcy institutions are of both research and policy interest because of their impact on bank's willingness to lend. This is of special significance in an economy where employment and growth, through the financing of new and on-going businesses are major development concerns. A sustainable financial market institution that enables a larger measure of positive net present value projects to be implemented is considered better than one that is either not sustainable or, reduces the amount of funds available to business. The degree of willingness to lend is measured by the extent of credit rationing by banks. If banks are flush with funds, classical economics suggests that price of borrowing, or the interest rate on loans, should come down to encourage borrowers to increase their demand for loans. However, we have seen how, because of asymmetric information between borrowers and lenders, interest rates alone do not determine the demand and supply of loans. In other words, excess supply is not sufficient for the price (i.e., the rate of interest) to fall and mop up the excess supply of loans. This is clearly an inefficiency as banks make less profit than they can as they end up with unutilised funds. This, in turn, slows down the growths of both employment and income.

Financial market infrastructure performs three fundamental roles in the real economy: run the payment system, channel savings to new investment and, reallocate failed investments to new investments with positive returns. The ease with, or the cost at, which the third happens is a function of the bankruptcy institution. Maksimovic and Phillips (1998)<sup>5</sup>, Wihlborg, Gangopadhyay and Hussain (2001)<sup>6</sup> and Bernstein, Colonnelli and Iverson (2018)<sup>7</sup> study the efficiency of different bankruptcy systems in the world.

To appraise the efficacy of the bankruptcy institution, it is important to distinguish between two opposing forces that affect efficiency of investment during bankruptcy or, when a firm becomes insolvent. A firm is insolvent at any time when it is unable to meet a financial obligation that has become due at that point in time. Economists often refer to an insolvent firm as a distressed firm and distinguish between two types of distress. A firm is said to be in economic distress when its net present value (NPV) has become negative. In this definition of distress there is no reference to the firm having missed a financial obligation or, being declared insolvent because of a default.<sup>8</sup> When calculating the NPV of a firm, or a project, all the future

<sup>4</sup> Tirole, Jean (2006). *The Theory of Corporate Finance*. Princeton University Press. Princeton. New Jersey

<sup>5</sup> Maksimovic, V. and Phillips, G. (1998). Asset Efficiency and Reallocation Decision of Bankrupt Firms. *Journal of Finance*, 53(5), pp. 1495-1532

<sup>6</sup> Wihlborg, Clas, Gangopadhyay, Shubhashis and Hussain, Qaizar (2001). Infrastructure Requirements in the Area of Bankruptcy Law. *Brookings-Wharton Papers on Financial Services*, pp. 281-329

<sup>7</sup> Bernstein, S., Colonnelli, E. and Iverson, B. (2018). Asset Allocation in Bankruptcy. *Journal of Finance*, 74(1), pp 5-53

<sup>8</sup> This distinction will become clear soon.

net returns (revenue minus cost) from the project are taken into consideration and discounted to the present. If this is negative, the NPV is negative. In economics, the project cost includes the opportunity cost of investment. Often when the value of an on-going project is calculated, the opportunity cost is not taken into account.

Suppose A runs a taxi company and has drivers and cars as assets (as well as dedicated customers). And, suppose A has a small amount of outstanding debt and little capital cost because her taxis are depreciated out and the revenue A earns is sufficient to service her debt, maintain the fleet of cars and pay her drivers enough to make them continue with her. However, because of Uber and commercial car leasing companies emerging on the scene, A is better off closing down her company, pre-paying her loan and starting an entirely new business. If A is considering only the net cash flow as her net returns, her company is both solvent and has positive value. If, however, A takes the opportunity cost of her managerial effort and time (i.e., the higher profit her time and effort will earn her in some other business), her company is of negative NPV. This is an example of a company that is solvent (for A can meet all her financial obligations) but in economic distress (since his NPV is negative).

Alternatively, a firm is in financial distress when it has defaulted on a payment obligation that has become due. Again, consider A's taxi company but in this example, A is doing a roaring business. A is also a good financial manager of her company and does not keep excess liquidity lying around. A is supposed to make a debt repayment by the end of day today and A's usual daily revenue and planned liquidity are together sufficient to make that payment. However, due to unexpected circumstances, the petrol stations shut down for the day, making it impossible for her to run her taxis and earn her usual daily revenues. The little revenue that she makes today and the accumulated liquidity together are not sufficient to pay the loan instalment that is due by the end of day. It is possible for the bank to claim that she has defaulted and take her to the bankruptcy court.

In such a scenario, if capital, or financial markets are perfect, it would be possible for A to raise a new loan to pay her dues to the erstwhile lender. The new lender would be willing to extend the loan to A as it knows that her business is of positive NPV and A will be able to pay it back. All that A has suffered is a shock to her cash flow and a day's revenue losses will be easily made up in the future. At one point of time in such a scenario, A is staring at her erstwhile creditor getting her declared as an insolvent firm by the end of day. If she cannot arrange for the new loan to repay her due payments (because of imperfect capital markets) A becomes an example of a company in financial distress but with positive NPV.

Economic efficiency demands that her taxi company in economic distress be wound up, or liquidated, while in the second case (financial distress but positive NPV), her taxi company continues either with her or with some other management. To make matters more complicated, companies could be in both financial and economic distress. An efficient bankruptcy institution ensures that an efficient outcome is more likely.

Table below categorises the various issues involved here.

**Table: Types of Distress and Efficient Action**

State	Definition	Efficient Action
Economic Distress	The NPV of assets is negative under any management team	Piecemeal liquidation of assets
	The NPV of assets is positive under a different management team	Sale of assets as a 'going concern' to enable a change of management
Financial Distress	The present value of cash flows is positive but it is lower than the value of claims by non-shareholders	Debt reduction along with restructuring and/or ownership change, if value of assets there by can be enhanced
	Liquidity-problem	Debt-rescheduling, Liquidity-enhancement

*Source: Wihlborg, Gangopadhyay, Hussain (2001)*

In only one of the four possible cases of distress liquidation is most efficient. This is because, in principle, the whole is larger than the sum of its parts. When a company is closed down, or liquidated, the intangible assets of the erstwhile company are dissipated. The most important loss comes from the dismantling of the 'team of workers'. This is a recognition of the fact that employees work in teams and the gains made by them through coordination, specialisation and complementarity are lost when they are broken up. Consequently, an efficient bankruptcy institution is one that engenders a low likelihood of liquidation (i.e., liquidate only when necessary) and a high likelihood of reorganisation or capital restructuring, thus keeping it as a going concern.

One thing that has been widely observed is that the longer it takes for companies to pass through the bankruptcy process, the greater is the loss of asset value. This is usually proxied by the proportion of outstanding claims in an insolvent company that is recovered at the end of the bankruptcy process. Consequently, the two quick measures that economists use to compare the performance of different bankruptcy institutions are (a) extent of recovery and (b) the time it takes for the bankruptcy process to be completed.

#### ROLE OF THE CODE

India passed a comprehensive and new Insolvency and Bankruptcy Code (Code) on May 28, 2016. Prior to this, institutional debt defaults were handled through a number of different laws and regulations, like the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA); the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI); the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI); and the Companies Act, 2013. In addition, for companies above a certain size, the High Courts had to be involved, especially in winding up decisions. The existence of these various laws made for a confusing and inefficient process and meant that people could file cases in different courts and tribunals delaying the restructuring process of bankrupt companies. The Code, being a uniform code, was meant to reallocate assets more efficiently and quickly.

The Code was drawn up with the objective to '*consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India (IBBI), and for matters connected therewith or incidental thereto*'.<sup>9</sup> Notice the stress on efficiency, the promotion of entrepreneurship and increasing the availability of credit in the objective of the Code.

Any unpaid creditor can approach the National Company Law Tribunal (NCLT), the sole judicial Adjudicating Authority for matters related to insolvency, which is effectively the bankruptcy court. Once the company is registered at the NCLT, it appoints an interim resolution professional (IRP) suggested by the applicant. A resolution professional (RP), who could also be the IRP, is appointed after the IRP submits its report (within 30 days). The (resolution process) is required to come up with a plan within 270 days of the registration of the insolvency proceedings. The objective of the resolution process is to come up with a restructuring of the claims that are acceptable to creditors. Only when that is not possible, will the company be liquidated. Clearly, the focus is on continuance, rather than abandonment, of the project.

From its inception in 2016 till the end of 2018 (the Code was implemented in December 2016), the Code has helped recover Rs. 1210 million in 61 big corporate debtors (CDs). The recovery rate is 46 per cent compared to 26 per cent under the previous bankruptcy regime. Within the first 2 years, 115 cases had completed the resolution process of which 92 were liquidated and 23 were reorganised through what has come to be known as the corporate insolvency resolution process (CIRP). The CIRP ends with either a resolution plan or an order for liquidation and liquidation commences only after CIRP has failed. The CIRP cases have taken an average of 243 days; while the average time for the liquidation order was 224 days. The Code had set a target of 270 days by which the resolution process was to be completed.

The decision to accept the resolution plan or go for liquidation is taken by the Committee of Creditors (CoC). The Code distinguishes between financial creditors (FCs) and operational creditors (OCs). Simply put, the FCs give investment loans while OCs are more like suppliers who are yet to be paid. According to the Code, only FCs are a part of the CoC with voting rights which are in proportion to their outstanding dues. The directors of the company and OCs (if their dues are more than 10 per cent of the total outstanding debt) can sit in the meetings but do not have voting rights. It is the CoC that receives, evaluates and votes on resolution plans.

The average realisation of FCs through CIRP was Rs. 215 crore (49.70 per cent of their outstanding claims). The first thing that is done before the resolution process begins is estimating the liquidation value of the CD. If these cases had ended in liquidation, the value received by the FCs would have been Rs. 119 crore (27 per cent of their outstanding claims). This is a rough and ready measure suggesting that the issues raised in Table above have been adequately addressed.

A better picture emerges if we take more recent data. Between January, 2017 and June, 2019 (i.e. in 2.5 years), 2162 companies went through the CIRP under the Code. Of these, 870

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<sup>9</sup> Long title of the Insolvency and Bankruptcy Code, 2016

have seen closure and 1292 are still in process. Of those where the resolution process is ongoing, 445 or 34 per cent have gone through more than 270 days. This is largely because the process is halted by various entities appealing to courts against the decisions taken, or the processes followed, by the RP. Ours is a 'rule of law' society and parties who feel aggrieved have a right to go to the court. The court, through its various judgments and directions, creates the case law that sets the precedent for future disputes. Once the dust settles, there will be less uncertainty in the process and its outcomes and the CIRP under the Code will become smoother and faster.

Of those with closure, liquidation has been recommended in 475 cases, i.e. in 55 per cent of the cases. This may be misconstrued as a bankruptcy process that liquidates a majority of insolvent companies. In economics, restructuring is always better than liquidation especially if, restructuring is accepted by creditors over liquidation. This signals that the restructured entity has greater value than the liquidation of the erstwhile insolvent entity. Recalling Table above, liquidation, after all, is only one of the four possible efficient actions. However, what must be kept in mind when looking at these figures is 348 of the 475 (or 73 per cent of liquidation) cases are for companies that were already in Board for Industrial and Financial Reconstruction (before the Code came into effect). These were largely defunct entities with outstanding claims but with little more than scrap value. If these 348 cases are removed, we then have 522 closures, of which 127, or 24 per cent were liquidated.

A successful resolution plan needs the votes of at least 66 per cent of the CoC. If no resolution plans are proffered or accepted by the CoC then the firm is liquidated. The resolution plan could be a restructuring of the outstanding claims with or without a fresh inflow of equity or, liquidation.

The Code came into effect when the bankruptcy institutions were in limbo. As mentioned above, a number of competing legislations were being exploited by vested interests resulting in large amounts of valuable capital being stuck in some dispute or the other. The total non-performing assets (NPAs) of public sector banks totalled USD 110 billion, as of September, 2017. The real problem, however, is better illustrated by the situation that prevailed as of October 31, 2015 and before the Code was enacted, which was as follows:

- There were 4,636 cases of winding up pending in court, out of which only 955 cases were less than five years old while a whopping 1274 cases were more than 20 years old.
- What was more ridiculous, perhaps, were the 545 cases of voluntary winding up (i.e., creditors and debtor had both agreed to liquidate) out of which, again, only 163 were less than five years in court while 203 of them have been stuck in the court system for more than 20 years.
- And, the debt recovery rate in India was 26 per cent of unpaid dues, while the OECD rate, at the same time, was 72 per cent.

A special feature of the Code is that the OCs have no vote in the CoC.<sup>10</sup> Nevertheless, the OCs received 66.40 per cent of their outstanding claims in those cases that were resolved through the CIRP.

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<sup>10</sup> The directors of the CD and OCs can be present in the meetings but may not vote on the resolution process.

### A SPECIAL FEATURE OF THE CODE

A distinctive feature of the Code is that, for the first time, the bankruptcy law has divided creditors into two groups, viz. FCs and OCs. While FCs offer loans at a rate of interest, OCs supply services and other inputs during operations and have outstanding payments due from the CD during insolvency proceedings. This distinction becomes important because in the CoC, where both types of creditors are present, the OCs do not have any voting rights; only the FCs can vote.

This asymmetry in voting rights in the Code between two groups of creditors resulted in a number of petitions in courts. Those opposing this feature maintained that this is discriminatory and puts OCs at the mercy of the FCs. The Committee that was set up to recommend a new bankruptcy code (that led to the enactment of the Code) had mentioned a number of reasons for dealing with the two types of creditors differently in the bankruptcy process. First, most FCs are secured creditors and, in any case, are supposed to be paid off before unsecured creditors like the OCs. The economics literature argues that, under optimal contracting (i.e., debt contracts with covenants attached to them), priority rules do not matter if, once set, they are not changed during insolvency procedures. Contract terms and conditions are adjusted keeping the priority of the loan in mind at the time of signing the contract. Putting it simply, the same loan will have different interest rates attached to it if its position in the priority ladder is different. What creates a problem is tampering with the priority ladder after it has been set.

Second, the OCs are large in number compared to the FCs but together have a much smaller exposure to the CD compared to FCs. Clearly, this increases the transaction cost of decision-making without changing the decision. Why? Given the large voting share enjoyed by FCs, and the fact they are few in number, it is easier for them to vote as a coalition or, out-vote the OCs.

Third, and most important, both for economists and for meeting the objective of the Code, the FCs are more interested in re-organising and restructuring the CD rather than shutting her down. In other words, FCs have long term interest in the CD's performance while the OC is interested in being paid, regardless of whether the CD is liquidated or continues as a new entity.

The Supreme Court upheld all these arguments and ended with a very simple observation:

'Ultimately, the total flow of resources to the commercial sector in India, both bank and non-bank, and domestic and foreign (relatable to the non-food sector) has gone up from a total of INR 14530.47 crores in 2016-2017, to INR 18469.25 crores in 2017-2018, and to INR 18798.20 crores in the first six months of 2018-2019. These figures show that the experiment conducted in enacting the Code is proving to be largely successful.'<sup>11</sup>

To understand the rationale even more, consider the following hypothetical example: the FCs of an insolvent debtor have an outstanding claim of 100 and the operating creditors have a claim of 50. Suppose there are two resolution plans, A and B, each of which has a bidder who is willing to pay 125 and 125 is the highest bid. Plan A treats FCs and OCs equally in the pay-out (i.e., FCs are offered two-thirds (=100/150) of 125 and OCs one-third of 125). Plan B, on the other

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<sup>11</sup> *Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.*, (2019) 4 SCC 17 (Swiss Ribbons)

hand, pays out 100 to FCs and 25 to OCs. Clearly plan B will be chosen by the CoC and not plan A since FCs get more under B.<sup>12</sup> This, in essence, changes the effective priority between FCs and OCs with the former having superior claims over the asset value of an insolvent CD.

This has raised two issues. First, even though unsecured creditors are treated as one class in the priority list and contain both FCs and OCs, in effect, as the example above shows, it gives unsecured FCs claim over that of OCs. This, OCs claimed, is discriminatory and it was not intended to be such under the Code. Second, they and their supporters pointed out that this will increase the cost of doing business as suppliers will charge a higher risk-premium and, hence a higher price because of the lower effective priority under insolvency.

First, what could be the possible justification for introducing such a feature into the Code? The OC usually gets into the game after the FCs have signed their loan contract with the CD. Also, in India, the OC is, often, a subsidiary, or group company, of the CD. It is well established that the firm has better information about the immediate future prospects, compared to the creditors. In particular, if a company is going to become insolvent soon, the CD will have this information before the creditor. In the worst possible scenario, the creditor will know only when there is a default on its loan repayment schedule.

Let us go back to the last example cited above. In year  $t$ , the FC contracted for a debt claim of 100 in year  $t+2$ . In year  $t+1$ , the CD gets a signal that it will not be able to pay the FC next year. It can ask one of its group companies to over-invoice the amount of operational credit claim from 50 to 100. If the CD was buying from an unrelated party, it would have bought the material for 50. However, because the OC is a related party (group company), it can decide on a recorded price of 100. This can be done because it is difficult to find a market price of the material supplied by the OC. Given the specificity of the materials used in a market of differentiated products, it is easy to argue that the CD must have some control over its own supply chain and that would be lost if the debtor goes outside its supply chain. If it can succeed in this over-invoicing in year  $t+1$ , then when  $t+2$  comes and it is unable to meet its debt claim by the FC, it goes into bankruptcy and gets paid (through its group company) an amount which is 0.5 of 125, instead of 0.33 of 125. This possibility of manipulation by related parties is recognised by many countries and it is not unique to India. In India, it may be more prevalent because of imperfect markets and lack of entrepreneurship.

However, the flip side is also possible as is evident in the now famous matter of *Binani Industries Ltd. v. Rajputana Properties Pvt. Ltd. & Ors*<sup>13</sup> In the example being considered, suppose the two plans are X, which offers 90 to the FC and nothing to the OC and plan Y that offers a total of 100 to be distributed according to the proportion of each of the outstanding debt of FCs and OCs. Clearly, according to the Code's voting rules, X will get passed but not Y though Y maximises the value of insolvent assets. Notice, however, that if the FCs had superior claims than OCs, then the resolution plan would be reworked in such a way that Y is the plan and FCs get at least what they were getting in plan X. Provided, of course, the proposer (funder) of plan Y is willing to do so.

There can be only one reason why the funder may not want to do this. She gains if OCs get paid more. This implies that the funder's objective is aligned with the OC's objective. And, that

<sup>12</sup> Indeed, observe that plan B will be preferred by FCs (who alone can decide) even if A has a bid of 130.

<sup>13</sup> Civil Appeal Nos. 3638-2018

makes the OC a 'related party' to the funder. And, as the court suggests (in the *Swiss Ribbons* case), such 'strategic default' of loans, coupled with over-invoicing by related parties to take value away from (financial) creditors needs to be plugged. A little reflection will convince anyone that the voting rules in the CoC coupled with section 29A, does precisely that.

#### CONCLUSION

While new investment leads to growth and expansion of employment, the process can be sustained only if capital is re-deployed from economically unproductive use to economically gainful ones. The efficiency of this function of capital markets is determined by the bankruptcy institutions. Prior to the Code, the bankruptcy institutions were time consuming and, often, defunct. The Code is the first attempt in the Indian economy to set this right. The fact that it has had a positive impact is evident in the large recoveries made by FCs from assets that were tied up in insolvency processes prior to 2016. And, even after 2016, insolvent companies are being reorganised much faster than they have ever been. This should improve the credit market efficiency and, in particular, ease the credit constraints faced by new projects.

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## *The Economics of Bankruptcy Laws*

Ajit Ranade

**T**he Insolvency and Bankruptcy Code (Code), passed by the Parliament of India in 2016, is one of the most important and comprehensive legal reform. For the first time in independent India, the law formally sets out a bankruptcy and insolvency resolution framework, and in doing so also strengthens creditors' rights, swinging the pendulum away from the rights of borrowers, which was the *de facto* situation earlier. It may be happenstance that the law which took years to be hammered out was passed when the non-performing assets (NPAs) problem in banks was mounting alarmingly. The Code will certainly help in resolution of NPAs, but its long-term and bigger impact will be on unseen behavioural aspects in the economy. The law as it stands lends transparency and predictability to the resolution process itself. But its significant impact will be in cases which will never come up for the Code-mandated resolution, because of the deterrence and change in players' incentives. Thus, in the coming years, the large measure of success would be in unobserved data, not in the number of cases that come up for resolution. In the long term, its effect will also manifest in behavior such as extra effort to avoid repayment default, lesser resources locked up in defaulting or under-litigation economic activity, and lower cost of credit.

A landmark law with similar intent as the Code was passed in 2002, called the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI). That law was limited in its scope as it was aimed at helping banks recover loans from defaulters. It too aimed at strengthening creditors' rights, in the eternal tug of war between rights of debtors and creditors. Over the past two decades it is not clear to what extent that law has been effective, which is perhaps one of the motivation for a comprehensive law such as the Code.

Interestingly, the enactment of SARFAESI in India came on the heels of bankruptcy law reform in the West, which was looking to beef up rights of debtors rather than creditors. In some ways while the West was looking at diluting some of the creditors' rights, India was coming from the other end of trying to reduce the stranglehold of debtors. The Bankruptcy Reform Act of 1978 in the US was a case in point. Prior to the 1978 reform it was easier for creditors to take debtor firms to full or piece-meal liquidation. There also was a tendency for many insolvency cases to end up in socially sub-optimal liquidation, due to perhaps hair trigger action of creditors with excessive powers. Debtors had lesser say. Indeed, in the earlier part of US history, it wasn't clear whether the constitution even empowered lawmakers to define and enhance debtors' rights under a bankruptcy law. The debtors' rights were covered only under 'insolvency laws' wherein the debtor had inadequate assets and hence was unable to discharge

his obligations. After 1978 the debtors' position was slightly stronger, and indeed they now had an option to file for bankruptcy preemptively as a strategy to fend off creditors or to reorganise themselves. This law too was amended in 2005 that curtailed debtors' rights with a view to prevent the abuse of the bankruptcy process. The 1978 Act was amended again in 2015 to reduce certain timelines, and effectively more curtailment of debtors' rights. The earliest comprehensive and well-settled bankruptcy code in the US dates back to 1898 (called the Nelson Act), which underwent a major reform in 1938 (called as the Chandler Act). Thus, the experience of US bankruptcy law history shows us the dynamic nature of such legislation, which needs to be tweaked or amended as per evolving and unanticipated situations. Since it is basically a tussle to find the right balance between creditors and debtors rights, such an evolution is inevitable. Not surprisingly India's Code which has benefited from the cumulative experience of the rich history of bankruptcy law in the west, most notably in the US and UK and other countries, has also undergone an amendment within three years of its initial enactment.

In this article, the next section briefly describes the economics of bankruptcy law, and the main challenges in the design of such laws. The subsequent section focuses on one particular aspect as it applies to India's bankruptcy law. This relates to the conditions that must be fulfilled for a case to be admitted to the bankruptcy process. The article suggests some reform in this area, which will indirectly enhance the effectiveness of the working of the Code itself.

#### ECONOMICS OF BANKRUPTCY LAW

The brief discussion below is based on the paper by Aghion, Hart and Moore (1992)<sup>1</sup> The modern capitalist market-oriented economy works on the foundation of the sanctity of contracts. These may be between private or public parties, individuals or corporate entities. What happens if a contract is breached? What is the recourse? Economic theory makes a distinction between *ex-ante* and *ex-post* behavior and the incentives of players involved in a contract. A contract which is attractive and mutually beneficial *ex-ante*, may not turn out to be so *ex-post*. Anticipating this, the contracting parties may find it necessary to agree a priori to have a neutral third party to enforce the contract. That is where the role of the state comes in, even in enforcing contracts between private parties. Parties have to approach a court and get a verdict on the course of action if a contract is breached.

A debt contract is a particular kind of contract wherein one party borrows money from another, with a promise to repay a higher sum in the future. If this contract is breached, it means the borrower has defaulted, either on the amount or on the timeline promised. The lender can then either seize the assets which was the collateral for the loan, or approach the third party (the state, or courts) by filing a suit. When the judgment is awarded, the enforcement machinery ensures that some compensation goes to the lender. This may involve seizing some personal property, or partial sale of assets of the borrower, or invoking guarantees if made by any third parties.

Unfortunately, such a straightforward process does not work when there are multiple creditors, or when debtors are insufficiently collateralised. Debt collection, even partially, by various creditors through uncoordinated actions can be time-consuming, costly and

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<sup>1</sup> Aghion, Philippe., Hart, Oliver., & Moore, John (1992). The Economics of Bankruptcy Reform. Working Paper No. 4097, *National Bureau of Economic Research*, Massachusetts, USA.

inefficient. There is a kind of 'tragedy of the commons' phenomenon that can happen in the competition between all creditors to recover their debts. As an example, if one creditor races ahead and tries to work out a private deal with the borrower to carve out a piece of the total assets, this itself may reduce the total value and lead to further value erosion. Or if another creditor brings a court order against the borrower, it may hamper the borrower's ability to work out a satisfactory deal for all. The situation can get further complicated if the borrower deliberately takes advantage of the weakness on the creditors' side, due to lack of coordination. As such in case of multiple creditors, the playing field is tilted in favor of the borrower, who can 'play' one creditor against another, or take advantage of asymmetric and imperfect information. That is why we have an arrangement of a consortium of lenders, wherein all information is shared to remove asymmetries. But even then, each creditor's incentive may not be aligned with those of others, leading to time- inconsistent behavior, and incentive to renege on agreements. Indeed, such a description is not theoretical at all and has been experienced in Indian banking. For instance, prior to 2016, it was seen that in a consortium lending arrangement, where there was some stress on the borrower, some lenders had classified the loan as 'non-performing', whereas other lenders in the same consortium had shown the loan as 'healthy'. This was creating all sorts of confusion. No wonder, the various initiatives of the Reserve Bank of India to sort out NPA problems using collective action of lenders did not produce any fruitful results. This is what ultimately led to the famous 'February 12' circular<sup>2</sup> which tried to cut the Gordian knot, discontinuing all earlier schemes and asked banks to resort to the corporate insolvency resolution process (CIRP) under the Code. Unfortunately, this circular had to be struck down by the Supreme Court as *ultra vires* to the Constitution of India.

The above discussion highlights the difficulty of resolving breach of debt contract, simply by going to a third party i.e. a court. In case of multiple creditors there is a need to have an orderly mechanism to dispose of the assets of the debtor, and pay off various claimants, even if partially. The third party has to decide on who gets how much, with what sequence and seniority, and also to ensure that the process is fair and time efficient.

At this stage, from a theoretical point of view, we have to distinguish between liquidation and resolution. The former is the case of the debtor's assets being sold or auctioned off, to pay fully or partially, in an agreed sequence of seniority to various creditors. The latter is the case where a standstill is imposed on all debts and due payments, and the debtor is given a chance to reorganise so as to be able to service all his debts, and returns to health and normalcy. This essentially has to be time bound and the process has to be fair to all parties. The US law distinguishes between liquidation, which is covered by insolvency law (i.e. Chapter 7 of the Bankruptcy Reform Act, 1978) and resolution and reorganisation (i.e. Chapter 11 of Bankruptcy Reform Act, 1978). Liquidation as a concept and process is more clearly defined, and can be seen as an 'efficient, market oriented' approach. But as Aghion et al. (1992) point out in their paper, this auction approach of Chapter 7 suffers from many drawbacks. There may not be many well-informed competing bidders, there may be absence of competition, or the incumbent management (of a debtor firm) may have an undue advantage in hiding the true value of the firm. The whole process of acquiring information about the entity is costly,

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<sup>2</sup> RBI Circular dated February 12, 2018 on 'Resolution of Stressed Assets – Revised Framework'

time consuming and hence may prove socially suboptimal. Hence liquidation is not the only solution to solving the issue of a breach of a debt contract.

Which brings us to the other option, i.e. reorganisation of business and resolution of the breached debt contract. In the U.S. context, this is covered by Chapter 11 of the statute, and in India it is the essence of the Code. But it may be appropriate to quote Aghion et al. (1992) here on the difficulty of the resolution process under Chapter 11 (and implicitly under the Code):

'... (it) involves significant legal and administrative costs, (and time), not least because (incumbent) management has so much de facto power over creditors, and it is not in management's interest to hasten proceedings if they are likely to end in liquidation... there can be a serious loss in value because of managerial distraction, incompetence or negligence; .. or a drop in demand (either because competitors behave more aggressively or because customers lose confidence)'.

There are also other disadvantages arising from low incentives of stakeholders with small stakes to be vigilant over the process, which tilts the balance of power further toward the management.

It is for this reason that a separate bankruptcy court, overseen by a judge or a similarly qualified person is necessary. From a social efficiency point of view bankruptcy proceedings cannot be mingled with other legal cases, as illustrated by the arguments above. The following section focusses on some of the salient features of the Code which explicitly or implicitly address the issues raised in the preceding section.

#### IMPORTANCE OF THE CODE

The passage of the Code is a historic milestone in the journey of India's economic reforms. Some people say that the Code ranks on par with industrial delicensing of 1991, the acme of reforms from those tumultuous years. Capitalism and market economies need free entry and free exit to function efficiently. Delicensing of 1991 made free entry possible, and the Code now makes exit relatively painless. It is not as if the country has not tried to legislate how to close down businesses. The ghosts of the older institutions like Board for Industrial and Financial Reconstruction (BIFR) and laws like Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) still haunt us, reminding us of failed attempts at reviving or closing down of sick industries. The Code provides a mechanism and forum that is quick in resolving or liquidating failing businesses. Unlike under SICA where a government board played the key role, under the Code the key decision whether to restructure or liquidate is taken by the empowered committee of creditors (CoC). The CoC takes a commercial decision, collectively assessing whether a distressed firm can be revived or should be liquidated. The kingpin of the Code is the time limit hard coded in the law itself. From the moment an insolvency case is admitted, it has 270 days for the distressed firm to be restructured, or be sold off to a new owner, or else liquidation is automatically triggered on the terminal day. Creditors thus have an inbuilt incentive to hurry if they want to extract value. Most cases will try and avoid liquidation since it yields value even lower than the harshest haircut of a creditors' forum. While in bankruptcy process, a distressed firm is as if in limbo. So, time is the enemy, and any delay just destroys value that may be worth salvaging. Hence the time limit is an extremely crucial part of the new law.

The Code empowers a creditor who is owed an amount as little as one lakh rupees to trigger this process. It also provides for the establishment of a new regulator, the Insolvency

and Bankruptcy Board of India (IBBI), which regulates the process as well as the insolvency professionals and institutions, and a new class called information utilities. The Code also led to the setting up of the National Company Law Tribunal, and its various benches, which admit cases destined for insolvency resolution. The amendment to the Code determined who can or cannot participate in the process. This reform was necessary to prevent promoters or related parties from getting back control of their firm at a distress value.

### A PROPOSAL FOR REFORM OF PRE-ADMISSION STAGE<sup>3</sup>

A breach of a debt contract can lead the case being admitted to the bankruptcy process. The breach can be of as small value as one lakh rupee as per the Code. The important prerequisite is that it must be established that a breach has occurred. Is there an incentive for the debtor to deny that it has happened? Is there an incentive for the creditor to hasten even before an actual breach has occurred? What if there are disagreements? That is why there is need for a third-party adjudication at this pre-admission stage.

In the current framework of the Code, an application for a case to be admitted to the bankruptcy or insolvency process, has to be subject to a judicial review. A key feature of the working of the Code is the time limit, but that clock does not start until the case is admitted. How to prevent inordinate, unfair delay at the pre-admission stage itself? If the courts or quasi-judicial bodies examining whether the plea for admission to bankruptcy itself is kosher or not, are clogged with high work load, then a delay is inevitable. Why not streamline this process and speed up the pre-admission stage wherever it is possible? Is it necessary to always apply a judicial mind at the pre-admission stage even for open and shut cases with crystal clear evidence? If a company has defaulted on its payment due to a creditor, and there is an authentic paper trail of purchase order, invoice, payment reminder notices and so on, surely admitting such a case should be an administrative matter? If there is default on the phone bill, monthly installments on home loan or credit card payment, action from the service provider company follows without it landing up in court. Similarly, if a check list approach is adopted to verify the claim of a creditor, surely the process of admission would be quicker.

Unfortunately, it is not so straightforward. The pronouncement that a 'breach of a debt contract has happened' is an important step. Thanks to a Supreme Court judgment<sup>4</sup>, the admission to the CIRP under the Code requires application of a judicial mind. What if the defaulting company has a counter claim against the creditor? What if there is an error in the calculation? What if the service was not fully provided for which the claim is being made? What if it is a frivolous claim? For all these reasons, the apex court opined that a judicial bench should 'hear out' the parties. But at this stage it can lead to untold delays by adjournments, minor objections, or simply traffic jam of cases. Indeed, there are already stories of several months of delays in merely getting cases admitted. Furthermore, the kind of situations described above can largely be taken care of by a 'templated approach' of filling out forms in prescribed format. The information utilities too will play a role in minimising such situations. Alternatively, the hearing at the admission stage can be a written hearing not an oral hearing, requiring parties to

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<sup>3</sup> Based on Ranade, Ajit. (July 24, 2018). Entry into the insolvency process needs to be made easy, *Mint*, New Delhi edition.

<sup>4</sup> *Dharani Sugar and Chemical Ltd. v. Union of India*, 2019 SCC OnLine SC 460

be physically present. Adjournments for written hearings are not possible easily. Another option could be a short hearing and not a long hearing. Otherwise unpredictable and long delays in getting cases admitted will defeat the very purpose of the law. One is reminded how applying for and getting a passport used to take months because it needed a lot of 'application of mind' and fraud checking. Due to a template approach, process reform and digitisation, it is now possible to get a passport in a couple of days. Same is the approach in applying for small ticket retail loans. A template approach by the bank reduces the time taken for loan disbursal drastically.

Hence, the proposal is that there is a need to strengthen the CIRP under the Code by templatising the admission process and make it largely procedural. Artificial Intelligence and other automated procedures can also help in this. For instance, in a company with hierarchies of 'approval and clearance authorities', the introduction of enterprising resource planning software like SAP or Oracle, greatly reduced the inefficiencies. The author is not making a case that an admission to CIRP can be decided by a machine, but posits that a great degree of facilitation is possible. Only in a small minority of cases will a judicial hearing and scrutiny be needed. This will go a long way in making this landmark law more effective.

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## *Safe Harbours in Insolvency Proceedings*

Unnikrishnan A.

**W**hat is a 'safe harbour' in insolvency proceedings and what is its impact? How do we justify the existence of such carve-outs in insolvency laws, which apparently do violence to the very fabric and object of insolvency proceedings? Does India require such safe harbours? If so, to what extent? Time and again, these issues crop up for discussion among academics, policy makers and practitioners of insolvency law.

'Safe harbour' is often stated to be a shorthand<sup>1</sup> for referring to a class of transactions to which the automatic stay or moratorium<sup>2</sup> in insolvency proceedings will not apply<sup>3</sup>. Even if an insolvency proceeding is initiated against a debtor, the counterparty to a transaction protected by the safe harbour can exercise the contractual rights as if nothing has happened, in accordance with the terms of contract. It may also include the power to net and close out, if such a clause is provided in the contract. These safe harbours may in effect also immunise some transactions that would otherwise have attracted the clawback of preferential transfers. The limited purpose of this article is to explain the concept of 'safe harbour provisions' in insolvency law, and their comparative merits and demerits.

The preamble to the Insolvency and Bankruptcy Code, 2016 (Code) informs that its object is the reorganisation and the insolvency resolution of corporates, firms and individuals in a time bound manner, for maximisation of value of assets of such persons. It also intends to balance the interests of all the stakeholders. Thus, the Code aims at value maximisation of all the stakeholders and the distribution of assets in an equitable and a rule-based manner. While keeping the broad objectives so, the Code provides for some priority<sup>4</sup> to certain stakeholders. It also leaves scope for certain immunities<sup>5</sup> to certain transactions to be notified by the Central Government.

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<sup>1</sup> According to Black's Law Dictionary (11<sup>th</sup> ed. 2019), the term 'safe harbour' refers to (i) An area or means of protection (ii) A provision (as in a statute or regulation) that affords protection from liability or penalty. See also: Lubben, Stephen J. (2010). Repeal the Safe Harbour, *American Bankruptcy Institute Law Review*. 18, 319 ('The term 'safe harbours' is a kind of shorthand for a variety of provisions in the Bankruptcy Code that reflect the 'well-established Congressional intent to protect the derivatives markets from the disruptive effects of bankruptcy proceedings.')

<sup>2</sup> In some jurisdictions, it is referred to as 'automatic stay'. In the Indian context, section 14 of the Code does not provide for an automatic stay, but only a moratorium by an order of the Adjudicating Authority (AA). The section however makes it mandatory for the AA to declare moratorium on the insolvency commencement date. Moratorium ordinarily refers to the temporary suspension of legal action against a person.

<sup>3</sup> The term 'safe harbour' does not seem to carry the same meaning throughout all jurisdictions. See for e.g., Akhtar, Zia. (2019). Safe Harbour Reform in Australian Insolvency law and restructuring schemes under the Corporations Act. *Company Lawyer*. (explaining that in Australia, the term 'safe harbour' is not used with a meaning as is done in America under s.546(e) of the US Bankruptcy Code and is only 'a quasi-defence for directors against the statutory duty to prevent a company trading while insolvent.')

<sup>4</sup> Sections 53 and 178 of the Code

<sup>5</sup> Section 14(1) of the Code; There is a significant distinction between the 'priorities' accorded in the waterfalls enumerated in the Code and the 'immunities' for transactions notified under this section. The priorities provide for a superior repayment position and places creditors in a senior-subordinate structure.

Ordinarily, the benefit of safe harbour provision is extended only to certain financial contracts, which if left to the normal rules of insolvency, can create systemic havoc. Thus, such provisions provide a privileged position to certain financial contracts. The rule of pro rata distribution among creditors of the same class is given a go-by in a safe harbour transaction.

In the United States (US), Title 11 of the U.S. Code (11 U.S.C.A. § 546)<sup>6</sup> provides that a trustee may not avoid a transfer that is a margin payment, or settlement payment, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, commodity contract, or forward contract. There are other exemptions to contracts like those involving swaps and repos.

### THE NEED FOR SAFE HARBOURS

Usually, the safe harbour protection is provided to certain selected financial transactions involving financial entities. The interconnectedness of the firms and the possible fall out of a systemic failure if such transactions fail, make them specifically eligible candidates for such protection.<sup>7</sup> The need for safe harbours spring from a notion that completion of certain transactions are necessary for the stability of the financial system as a whole, and upsetting them on the reason of insolvency is an invitation for systemic trouble.<sup>8</sup> The second reason often articulated is the possible avoidance of cherry picking.<sup>9</sup> The safe harbour provisions allow the non-defaulter counterparty to liquidate, terminate or exercise set off in contracts, without being affected seriously by the moratorium.

In the US, safe harbour provisions were introduced because the Congress considered the need for exemption from automatic stay called for, to obviate the 'insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.'<sup>10</sup> In the Report<sup>11</sup> on the Bankruptcy Abuse prevention and Consumer Protection Act, 2005 the Committee of the House of Representatives explained the rationale for such protection very succinctly:

'Systemic risk is the risk that the failure of a firm or disruption of a market or settlement system will cause widespread difficulties at other firms, in other market segments or in the financial system as a whole. If participants in certain financial activities are unable to enforce their rights to terminate - financial contracts with an insolvent entity in a timely manner, or to offset or net their various contractual obligations, the resulting uncertainty and potential lack of liquidity could increase the risk of an inter-market disruption.'

<sup>6</sup> 11 U.S.C. § 546(e)-(g), (j) (2012); 11 U.S.C. § 555; 11 U.S.C. § 556; 11 U.S.C. § 560; 11 U.S.C. 561; 11 U.S.C. § 741(5), (7), (8).

<sup>7</sup> Lubben, Stephen J. (2010). Repeal the Safe Harbours, *American Bankruptcy Institute Law Review* 18, 319, 321 ('The volatility, interconnectedness and sheer magnitude of the sums of money involved make financial firms unique.')

<sup>8</sup> This is not a view without critics. See for instance: Mokal, Rizwaan Jameel (2015). Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts, *Brooklyn Journal of Corporate, Financial & Commercial Law*.10,15, 15 'This view derives from the outdated "micro prudential" understanding of systemic risk, and is theoretically flawed and empirically false.'

<sup>9</sup> Lubben, Stephen J. (2010). The Bankruptcy Code without Safe Harbours, *American Bankruptcy Law Journal*, 123 (2010) ('The cherry picking argument rests on the belief that it is somehow inequitable for a debtor to retain favorable derivatives while rejecting unfavorable contracts.')

<sup>10</sup> H.R. Rep. No. 97-420, at 1 (1982).

<sup>11</sup> Report on H.R. 4393 - Quoted in H.R. Rep. No. 109-31, pt. 1, at 20 n.78 (2005) (August 28, 2019). <https://www.congress.gov/109/crpt/hrpt31/CRPT-109hrpt31.pdf>.

As noted by the Second Circuit Court<sup>12</sup> in the United States:

'The purpose of the 'safe harbour' statute, 11 U.S.C.A S. 546(e) prohibiting bankruptcy trustees from avoiding transfers that were margin or settlement payments made by or to financial institutions, is to protect the market from systemic risk and allow parties in the securities industry to enter into transactions with greater confidence.'

While there is a large quantity of academic literature available on the subject, explaining the need for safe harbour provisions, there is an equally forceful view that such safe harbours have not resulted in any kind of advantage to the financial system. The critics argue that instead of advancing the cause of system stability, it has only destabilised the system as a whole.

#### PROVISIONS OF THE CODE

Section 14(1) of the Code states that on the insolvency commencement date, the Adjudicating Authority shall by order declare moratorium for prohibiting certain transactions, viz.:

- '(a) the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgment, decree or order in any court of law, tribunal, arbitration panel or other authority;
- (b) transferring, encumbering, alienating or disposing of by the corporate debtor any of its assets or any legal right or beneficial interest therein;
- (c) any action to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property, including any action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
- (d) the recovery of any property by an owner or lessor where such property is occupied by or in the possession of the corporate debtor.'

Section 14(3) however states that these prohibitions will not apply to such transactions as are notified by the Central Government. By an amendment that came into effect on June 6, 2018 it has been declared by the statute that the moratorium will not affect a surety in a contract of guarantee to a corporate debtor. The Central Government has not yet notified any such transaction so far as exempt.

The order of moratorium is intended to preserve the value of the going concern surplus. A cursory glance at the provision reveals that it operates only as a bar against third parties from proceeding against the corporate debtor through institution of proceedings or continuing with the already initiated suits. It does not debar a corporate debtor from proceeding against a third party who owes a debt to it. At the same time, the statute proscribes the corporate debtor from transferring, encumbering, alienating or disposing of its assets. Further, any action by creditors to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property is barred during this period.

#### SAFE HARBOURS: FOR AND AGAINST

##### **Arguments in Favour**

There are many justifications proffered for providing a special dispensation to certain financial contracts like derivatives and repos:

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<sup>12</sup> *Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d 98 (2d Cir. 2016).

- One of the most prominent arguments in favour of bringing in some safe harbour for financial contracts is the possible domino risk, i.e., the possibility of a ripple effect on the system, if a significant participant fails. This line of view proceeds on the basis that there is significant interconnectedness among transactions in financial contracts and the failure of one should not be allowed to snowball into a systemic failure.
- Unfair cherry picking of the contracts could be avoided.
- It enhances ability to achieve quick closeout netting, and thus reduces risk.
- The safe harbour makes parties more willing to enter into contracts falling within its ambit, which would minimise the costs.
- Some commentators tend to think that development of markets like derivatives would simply be impossible without the protection afforded by the safe harbours.<sup>13</sup>

### Arguments Against

On the face of it, the safe harbour provisions appear to run against the basic philosophy of insolvency action. A forceful and appealing argument against safe harbours is that they negate the underlying philosophy of insolvency proceedings.<sup>14</sup> The basis of equity in an insolvency proceeding gets distorted and a group of transactions which are falling within the ambit of safe harbour gets a preferential treatment over others. This may act as a disincentive for others. There are certain other factors also which are relevant in this context:

- As a result of the protection accorded by the insolvency regime, the creditor may not insist on appropriate collaterals or may not have appropriate incentives for insisting so.
- If the insolvency law provides immunity to the creditors, they may not do the pre-lending due diligence effectively. Further, monitoring of the assets created through lending may be shoddy, since the bankruptcy may not affect them.
- The incentive for diversification which a normal creditor would have, may not be there with a creditor who enjoys the safe harbour protection. Such a behavior may be the result of a thinking that the creditor is protected even otherwise.
- The usual rationing of credit will be absent. There may be a tendency on the part of the creditor to lend more at a lower cost. This is of course both an advantage and a disadvantage.
- The other creditors will not have a share to the extent of the claim of the creditor in the safe harbour. Thus, non-safe harboured creditors are providing a subsidy to the safe harboured creditors.<sup>15</sup> This can lead to the insolvency of the non-exempt creditors in certain situations.
- Creditors will engage in an opportunistic behaviour and take away the assets of the debtor, which would be ultimately detrimental to the debtor. In an insolvency

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<sup>13</sup> See: Edwards Franklin R. & Morrison, Edward R., Derivatives and the Bankruptcy Code: Why the Special Treatment? *Yale Journal on Regulation* 22, 91('A counterparty is more willing to enter a derivatives contract with a firm (or will enter at a lower price) if it can minimize the costs it may incur if the firm suffers financial distress.')

<sup>14</sup> Lubben, Stephen J.,(2017). Subsidizing Liquidity or Subsidizing Markets? Safe Harbours, Derivatives and Finance. *American Bankruptcy Law Journal*, 91, 463(arguing generally that, in bankruptcy, preservation of 'going concern surplus' outweighs most other concerns, the safe harbour reverses the configuration, offend the theoretical base of collective resolution of financial distress, and imposes a cost on society at large.)

<sup>15</sup> Vasser, Shmuel & Kerfoot. Matthew K., (2010). Preferential Treatment of Derivative Contracts - Saviour or Scourge? 30 *Futures and Derivatives Law Report* 30, 11('When certain transactions are afforded safe harbour treatment, the Code effectively subsidizes such transactions by reducing the risk - i.e., the cost - of these transactions.')

situation, the debtor has very little effective bargaining power.

- The potential for an effective reorganisation or resolution is thwarted to a great extent because of the power to withdraw the collateral by the creditor in safe harbour.
- Obviously, in the area of design of financial products and contracts, participants would concentrate more on products which would have the safety of safe harbour protection. Potential lenders will have a tendency to design credit products in such a way that they will fall within safe harbours. If the relevant legal system does not allow a judicial scrutiny of the economic substance of the transaction, it becomes easy for the creditors to bring a transaction within the fold of safe harbours merely by naming them with that of an instrument or contract specially protected.
- Once a favourable treatment is given to a certain set of transactions, there is a tendency to broaden the scope and ask for more. In the US, the safe harbour protection was much narrow in scope when started. But, over a period of time, the scope got so very wide.

#### LOOKING FORWARD

Where should we proceed from here and what are the types of transactions that the country should consider for bringing within the safe harbour? These are not questions with easy answers. But, that is no reason not to ponder over them.

One word of caution would be apposite here. As is seen under the U.S. Bankruptcy Code, once brought into effect, there is always a tendency to demand, and consequently expand, the scope of safe harbour provisions. Keeping a close watch on the issue therefore gains importance. It is also extremely important to craft safe harbours keeping in mind the potential imbalance it creates. It should not be too wide or too narrow. Striking a balance is definitely bound to be a tough exercise. It is necessary to make an assessment of the costs and benefits and the collateral effects, in deciding how broad or narrow should be the safe harbour.

Another issue of significance is whether non-financial institutions should be allowed the benefit of safe harbour, as the argument of systemic risk may not be forceful there. Unless, the exemptions are limited to transactions involving financial entities, the avowed object will not be achieved. So is the issue whether *ipso facto* contractual clauses (clause that allows termination on filing of insolvency petition) should be permitted or not. There can be questions as to whether they should be extended to contracts executed outside a recognised stock exchange.

Again, a debatable and contentious issue with respect to safe harbours would be the decision whether the exemption should be based on form or substance.<sup>16</sup> Merely by adding the label, whether parties should be able to take benefit of the safe harbour provisions? Or should the participants be allowed to run the risk of a regulator or a court of law recharacterising the transaction, apparently depriving the benefit to a party entering into a *bonafide* transaction?

It is beyond cavil that wrong immunities have the potential to destroy the value of the debtor firm.<sup>17</sup> Therefore, while crafting a policy on immunity from the moratorium, one has to

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<sup>16</sup> Chung, John J. (2010). From Feudal Land Contracts to Financial Derivatives: The Treatment of Status through Specific Relief. *Review of Banking and Financial Law* 29,107. ('If a party to a contract calls it a derivative, then it is a derivative, and any attempt by a seasoned bankruptcy judge to determine the true substance of the contract will be severely limited.')

<sup>17</sup> Jameel Mokal, Rizwaan (2015). Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts. *Brooklyn Journal of Corporate, Financial & Commercial Law*, 10(15), 32–33. (stating that the primary cost of ill-chosen priority rules is the misallocation of value from the bankruptcy estate but the effect of wrong immunities is not merely the misallocation but the *destruction* of value from the estate.)

be careful about the possible negative impact it can make, along with the expected benefits. An equally important aspect is the choice of words in the exemption notification. Going by the settled canons of statutory construction, an exemption being a deviation from the general rule, has to be interpreted strictly.<sup>18</sup> This would require paying enormous attention to the choice of words in the notification. A loosely worded or generalised notification<sup>19</sup> may create more uncertainty and invite litigation.

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<sup>18</sup> *M.A.C. Laboratories (P) Ltd. v. Collector of Central Excise*, AIR 1995 SC 510.

<sup>19</sup> For instance, a general description may lead to disputes on the appropriate classification and this may be more acute when hybrid instruments are involved.

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## *Frontiers of Corporate Governance – an Aid to Insolvency Framework*

U. K. Sinha, Saparya Sood and Saumya Sahai

**M**ultiple examples have come to light in the last two decades where mis-governance in corporations has led to significant market wide impact across jurisdictions. The remedial measures have resulted in enactment of strong corporate governance laws. There has been a global consensus on these reforms. UN agencies and institutions like the International Organization of Securities Commissions, have come out with governance standards, which most of the member countries have agreed to adopt.

In India, a series of expert committees examined this issue and recommended corporate governance measures which have been adopted by Securities and Exchange Board of India (SEBI). The minimum public shareholding has been mandated in order to reduce the hold of dominant shareholders and also to have reasonable amount of public float for fair price discovery. The Companies Act, 1956 was amended from time to time and finally a new Companies Act has been put in place in 2013 (Companies Act, 2013). SEBI came out with the SEBI (Listing Obligations and Disclosure Requirements) Regulations in 2015 (LODR Regulations), which introduced the idea of principles of corporate governance. SEBI mandated that the principles of governance would prevail over regulations in case of any incongruity or ambiguity. The principles have expanded from shareholder protection to safeguarding the interest of all the stakeholders of the company, such as employees, environment and the community at large. The idea of shareholder democracy has been strengthened through the requirement of uniform, timely and adequate disclosures as well as through measures to facilitate effective participation of the shareholders in the affairs of the company, such as electronic voting.

It is also important to note that the typical principal-agent conflict (shareholder-manager) assumes a different dimension in India, primarily because a higher percentage of companies are promoter driven. Not only do promoters have high shareholding but also in almost all cases they work as directors and managers in their companies, which creates the incentive for principal-agent collusion rather than conflict. The minority shareholders and other stake holders are more vulnerable in these companies. The laws and regulations have been conscious of this risk and have incorporated remedial and preventive measures. However, this agency problem aggravates when the company witnesses financial troubles or approaches insolvency. Promoters and managers are at the helm of affairs of the company and are the first ones to know and recognise the signs of stress. At this stage, they may use their position to attain undue advantage for themselves thereby compromising the rights of

shareholders and creditors. It is often seen that the creditors and other stakeholders of financially troubled corporations allege that the board and management did not discharge their fiduciary duties and engaged in questionable corporate governance practices.

#### HETEROGENEITY OF BOARDS

Earlier boards used to be homogenous, often hand-picked by the promoters or the dominant shareholders. Rules now provide for compulsory heterogeneity in the board so that different points of view emerge and independent perspectives also come into play while taking a decision. Besides whole time director, there have to be independent directors, woman directors and even non-executive non-independent directors. The ratio of independent directors in the board has been increased. Detailed duties and liabilities of the directors and the board as such have been prescribed.

#### **Duties of the Board**

Directors are the officers in charge of a company and owe fiduciary duties to the company and its stakeholders<sup>1</sup>. The duties of directors of a company are primarily governed by section 166 of the Companies Act, 2013. A director must exercise good faith in order to promote the objects of the company, for the benefit of the members, the company, employees, shareholders, communities and for the protection of environment; he must exercise independent judgement and discharge his duties with due care, skill and diligence; a director must not be involved in any situation which has a direct or indirect conflict of interest or attempt to achieve any undue gain or advantage for himself or his relatives, partners, or associate.

In addition to the above, under the LODR Regulations, the board is required to provide strategic guidance to the management of the company. It has to ensure that the financial reporting is correct and fair and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards. The board has to review and guide the corporate strategy, major plans of action, risk policy, annual budgets and business plans, set performance objectives, monitor implementation and corporate performance. It is also required to monitor the effectiveness of the listed entity's governance practices and make changes as needed.

Certain committees of the board like the audit committee or the nomination and remuneration committee have to be led by an independent director and are required to have majority of independent directors. The audit committee has been given a critical role in matters like approving the accounts or appointment of boards or in examining the internal audit finding. They are responsible for all internal financial control and have to ensure that the accounts are drawn as per the prescribed accounting standards. They are also responsible for following the regulations to prevent any insider trading and for dealing with environment, health and safety issues.

Disenfranchisement is another innovation designed to isolate the promoter – director or his relatives and associates when any related party transaction is to be approved. If any asset is to be sold or acquired or any new business has to be entered into where the other contracting parties are a related one, or even normal business operations of the company require dealing

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<sup>1</sup> Section 166 of the Companies Act, 2013.

with goods and services of a related party, the audit committee has to approve it. The same applies in cases of inter-corporate loans or sharing of common services. The tests of transaction being at arm's length and at fair value have to be applied. Not only that, where the related party transactions are material in nature, shareholder's approval is required. In such cases the promoter shareholder and its related parties are debarred from voting to approve. The resolution has to be carried out with a majority of minority shareholding approval.

#### SHAREHOLDERS AND CREDITORS

This paper argues how good governance practices can help a company in dealing with stress and help in minimising the impact or even avoiding the insolvency situation. Often, the conflict of interest is not between the shareholders and the creditors. In many cases, it is between shareholders and creditors on one side and the promoters and managers of the company on the other side. Most large public companies have concentrated promoter shareholding, thereby disturbing the balance of power between the minority shareholders and managers. While the board of directors is supposed to act in the best interest of all the stakeholders, in many scenarios, directors are accustomed to act as per the directions of the promoter. When the directors and promoters see incipient signs of stress in a company, often they are seen to be indulging in fraudulent practices like diverting funds to related parties, selling off the assets of the company, taking loans recklessly, taking decisions that involve high risks and so on. Hence, agents indulge in self-serving practices and make unjust enrichments for themselves and if the company undergoes insolvency, shareholders and creditors are the ones to bear the consequences.

Corporate governance tries to impose checks and balances in the power dynamics of the principals and agents. The Insolvency and Bankruptcy Code (Code) has put in place strong deterrence measures to prevent directors and promoters from indulging in self-serving practices.

Under the framework of the Code, directors have a duty to act in the best interest of the creditors when the initial signs of distress are felt and when they have reasonable cause to believe that the company may face an insolvency situation. This is the look back period or the twilight period which is the time-period preceding the insolvency commencement date for which directors can be held liable for past actions. In April 2018, the head of Insolvency and Bankruptcy Board of India sent a cautionary notice to the directors saying that they have an additional responsibility to protect the interest of the creditors especially during the twilight period.<sup>2</sup>

Section 66(2) of the Code lays down the duties of the director during the twilight zone. It states that on an application made by the resolution professional during the corporate insolvency resolution process, the Adjudicating Authority (AA), which is the National Company Law Tribunal (NCLT) may by an order direct that a director of the corporate debtor (CD) shall be liable to make such contribution to the assets of the CD as it may deem fit if:

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<sup>2</sup> K. R. Srivats, (April 4, 2018). Insolvency law: IBBI chief puts India Inc's directors on notice. *The Hindu*

'before the insolvency commencement date, such director or partner knew or ought to have known that there was no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process in respect of such corporate debtor; and such director did not exercise due diligence in minimising the potential loss to the creditors of the corporate debtor.'

Further, under sections 45, 49 and 69, the resolution professional or liquidator has been empowered to approach the NCLT for taking corrective actions if he is of the opinion that a transaction has been undervalued or for defrauding creditors.<sup>3</sup> A transaction shall be considered undervalued where the CD:

'(a) makes a gift to a person; (b) enters into a transaction with a person which involves the transfer of one or more assets by the corporate debtor for a consideration the value of which is significantly less than the value of the consideration provided by the corporate debtor; and such transactions have not taken place in the ordinary course of business of the corporate debtor.'<sup>4</sup>

Where the NCLT is satisfied that an undervalued transaction has been entered into by the CD:

'(a) for keeping assets of the corporate debtor beyond the reach of any person who is entitled to make a claim against the corporate debtor; (b) in order to adversely affect the interests of such a person in relation to the claim', it may make orders as provided under the Code.<sup>5</sup>

The look back period for such transactions is two years preceding the date of commencement of insolvency if it was entered with a related party and one year, otherwise.<sup>6</sup> Section 69 lays down the punishment for an officer of the corporate debtor for defrauding creditors. The section also lays down defences that a director may take in such a situation. A person shall not be punished if he is able to prove that, at the time of the commission of the act, he had no intention to defraud the creditors of the CD.

Moreover, the Code also imposes civil and criminal liability for the erring directors of the company. Civil liability extends to disgorgement of personal assets of directors, whereas in cases of actual fraud, falsification of books of account and siphoning off of funds, the Code imposes fines and imprisonment.

#### A CHECK ON THE PROMOTERS

Another strong deterrence imposed by the Code is the fear of loss of company by the promoters. From the date of appointment of the interim resolution professional, the management of the affairs of the CD vest in the insolvency resolution professional and the powers of the board or the partners of the CD are suspended and exercised by the interim resolution professional.<sup>7</sup> Once, the insolvency resolution professional takes charge of the affairs of the company, the officers and managers of the corporate debtor have to report to the interim professional. Further, the personnel, promoters or any other person associated with the management of the corporate debtor are required to extend all assistance and cooperation to the interim resolution professional as may be required by him in managing the affairs of the company.<sup>8</sup> Therefore, as soon as the company enters into insolvency, promoters lose the management of

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<sup>3</sup> Section 45 (1) of the Code

<sup>4</sup> Section 45 (2) of the Code

<sup>5</sup> Section 49(1) of the Code.

<sup>6</sup> Section 46(1) of the Code

<sup>7</sup> Section 17 of the Code

<sup>8</sup> Section 19 of the Code

the company. In this regard, the observations of the Bankruptcy Law Review Committee (BLRC) are quite pertinent and apt:

'The limited liability company is a contract between equity and debt. As long as debt obligations are met, equity owners have complete control, and creditors have no say in how the business is run. When default takes place, control is supposed to transfer to the creditors; equity owners have no say.'<sup>9</sup>

Under the scheme of the Code, promoters are practically barred from bidding for their own company.<sup>10</sup> This is one of the biggest structural changes introduced by the Code whereby, the promoter loses his company for not complying with the corporate governance norms.

#### INTERNATIONAL PERSPECTIVE

The insolvency framework in the United Kingdom and Italy also emphasises a similar need for protection of the creditors before a company goes into insolvency and the duties of directors that become more onerous once the signs of stress are clear that a situation of insolvency cannot be avoided. The frameworks in the two jurisdictions are briefly discussed below.

#### United Kingdom

The insolvency resolution framework in the United Kingdom (UK) comprises the Insolvency Act of 1986, which was modified by the Insolvency Act of 2000, and the Enterprise Act of 2002. The Insolvency Act, 1986 was supplemented by the Insolvency Rules, 1986 which have been replaced by the Insolvency Rules, 2016. These rules came into effect on April 6, 2017. The Companies Act, 2006 of the UK (hereinafter 'the UK Act') is also an important legislation that is *pari materia* to the Indian Companies Act.

The UK Act lays down the duties of directors. The duties laid down are broad ranging and include the duty to promote the success of the company for the benefit of its members as a whole and in doing so have regard (amongst other matters) to:

- the likely consequences of a decision in the long term;
- the interests of the company's employees;
- the need to foster the company's business relationships with suppliers, customers and others;
- the impact of the company's operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct; and
- the need to act fairly as between members of the company.<sup>11</sup>

As in India, the UK Act does not in the first place, recognise the duty of the directors explicitly towards the creditors of the company. However, under the UK law, the duty to promote the success of the company has been made subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company. The explanatory notes to section 172 of the UK Act clarify that:

'the duty to promote the success of the company is displaced when the company is insolvent. Section

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<sup>9</sup>The Report of the Bankruptcy Law Reform Committee Volume I: Rationale and Design. pp. 10.

<sup>10</sup>Section 29A of the Code

<sup>11</sup>Section 172 of the UK Act.

214 of the Insolvency Act, 1986 provides a mechanism under which the liquidator can require the directors to contribute towards the funds available to creditors in an insolvent winding up, where they ought to have recognized that the company had no reasonable prospect of avoiding insolvent liquidation and then failed to take all reasonable steps to minimise the loss to creditors.'

Thus, as a company's financial position worsens and there are incipient signs of stress, the duties and responsibilities of the directors become more important and undergo a shift in focus from the interests of the stakeholders mentioned under the sections to that of the creditors. The Insolvency Act, 1986 defines 'wrongful trading' which applies (i) once the company has gone into insolvent liquidation, (ii) at some point before the commencement of the winding up, when the directors know, or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.<sup>12</sup> At this point, unless the directors place the company into an insolvency process, they should have taken every step that is available to them in order to minimise the potential loss to the company's creditors. This could include consulting professional advisers, consulting the bankers, taking steps to make financial forecasts etc. The section lays down an objective test which must be applied to come to a finding that the inevitability of the company going into insolvency process was evident. Under the section:

'the facts which a director ought to know or ascertain, the conclusion which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both, (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that director has.'<sup>13</sup>

There is no look back period provided under the section for wrongful trading or fraudulent trading<sup>14</sup> (when in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose) within which a director's actions may be assessed. These provisions under the UK insolvency law finds a place under section 66 of the Code which is titled 'fraudulent trading and wrongful trading' and also has no look back period as is the case with the UK law. A director's failure to comply with the wrongful trading test or with his or her duties (under the UK Act or under common law) may lead to personal liability or disqualification as a director. Consequently, directors are often eager to file for insolvency without too much delay, although a premature filing which causes losses to creditors also presents a risk to directors.

Further, the courts in UK have held<sup>15</sup> that the standard to be applied to assess a director's conduct and for the discharge of his duty to exercise reasonable care, skill and diligence under section 174 of the Companies Act, 2006 has to satisfy this test under section 214 of the Insolvency Act, 1986. This makes the directors' pre-emptive duties more stringent and thus, requires them to be alert to the company's financial situation.

Evidently, the insolvency framework in India is closely modelled to that under the UK law.

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<sup>12</sup> Section 214 of the Insolvency Act, 1986 (UK).

<sup>13</sup> Section 214 of the Insolvency Act, 1986 (UK).

<sup>14</sup> Section 213 of the Insolvency Act, 1986 (UK).

<sup>15</sup> *Re D'Jan of London Ltd, Copp v D'Jan*[1994] 1 BCLC 561; *Cohen v Selby* [2001] 1 BCLC 176 at [21]

The Bankruptcy Law Reform Committee referred to several provisions from the Insolvency Act, 1986 in the UK in its report. The provision of 'wrongful trading' in the UK law incorporates the importance of corporate governance under the insolvency framework. It places on directors the obligation to identify signs of stress and to respond proactively in order to protect the creditor's interests. This combined with the fact that there is no definite look back period for wrongful trading in the UK law and the assessment of whether a director took all possible measures to protect a creditor's interest once it was clear that the company could not have avoided going into insolvency could happen up to an indefinite period preceding the commencement of insolvency, makes the UK and the Indian insolvency framework stringent from a corporate governance perspective. The UK law places on directors the need to shift their focus from the shareholders to the creditors on identification of signs of financial stress and places on them the obligation to identify these signs and take adequate measures to protect the creditors' interest once it becomes evident that a situation of insolvency cannot be avoided.

While the direct nexus between corporate governance and insolvency, has definitely taken a cogent legal form under section 66 with the enactment of the Code, the section aims to shift the focus of directors in the pre-insolvency stage from the shareholders to the creditors and other stakeholders (under section 166 of the Indian Companies Act) of the company. As under the UK law, if the duty of a director to exercise skill, care and diligence under section 166 of the Indian Companies Act is read with the 'wrongful trading' provision of the Code, it is not far-fetched to conclude, that creditors are now envisioned as a stakeholder under the Code towards whom the directors owe fiduciary duties which was not the case under the Companies Act in India. It is important to note that the UK law, like the Indian law, does not place on the directors the obligation to identify signs of financial stress and avoid a situation of insolvency altogether. While this duty may exist on a general interpretation of the duties of directors as codified under the UK Act there is no liability that can be incurred for failure to prevent a company from going into insolvency. In this sense, the Italian law has made some progress recently and is discussed below.

### **Italy**

The insolvency framework in Italy with respect to liability of directors is more expansive than in the UK and India. The Italian law places extensive responsibility on the directors to identify incipient signs of stress in the company's financial position. On January 10, 2019, the Italian Government enacted a new bankruptcy code through the Legislative Decree No. 14/2019 named the '*Code of Crisis and Insolvency*' (the Italian Insolvency Code) which replaces large parts of Italy's insolvency legislation dating back to 1942. The Italian Insolvency Code will enter into force only in August, 2020 and will majorly overhaul Italy's bankruptcy and restructuring framework. The main purpose of the overhaul is to reform the bankruptcy proceedings with a view to preserve the continuity of the company but more importantly, it aims to put in place measures to prevent such a situation of bankruptcy in the first place. This has been done by enacting many corporate governance measures that aim to identify and then, prevent the aggravation of the incipient signs of distress in a company. Certain amendments under the Italian Insolvency Code has also amended certain sections of the Italian Civil Code (ICC) which have come into force since March 16, 2019.

Under the ICC, the definition of 'distress' has been introduced and equated to probable future insolvency, in turn defined as the determination that prospective cash-flows will be insufficient to meet the debtor's expected obligations over the next six months. Several reforms have been introduced including a system of crisis alert measures to identify and address distress situations at a stage when insolvency can still be avoided. Distress as defined under the Italian Insolvency Code will be requisite to trigger the alert measures. This system of alert measures will not apply to listed companies, 'large enterprises' (as defined under the laws of the EU) and financial institutions.

As per the provisions of the ICC, in association with local Chambers of Commerce, a Crisis Composition Committee will be set up to help debtors in working out arrangements with creditors.<sup>16</sup> Further, if statutory or outside auditors are of the opinion that the debtor is in distress, the board of directors must be informed. Further, certain external agencies such as the Tax Authority, the National Social Insurance Agency, and the collection agency, must also immediately notify the debtor, in the event the company fails to pay taxes or social security contributions for an amount exceeding the thresholds provided for by the ICC. These indicators of crisis may be supplemented by additional crisis indicators that a company may adopt if it believes that the ones laid out under the Italian Insolvency Code are insufficient for the circumstances and the financial situation of the company.

A noteworthy change to the ICC is that the directors of all types of businesses that act as corporations or in collective form, i.e. sole proprietorships, joint-stock and limited liability companies will have to take the necessary steps to adopt an organisational, administrative and accounting structure that is appropriate for the nature and size of the company, in order to facilitate the early detection of an emerging sign of distress. After the detection of distress, the directors have a duty to implement those instruments provided by the regulations to overcome the state of crisis and restore the continuity of the business.<sup>17</sup>

Another article of relevance that must be noted is Article 2476 (6) of the ICC which has a new paragraph that has been added. It extends the liability of the directors of a joint-stock corporation as provided under Article 2394 of the ICC to the directors of the limited liability company specifically and states that:

'the directors are liable towards the company's creditors for failure to comply with the obligations inherent to the preservation of the integrity of the company's assets. The cause of action can be proposed by the creditors when the corporation's assets are insufficient to satisfy their claims. The waiver of the action by the company does not prevent the exercise of the cause of action by its creditors. The transaction can be challenged by the company's creditors with a revocatory action when the required grounds are present.'

Thus, the Italian law not only places a responsibility on directors to identify signs of stress when they first appear so as to avert a situation of insolvency, it also seeks to hold them responsible for actions that they took in applying their business judgment to save the crisis but which actually aggravated the situation and drove the company to insolvency. In this regard, the insolvency framework under Italy now seeks to make directors responsible for detecting

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<sup>16</sup> Piscicelli, Carlo de Vito. & Francesco, Iodice. (July 16, 2019) Italy's New Insolvency Code, *Oxford Business Law Blog*, <https://www.law.ox.ac.uk/business-law-blog/blog/2019/07/italys-new-insolvency-code>.

<sup>17</sup> Article 2086 (2), Italian Civil Code, 1942

early stage symptoms of financial distress in a company, and managing the crisis once the incipient signs are identified or limiting the crisis.

Evidently, the amendments made to the Italian Insolvency Code are in line with the evolving corporate jurisprudence that looks at directors as having the ability to steer the company in the direction away from a crisis or insolvency situation. The nexus between corporate governance and companies coming into insolvency is clear. Italy has taken steps to give this nexus a shape and form by expanding the role of the board of a company.

## CONCLUSION

The Italian model makes corporate governance the backbone of the insolvency framework and expands the realm of mandated governance expected from the board of a company to include the responsibility to identify signs of distress and take steps towards aversion of risk of insolvency. Admittedly, there may be external factors that play a role in driving the company to insolvency and it may not always be the case that it is the actions of the directors that are the necessary reason for a crisis. It can be said that in absence of any adverse external factors, the directors may take decisions where even though they were trying to dispel a crisis, they may aggravate a situation. However, these decisions are not questioned by the court if taken within the bounds of economic rationality and prudent business judgment.

The principles of corporate governance inform a duty on the directors to act with care, skill and reasonableness and in the best interests of the company. They have to ensure that provisions of all applicable laws are followed and rights of all stakeholders are respected. The board has a responsibility to monitor conflicts of interest and be alert on misuse of related party transactions. They have to monitor the management effectively, set the culture of the organisation with high ethical standard and take into account the interests of all stakeholders. Non-adherence of these governance principles is often the cause of destruction of value – not only for shareholders but also for all stakeholders. A good governance principle is the first and fundamental line of defence for all stakeholders. If the board and its committees are alert and follow the governance norms in letter and in spirit, the impact of financial distress in the company or its stakeholders could be reduced or averted.

The corporate governance norms under the Companies Act, 2013 and the LODR Regulations have evolved constantly in the last few years. The Code supplements these governance requirements by seeking to refocus the responsibilities of the company and the board towards protecting the interest of the creditors. But often the conflict is not between the interests of the creditors and other stakeholders, such as shareholders, employees, customers and the community but between the stakeholders on one side and the board and management vested with the responsibilities to steer the company away from a crisis situation, on the other. A harmonious working of governance provisions and the insolvency resolution process can be mutually reinforcing and also be beneficial to the larger economy.

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## *Company Law vis-à-vis the Code*<sup>1</sup>

Rohan Kohli

**T**he transformation of the Indian economy from being a *license-raj* regime to the present business-friendly destination of foreign investment has been an arduous one. Central to this success story is the sweeping changes made in the regulatory space with the new Goods and Services Tax and the Insolvency and Bankruptcy Code, 2016 (Code) as the hallmark of such efforts. These path-breaking legislations have been key in significantly changing India's perception globally as a business-friendly environment.<sup>2</sup>

The Code is a comprehensive legislation 'to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner';<sup>3</sup> hence bringing it into force would naturally be a difficult endeavour. The Government has chosen to proceed in a cautious manner to implement it, notifying provisions in a phased manner along with the relevant rules and regulations, and even seeking stakeholders' participation for suggestions. In this manner, while the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) has been repealed entirely, the relevant provisions dealing with winding up in the Companies Act, 2013 (the Act) have been dealt with differently.<sup>4</sup> Certain chapters have been entirely omitted, while others have been substantially amended, even reduced to a skeletal fashion.

Hence, with the Code encroaching into the functioning of the Act, clashes between the two legislations, and subsequent confusion in their manner of working is inevitable. This research has been undertaken with the following objectives:

- Ascertain the change in position of law in the erstwhile Act before and after it was amended by the Code and its present functioning alongside the Code;
- Identify the possible lacunae in the present law which might be subject to misuse; and
- Suggest solutions to cure the lacunae harmoniously between the Act and the Code.

In the first part of this article, the existing law in the Act is examined with the erstwhile position of the law in the Act before the Code came into existence. The next compares the liquidation process under the Code against the Act. The article then identifies possible loopholes in the existing regime, specifically those that emerge with the joint functioning and interaction between the Act and the Code. It then provides for suitable solutions to overcome these

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<sup>1</sup> This is an updated version of an award winning essay of a research writing competition organised by the Gujarat National Law University, in collaboration with the IBBI, in January, 2018.

<sup>2</sup> World Bank, Doing Business Report, 2018.

<sup>3</sup> Preamble of the Code.

<sup>4</sup> Notification No. S.O. 3568(E), 3569(E). November 25, 2016.

loopholes and strengthen the framework. The research questions have been individually mentioned in each of the parts surrounding the central question:

'Whether the entire provisions of winding up in the Act should have been removed or the present situation of partly retaining the provisions in addition to provisions of the Code serves as a better model?'

#### COMPANIES ACT: MODIFIED OR MUTILATED BY THE CODE?

With the sole exception of SICA, the Code has had the greatest impact on the Act under Schedule XI to the Code, which makes 36 changes to the Act. While examining these provisions we seek to answer whether the Act has been amended in an efficient manner or whether it could have been entirely omitted. These provisions assume significance since their scope is immense and applies to all kinds of companies, while SICA specifically applied only to industrial companies.

Chapter XIX sought to borrow the concept of 'sickness' from SICA as a starting point to initiate corporate rescue whereby the company fails to pay 50 percent or more of its outstanding amount of debt within a period of 30 days of service of notice of demand.<sup>5</sup> In fact, the Bankruptcy Law Reform Committee (BLRC) has regarded Chapter XIX as an improvement over erstwhile SICA (features such as greater creditor involvement in rehabilitation, no automatic moratorium, creditor's consent for approval of scheme, appointment of administrators as managers of the company; make it significantly better than SICA, yet acknowledging that the provisions require few substantive changes and institutional changes).<sup>6</sup> Any application for determining a company as sick could be made by either the secured creditor, or the company itself, or several other entities [section 253 (5)]. On determination as a sick company, any secured creditor of that company or the company may make an application to the Tribunal for the determination of the measures that may be adopted with respect to the revival and rehabilitation of such company.<sup>7</sup> The entire Chapter XIX stands omitted by the Code, presumably as the ambit of the resolution plan under the Code is very similar in nature to the revival and rehabilitation scheme under this Chapter. Similarly, any stay that would have been granted by the Tribunal to give a suitable opportunity for the revival to take place under section 289 has also been omitted in view of the automatic moratorium under section 14 of the Code.

The Code also introduced a new definition of 'winding up' in section 2 (94A) whereby winding up means winding up under the Act or liquidation under the Code, thus harmonising both statutes. The Code also introduces ancillary changes to the Act such as substituting the words '*commits default within the meaning of section 271 (2) to pay the amount of his debt or claim*' with '*commits default, within the meaning of section 6 of the IBC, 2016, in respect of the amount of his debt or claims*' for triggering reduction of share capital. Alternatively, inserting words '*liquidator appointed under this Act or the Code*' in section 77 (3) which prescribes that unregistered charges shall not be considered by the liquidator or any creditor.

Such insertions are common throughout the Act - in every place where there is a mention of any exercise of powers by a liquidator (previously appointed under the Act), now reads as being appointed either under the Act or under the Code. Such as in sections 224 (2) (providing for winding up in pursuance to the Inspectors Report) and 230 (1) & (6) (liquidator's power to compromise or make arrangements with creditors).

<sup>5</sup> Section 253 (1) of the Companies Act, 2013.

<sup>6</sup> Interim Report of the BLRC (2015), Department of Economic Affairs, Ministry of Finance, Government of India

<sup>7</sup> Section 254 of the Companies Act, 2013.

A notable change introduced by the Code has been the complete omission of all voluntary liquidation provisions in the Act. Instead, the provisions for voluntary liquidation currently stand in Chapter V of the Code. Further, there are five circumstances for a Tribunal to allow winding up under section 271 (special resolution, the sovereignty of India, fraud, default in compliance, justice and equity). The Code has omitted sub-section (a) – when a company is unable to pay its debt, and sub-section (d) – when a winding up has been ordered under Chapter XIX, which itself has been omitted. Similarly, in section 272 that provides for presentation of petition for winding up, creditors have been removed from being eligible persons to do so; the Registrar has also been barred from instituting a petition stating that the company cannot pay its debt. A joint reading of the changes made in the two sections gives the intention that since the Code provides for a sufficient remedy to institute insolvency resolution, winding up on grounds of inability to pay debt would be a duplication of remedies and is hence unnecessary.

Further, the Code also brings a gamut of institutional changes including insolvency professionals as the practitioners under the Code. Section 275 (2) of the Act which relates to Company Liquidators and their appointments has been harmonised with the Code to the effect that '*any provisional liquidator or the Company Liquidator, as the case may, shall be appointed by the Tribunal from amongst the insolvency professionals registered under the Code.*'

The Act has also been amended in sections 326 and 327 that deal with the waterfall mechanism of preferential payment (refers to the order of priority in payment of liquidation proceeds) and overriding it. Section 326 (2) has been amended to accord the highest priority to workmen's dues and the unrealised portion of the secured asset of a secured creditor additionally on a pro-rata basis with each other. Further, the erstwhile non-obstante clause in section 326 (1) has been dispensed with and sub-section (7) added to section 327 stating that both sections 326 and 327 shall not be applicable in the event of liquidation under the Code, giving a higher priority to the waterfall mechanism provided under the Code vis-à-vis the Act. While this amendment was necessary to give supremacy to the Code and prevent conflict between the non-obstante clause under the Code and the erstwhile non-obstante clause under section 326 (1), this has rendered the Act otiose and a mere rubber stamp. The non-obstante clause under the Code reads as '*the provisions of this Code shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law.*'<sup>8</sup>

The combined effect of this interpretation and the immense positive perception surrounding the Code has resulted in almost every case being instituted in the National Company Law Tribunals (NCLTs) under the Code instead of NCLTs under the Act. The only conclusion emerges is that the approach of retaining winding up provisions under the Act has led to a duplication of remedies. Moreover, since the Code has a clear prominence over the Act, the result has been disproportionately in favour of the Code. Thus, even if the entire Chapters on winding up were omitted by the Code, it would not have caused any manifest injustice to any stakeholder, since the Code provides for an adequate remedy and encompasses the entire scope of insolvency. A further discussion on these interactions between the Act and the Code continues in the forthcoming Parts.

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<sup>8</sup> Section 238 of the Code.

## EFFICIENCY OF THE CODE AGAINST THE ACT

This part shall focus on the question of whether winding up under Chapter XX of the Act provides a more efficient remedy than liquidation under Chapter III of the Code. Since the Code has already repealed Chapter XIX of the Act and voluntary winding up under Part II of Chapter XX, at present the Code is the only statute that also allows for corporate debt recovery as well as voluntary liquidation.

For all practical purposes, the Code is more effective than the Act, since it is a legislation with wide overreach over all other legislations by virtue of the non-obstante clause and wide moratorium under section 14. Further, in the matter of *M/s Innoventive Industries Ltd. v. ICICI Bank Ltd. & Anr.*<sup>9</sup>, the Supreme Court also clarified the prominence of the Code in the clearest words:

'There can be no doubt, therefore, that the Code is a Parliamentary law that is an exhaustive code on the subject matter of insolvency in relation to corporate entities. ... It will be noticed that whereas the moratorium imposed under the Maharashtra Act is discretionary and may relate to one or more of the matters contained in Section 4(1), the moratorium imposed under the Code relates to all matters listed in Section 14 and follows as a matter of course. ... It is precisely for this reason that the non-obstante clause, in the widest terms possible, is contained in Section 238 of the Code, so that any right of the corporate debtor under any other law cannot come in the way of the Code'

Thus, in any conflict between winding up under the Act and an application under the Code, the Code shall prevail. Nevertheless, academic purposes necessitate discussing the finer distinctions.

Creditors can only make an application under the Code –they cannot approach for winding up under the Act anymore by virtue of the amended section 272 (1). A major reason for the Code being perceived as more efficient against the Act is the strict timeline made out in the Code. This could be seen not just from the strict overall time period of 330 days (including any extension and time elapsed in litigation) allowed for the corporate insolvency resolution process (CIRP), but even from the time period of initial scrutiny of the application to ascertain the existence of default has been reduced from previously 90 days under the Act.<sup>10</sup> Now, a CIRP may be initiated by financial creditor (FC) [section 7 (4)], by operational creditor (OC) [section 9 (5)], and by corporate applicant [section 10 (4)] in 14 days.

The reasons for the Code being more efficient than the Act are not limited to the time period under the statutes; but also reflective from the general overall scheme of the Code. The Code is a lean legislation with ample independence given to the committee of creditors (CoC) and the resolution professional rather than micro management by the Tribunal – as is under the Act. Hence, steps such as examination of promoters and directors under section 300 of the Act, floating charges on the company property after winding up under section 332, extensive procedure for fraudulent conduct and the like in sections 336 to 342 which puts liquidators and promoters in threat of pecuniary liability and imprisonment– have been dispensed with. Instead, the Code has introduced several new concepts from common experience which were an existential reality yet were unrecognised in law, examples being undervalued transactions (section 45), transactions defrauding creditors (section 49), extortionate credit transactions

<sup>9</sup> (2018) 1 SCC 407

<sup>10</sup> Section 273 (1) of the Companies Act, 2013.

(section 50 & 51). Further, it has given more weight to concepts that were not adequately recognised earlier such as preferential transactions (sections 43, 44).

Similarly, earlier cases such as *Kritika Rubber Industries v. Canara Bank*<sup>11</sup> took place in which there was lack of basic exchange of information between regulators and adjudicators leading to delays and confusion. One group of secured creditors had initiated an action in the DRT, while another group filed a winding up petition in the High Court. The DRT decided in favour of the creditors and ordered the attachment of the property securing the debt, sold at auction. In the meantime, the High Court ordered the winding up of the debtor and appointed an official liquidator (OL). The OL sought an order to set aside the sale by auction, which the High Court allowed. Interestingly, the parties to DRT proceedings were unaware of the winding up petition, until the auction was set aside.<sup>12</sup>

To prevent such situations, the Code has put in place about information utilities (IUs) as a centralised repository of credit information regarding lenders and debtors.<sup>13</sup> Moreover, under the Act, the entire process is highly judge-centric, while the Code introduces a regulator – the Insolvency and Bankruptcy Board of India (IBBI). This shall encourage more professionalism, a closer oversight over each insolvency application or liquidation by recommending insolvency professionals (when CIRP has been initiated by an OC and no name has been proposed (section 16 (3)), and during replacement of any such professional by the CoC [section 27 (4)], in addition to prescribing standards of appointment and conduct, and conducting research. The result is a vibrant insolvency ecosystem with a continually evolving ecosystem synonymous with the continuously changing landscape.

Although, a lacuna existed which allowed some possibility for disgruntled management or shareholders to try to resist any resolution plan agreed to by the CoC. Such a situation was possible, in case the plan required any action to be undertaken by the company that mandates any form of board or shareholder approval or both. Such action includes corporate restructuring such as mergers, amalgamations, takeovers, slump sale; debt restructuring schemes including debt-equity swaps, increasing or reducing share capital by any means such as issuing or buying back shares etc.; or a combination of these. In this regard, the clarification provided by the Ministry of Corporate Affairs regarding approval of resolution plans under section 30 and 31 of the Code has cleared this ambiguity conclusively.<sup>14</sup> This clarification was sought since section 30 (2) (e) requires the resolution professional to confirm that the resolution plan does not contravene any provisions of the law for the time being in force. Section 31 (1) further binds the approved plan on all the stakeholders such as the corporate debtor, employees, members, creditors, guarantors and authorities to whom statutory dues are owed to – such as Central Government, State Government and local authorities. The circular states:

'the approval of stakeholders/members of the corporate debtor for a particular action required in the resolution plan for its implementation, which would have been required under the Act or any other law if the resolution plan of the company was not being considered under the Code, is deemed to have been

<sup>11</sup> CA No 190/2008.

<sup>12</sup> Rohan Kohli (2016). Corporate Resolution and Insolvency Resolution in India: Lacunae in the present and remedy for the future. *RFMLR3(2)*, pp. 97-102.

<sup>13</sup> Report of the Working Group on Information Utilities (2017). Ministry of Corporate Affairs. Government of India.

<sup>14</sup> General Circular No. IBC/01/2017. Ministry of Corporate Affairs. Government of India.

given on its approval by the Adjudicating Authority.<sup>15</sup>

Thus, there can be no hesitation in affirming the Code is providing a much more efficient remedy for any insolvent company.

#### THE CODE AND THE ACT: POSSIBLE LACUNAE AND LOOPHOLES

This part seeks to answer the question as to what sort of conflicts may arise between the Act and the Code. Any interaction between the Code and the Act can be clearly bifurcated into two spheres, one which relates to transitional periods which can witness confusion over the pending cases as to which forum shall adjudicate and according to which statute. And second, relating to conflicts that may emerge from a gradual and conjoint functioning of the two statutes.

From December 15, 2016, onwards every proceeding under the Companies Act, 1956 relating to winding up where the petition has not been served on the respondent was transferred to the NCLT. However, there is a difference between the winding up cases instituted due to inability to pay debts and otherwise. In the former, the cases shall be treated as application to initiate CIRP under the Code.<sup>16</sup> While in the latter cases, they shall be treated as winding up cases under the Act.<sup>17</sup> Further, any winding up initiated under provisions of SICA – which used to forward winding up cases to the High Courts – shall continue to be dealt by the High Courts as per the provisions of the Companies Act, 1956.<sup>18</sup> This presents a fractured regime since there is scope of overlapping of jurisdiction in cases of multiple petitions being continuing under the previous Acts. However, as these provisions are of a temporary nature, the scope for long lasting delays is minimal.

Currently, section 11 (d) of the Code bars a corporate debtor in respect of whom a liquidation order has been made from making an application to initiate CIRP under the Code – thereby clearly making a demarcation between the Act and the Code. But in reality, the situation has been far from this clarity.

In *Nikhil Mehta & Sons (HUF) & Ors. v. M/s AMR Infrastructures Ltd.*,<sup>19</sup> one of the reasons given by NCLT in dismissing the petition was that 11 winding up petitions had been filed before the High Court, and the official liquidator had been appointed – even though no winding up order had been passed.<sup>20</sup> Whereas in another case, the counsel for the CD has raised an objection with regard to maintainability that a winding up petition is *sub-judice* before the High Court which had already appointed an auditor as well, to which the High Court stated that since no winding up order had been passed and no official liquidator had been appointed, the pendency of the winding up petition cannot operate as a bar under the Code.<sup>21</sup> Thus, until a winding up order has been passed, even the CD can make an application under the Code, and once the winding up order had been made, an application should be made after seeking leave of the court. Nevertheless, the creditor is still open to make an application under the Code even without the leave of the court, since the bar of section 11 does not apply to a creditor. Hence,

<sup>15</sup> Ibid.

<sup>16</sup> Rule 5 (1) Companies (Transfer of Pending Proceedings) Rules 2016.

<sup>17</sup> Id. rule 6.

<sup>18</sup> Id. rule 5 (2).

<sup>19</sup> (ISB)-03(PB)/2017

<sup>20</sup> C.P. No. (ISB)-03(PB)/2017 p 14.

<sup>21</sup> *Alcon Laboratories (India) Private Limited v. Vasan Health Care Private Limited*, C.A/1/ (IB)/2017[5].

these transitional periods could witness at least some amount of such dichotomy when the tribunals grapple with pure questions of law.

In the long run, there is potential for several interesting interactions between the two statutes. One such instance arises while evaluating voluntary liquidation under Chapter V against section 271 (a), which provides for winding up on a special resolution of the company. Prima facie, the latter process might appear counterproductive since it is longer and faces more involvement of the Tribunal than the one under the Code, yet the fine print tells otherwise.

Under section 59 of the Code, a condition precedent to the process is that the corporate must not have committed default, while such a condition is not required under section 271 (a). Default means '*non-payment of debt when whole or any part or instalment of the amount of debt has become due and payable and is not repaid by the debtor or the corporate debtor, as the case may be.*'<sup>22</sup> Debt has been defined as '*a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt.*'<sup>23</sup> Hence, in cases of default, a company cannot voluntarily liquidate itself under the Code, yet by a special resolution may seek winding up under the Act. Interestingly enough section 59(3)(c)(i) of the Code also requires a special resolution to be passed by the company. Thus, why did the Parliament retain the option for members to file for the cumbersome winding up process under the Act, especially since it has no explanation as to when a winding up petition based on section 271(a) is admitted?<sup>24</sup>

One reason could be to afford the company to liquidate itself even if a default subsists, and the creditors want to continue with the functioning—an academic example with little practical justifiable examples. The other reason could be to give the promoters and management greater control over the entire process—since the Code substitutes the management of the company with an insolvency professional and the entire process goes in accordance largely with the creditors. Thus, section 271 (a) provides a silver lining to the management to conduct the process with greater Tribunal oversight - translating into greater management oversight and control over the process. In this regard the provisions are somewhat contradictory in themselves, though they are worded as 'voluntary' liquidation, the special resolution still has to be approved by two-thirds of the creditors [proviso to section 59 (3)], thereby making the process not exactly 'voluntary'.

Further, section 59(3) (a) provides that majority of directors should ascertain whether the company has any debt or not, and if any, whether it can repay the debt from the proceeds of voluntary liquidation. Thus, this section makes a fine distinction between debt and default, with the latter being debt that is 'due'. This may be potentially used by the company to its advantage by seeking to liquidate itself before its debt is 'due' to be paid.

In view of these loopholes, the approach of the Tribunals remains to be seen. Presuming a deference for the process under the Code, the Tribunal may not honour the above approach being taken by the company to circumvent the provisions of the Code – making section 271 (a) irrelevant. Again, this is mere conjecture.

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<sup>22</sup> Section. 3 (12) of the Code

<sup>23</sup> Section of the Code 3 (11).

<sup>24</sup> Anirudh Gotety (2017), Winding-up under section 271(a) of the Companies Act and its Impact on the Insolvency and Bankruptcy Code. *India Corp Law*

## CONCLUSION

Through this research, an attempt has been made to predict and foresee the possible situations where the Code and the Act may coexist and overlap. The result that emerges is virtual supremacy of the Code vis-à-vis the Act. This begs the question that when the Code was intended to be an overarching legislation covering the entire scope and an exhaustive code on the subject matter of insolvency in relation to corporate entities; why were the provisions of Chapter XX of the Act retained. While the previous parts have attempted to provide nuanced solutions to this conundrum, yet the overall result is that the remedy provided in Chapter XX is simply less efficient, and subordinate to the one under the Code. While an argument could be made that Chapter XX is meant to give certain exclusive powers to the corporate debtor by excluding the creditor totally, this argument contradicts the reality that the corporate debtors themselves have been favouring the Code. Of the 148 cases approved so far by the NCLT under the Code, more than a third were initiated by the defaulters themselves.<sup>25</sup>

Hence, to answer the central question of this research, one of the recommendations would be a total omission of Chapter XX, to make a leaner and coherent legislative policy for insolvency.

Alternatively, more clarity can be provided on section 271 (a), as to what circumstances can trigger it, and limit the opportunity of its misuse as a means to circumvent the process of voluntary liquidation under the Code.

The author further recommends that a waiver must be provided for stamp duty for any merger or amalgamation proposed to encourage stressed companies to adopt this as one of the mode under the resolution plan under the CIRP. Not only do M&A tend to result in a much efficient and smoother result than other restructuring modes; but they also lead to greater public benefit, since the entire industry would be better off due to economies of scale, greater efficiency etc. Moreover, creditors should also benefit from this waiver since any encouragement for M&As would mean that their debts could be paid off much faster by the combined entity, and that the creditors would not have to assume management or ownership of the company in any debt-equity swaps.

Finally, one recommendation would be to encourage the use of 'scheme of arrangement' as one of the modes of corporate debt restructuring (schemes of arrangements and compromise are provided under section 230 between the company and its members or creditors including any of their respective classes). Currently, the mode of debt restructuring in India is mainly the various non-judicial schemes launched by the RBI from time to time, the latest being the Prudential Framework for Resolution of Stressed Assets. Paradoxically, the provisions of scheme of arrangement are used mainly for corporate restructuring, but hardly for debt restructuring. The BLRC acknowledges that schemes of arrangement for debt restructuring have been unpopular due to delays, significant costs, and holdouts by creditors, yet can become a very effective tool for debt restructuring, acknowledging however that such restructurings can also be achieved less formally. The BLRC report further talks about 'pre-packaged rescues' where the debtor company and its creditors conclude an agreement for the sale of the company's business prior to the initiation of formal insolvency proceedings. Indian law can recognise such a design as part of a scheme of arrangement.

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<sup>25</sup> Radhika Merwin (July 23, 2017). Debtors have filed over 33% of insolvency cases. *Hindu Business Line*.

One benefit that schemes of arrangement may provide in cases of debt restructuring is that it can be utilised for both insolvent and solvent companies (particularly to enable early restructuring to help avoid insolvency).<sup>26</sup> Even so, it may be suitable to the debtor since there is no requirement to substitute the management, as the Code currently does, helping them in retaining control. Hence, it is recommended that this lesser known mechanism for resolution should be given its due importance as not just an academic reality but also as a viable practical option. Favourable asset classification norms similar to those under the RBI schemes should be introduced to incentivise banks to adopt it.

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<sup>26</sup> Varottil, Umakanth (2017). *The Scheme of Arrangement as a Debt Restructuring Tool in India: Problems and Prospects*. *NUS Law Working Paper 5/2017*.



## Part II

### The Process



# 7

## *Vertical and Horizontal Equity in Corporate Processes*

L. Viswanathan and Gaurav Gupte\*

One of the objectives of the Insolvency and Bankruptcy Code, 2016 (Code), as stated in its preamble, is to '*balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues.*' The Code itself has several provisions which strike a balance between the interests of the several stakeholders in the insolvency process, including that it recognises the rights of creditors of all types.<sup>1</sup> Further, while recognising the rights of all creditors, the Code does not make uniform prescriptions for all creditors; rather, it takes into account the relative situation of the creditors. In '*ensuring equitable treatment of similarly situated creditors*', the Code meets a key objective of an effective and efficient insolvency law as laid down in the Legislative Guide on Insolvency Law prepared by the United Nations Commission on International Trade Law (UNCITRAL).<sup>2</sup>

In practice, several questions need to be addressed to ensure equitable treatment of creditors. For instance, should financial creditors (FCs) and operational creditors (OCs) be treated at par, irrespective of the nature of the debt? In determining payment under a resolution plan, can you disregard the security interests and *inter se* priorities of the FCs? Is it equitable to propose similar treatment for FCs who have crystallised debt and FCs who have contingent debt, say in the nature of guarantees? What about home buyers who belong to the same class as FCs, but whose interests may be completely different from lenders? Can different treatment be proposed for OCs based on the amount of debt? These questions are not merely abstract jurisprudential questions, but have deep economic and social implications as well.

The lawmakers in India have been alive to the challenges posed by the competing claims of creditors and balancing the same in order to reach an equitable outcome. Where required, the Code has been amended, including by way of the recent Insolvency and Bankruptcy Code (Amendment) Act, 2019 (2019 Amendment). The Insolvency and Bankruptcy Board of India (IBBI) has also been reviewing the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (CIRP Regulations) and has introduced amendments to address emerging issues. In addition, the National Company Law Tribunal (NCLT), the National Company Law Appellate Tribunal (NCLAT) and the Supreme Court of India have significantly contributed to the development of the law.

With this background, this article examines the application of the principles of equity to creditors in the context of the corporate insolvency resolution process (CIRP). The article

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<sup>1</sup> The Report of the Bankruptcy Law Reform Committee (2015) had recommended that one of the principles of the Code should be that the '*Code will respect the rights of all creditors equally.*'

<sup>2</sup> UNCITRAL, Legislative Guide on Insolvency Law (2005).

specifically examines such application to creditors in different classes (vertical equity) and creditors in the same class (horizontal equity).

### VERTICAL EQUITY

The principle behind vertical equity is enshrined in section 30(2)(b) of the Code. Section 30(2)(b), as amended by the 2019 Amendment, requires that every resolution plan:

- (b) provides for the payment of debts of operational creditors in such a manner as may be specified by the Board which shall not be less than –
  - (i) the amount to be paid to such creditors in the event of a liquidation of the corporate debtor under section 53; or
  - (ii) the amount that would have been paid to such creditors, if the amount to be distributed under the resolution plan had been distributed in accordance with the order of priority in sub-section (1) of section 53, whichever is higher...

Explanation 1. – For the removal of doubts, it is hereby clarified that a distribution in accordance with the provisions of this clause shall be fair and equitable to such creditor.’

Section 30(2)(b), as originally enacted, only required that OCs should receive a payment not less than the amount to be paid to such creditors in the event of a liquidation of the corporate debtor (CD) (hereinafter, the 'liquidation value due to OCs.'). In this respect, the provision was similar to provisions in insolvency laws of other jurisdictions, namely the United States (US) and the United Kingdom (UK).

Section 1129(a) of Chapter 11 of the United States Bankruptcy Code (US Code) sets out the minimum requirements which a proposed reorganisation plan should meet in order to be confirmed by the courts. Section 1129(a)(7) of the US Code provides that:

'each holder of a claim or interest will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under Chapter 7 of this Title on such date.'<sup>3</sup>

This test codified under section 1129(a)(7) of the US Code is known as the 'best interest of creditors test' and is an individual guarantee to each creditor that it will receive at least as much in the reorganisation as it would have in case of liquidation.<sup>4</sup>

In the UK, whilst there is no explicit statutory provision regarding vertical equity, courts have applied the principle of vertical equity while evaluating voluntary arrangements. Section 6 of the Insolvency Act, 1986 provides that any voluntary arrangement may be challenged, *inter alia*, by a creditor of the company on the grounds that the voluntary arrangement '*unfairly prejudices the interests of a creditor, member or contributory of the company.*' Courts have assessed fairness of voluntary arrangements against the benchmark of '*the irreducible minimum below which the return in the voluntary arrangement cannot go.*'<sup>5</sup> This benchmark is determined by comparing what a creditor would receive in the voluntary arrangement *vis-à-vis* what that creditor would receive in the alternative to the voluntary arrangement, that is, liquidation of the company. In a landmark judgment *In Re T & N Ltd.*,<sup>6</sup> it was held that:

<sup>3</sup> United States Bankruptcy Code, of Chapter 11, section 1129(a).

<sup>4</sup> Hicks J. (2005). Foxes Guarding the Henhouse: The Modern Best Interests of Creditors Test in Chapter 11 Reorganizations, *Nevada Law Journal*, Vol. 5:3.

<sup>5</sup> *Mourant & Co. Trustee Ltd. v. Sixty UK Limited (In Administration)*, [2010] EWHC 1890 (Ch).

<sup>6</sup> [2004] EWHC 2361 (Ch).

'I find it very difficult to envisage a case where the court would sanction a scheme of arrangement, or not interfere with a voluntary arrangement, which was an alternative to a winding up, but which was likely to result in creditors, or some of them, receiving less than they would in a winding up of a company, assuming that the return in a winding up would in reality be achieved and within an acceptable time-scale.'

This principle of assessing fairness has also been upheld in *Prudential Assurance Co. Limited v. PRG Powerhouse Limited*.<sup>7</sup>

Indeed then, the principle of vertical equity enacted in section 30(2)(b) of the Code that OCs should receive a payment not less than the liquidation value due to OCs, is in line with the international practice. In practice, the amounts proposed to be paid under successful resolution plans have often been insufficient to satisfy even the claims of the secured FCs in full. Consequently, the liquidation value due to OCs would be nil and no provision for any payment to them would be made.

However, the NCLAT found this position to be discriminatory. In *Binani Industries Limited v. Bank of Baroda*<sup>8</sup> (hereinafter 'Binani Industries'), the NCLAT laid down the following principles to be taken into account while evaluating a resolution plan:

- i. The liabilities of all creditors who are not part of 'Committee of Creditors' must also be met in the resolution.
- ii. The 'Financial Creditors' can modify the terms of existing liabilities, while other creditors cannot take risk of postponing payment for better future prospectus. That is, 'Financial Creditors' can take haircut and can take their dues in future, while 'Operational Creditors' need to be paid immediately.
- iii. A creditor cannot maximise his own interests in view of moratorium.
- iv. If one type of credit is given preferential treatment, the other type of credit will disappear from market. This will be against the objective of promoting availability of credit.
- v. The 'I&B Code' aims to balance the interests of all stakeholders and does not maximise value for 'Financial Creditors'.
- vi. Therefore, the dues of creditors of 'Operational Creditors' must get at least similar treatment as compared to the due of 'Financial Creditors'.

The NCLAT observed that:

'the 'I&B Code' or the Regulations framed by the Insolvency and Bankruptcy Board of India do not prescribe differential treatment between the similarly situated 'Operational Creditors' or the 'Financial Creditors' on one or other grounds.'

and:

'a discriminatory plan ... is against the basic object of maximization of the assets of the 'Corporate Debtor' on one hand and for balancing the stakeholders on the other hand.'

The NCLAT further observed that:

'If the operational creditors are ignored and provided with liquidation value on the basis of misplaced notion and misreading of Section 30(2)(b) of Code, then in such case no creditor will supply the goods or render services on credit to any corporate debtors. All those who will supply goods and provide services, will ask for advance payment for such supply of goods or to render services which will be against the basic principle of the Code and will also affect the Indian economy.'

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<sup>7</sup> [2007] EWHC 10002 (Ch).

<sup>8</sup> Company Appeal (AT) (Insolvency) Nos. 82, 123, 188, 216 and 234 of 2018.

This position was further reinforced by the NCLAT in the case of *Standard Chartered Bank v. Satish Kumar Gupta, R.P. of Essar Steel and Ors.*,<sup>9</sup> wherein the NCLAT observed that:

'In the present case, we have noticed a huge discrimination made by the 'Committee of Creditors' in distribution of proposed amount to the 'Operational Creditors' qua 'Financial Creditors'. Majority of the 'Financial Creditors' have been allowed 99.19% of their claim amount, whereas 'NIL' i.e. 0% in favour of the 'Operational Creditors'. Such distribution is not only discriminatory but also arbitrary.'

The NCLAT then held that:

'Sub-clause (b) of sub-section (2) of Section 30 of the 'I&B Code' mandates that the 'Resolution Plan' must provide for the payment of the debts of 'Operational Creditors' in such manner as may be prescribed by the Board which shall not be less than the amount to be paid to the 'Operational Creditors' in the event of a liquidation of the 'Corporate Debtor' under Section 53. That means, the 'Operational Creditors' should not be paid less than the amount they could have received in the event of a liquidation out of the asset of the 'Corporate Debtor'. It does not mean that they should not be provided the amount more than the amount they could have received in the event of a liquidation which otherwise amount to discrimination.'

Similarly, the NCLAT did not permit a distinction between secured and unsecured FCs. It observed that:

'it is evident that there is no distinction made between one or other 'Financial Creditor'. All persons to whom a financial debt is owed by the 'Corporate Debtor', which debt is disbursed against the consideration for time value of money, whether they come within one or other clause of Section 5(8), all of such person form one class i.e. 'Financial Creditor' they cannot be sub-classified as 'Secured' or 'Unsecured Financial Creditor' for the purpose of preparation of the 'Resolution Plan' by the 'Resolution Applicant'.'

Thereafter, the NCLAT held that:

'the 'Financial Creditors' cannot be discriminated on the ground of 'Secured' or 'Unsecured Financial Creditors' for the purpose of distribution of proposed amount amongst stakeholders in the 'Resolution Plan' by the 'Resolution Applicant'.'

When dealing with a constitutional challenge to the treatment of OCs in *Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.*<sup>10</sup> the Supreme Court (SC) observed that:

'The NCLAT has, while looking into viability and feasibility of resolution plans that are approved by the committee of creditors, always gone into whether operational creditors are given roughly the same treatment as financial creditors, and if they are not, such plans are either rejected or modified so that the operational creditors' rights are safeguarded.'

However, the SC also went on to state that:

'It may be seen that a resolution plan cannot pass muster under Section 30(2)(b) read with Section 31 unless a minimum payment is made to operational creditors, being not less than liquidation value.'

It may be implied from the above observation of the SC that the minimum payment of liquidation value to OCs was sufficient to hold a resolution plan to be in compliance with the Code thereby reinforcing vertical equity.

Further, section 30 as amended by the 2019 Amendment, recognises a distinction between FCs who vote in favour of a resolution plan (assenting creditors) and FCs who do not vote in

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<sup>9</sup> Company Appeal (AT) (Ins.) No. 242 of 2019.

<sup>10</sup> (2019) 4 SCC 17.

favour of a resolution plan (dissenting creditors) and provides that a resolution plan should provide for '*the payment of debts of financial creditors who do not vote in favour of the resolution plan, in such manner as may be specified by the Board, which shall not be less than the amount to be paid to such creditors in accordance with sub-section (1) of section 53 in the event of a liquidation of the corporate debtor.*' Thus, section 30 guarantees minimum liquidation value to dissenting creditors.

The erstwhile regulation 38(1)(b) of the CIRP Regulations had similarly mandated the payment of the liquidation value to the OCs and the dissenting FCs. However, the NCLAT had, in *Central Bank of India v. Resolution Professional of Sirpur Paper Mills Ltd.*<sup>11</sup> held that regulation 38(1)(b) was *ultra vires* the Code as it had the effect of discriminating between two sets of creditors similarly situated, by discriminating between assenting creditors and dissenting creditors. The NCLAT observed that:

'...the Board may make regulation but it should be consistent with the I&B Code and rules made therein (by Central Government) to carry out the provisions of the Code. Therefore, we hold that the provisions made by the Board cannot override the provisions of I&B Code nor it can be inconsistent with the Code. Clause (b) and (c) of Regulation 38(1) being inconsistent with the provisions of I&B Code, and the legislators having not made any discrimination between the same set of group such as 'Financial Creditor' or 'Operational Creditor', Board by its Regulation cannot mandate that the Resolution Plan should provide liquidation value to the 'Operational Creditors' (clause (b) of regulation 38(1)) or liquidation value to the dissenting Financial Creditors (clause (c) of regulation 38(1)). Such regulation being against Section 240(1) cannot be taken into consideration and any Resolution Plan which provides liquidation value to the 'Operational Creditor(s)' or liquidation value to the dissenting 'Financial Creditor(s)' in view of clause (b) and (c) of Regulation 38(1), without any other reason to discriminate between two set of creditors similarly situated such as 'Financial Creditors' or the 'Operational Creditors' cannot be approved being illegal.'

Thus, it was held that the Code did not make any such discrimination and the regulation cannot mandate the resolution plan to provide liquidation value to the dissenting creditors. *Vide* an amendment dated October 5, 2018, the IBBI amended regulation 38(1) of the CIRP Regulations to omit the requirements regarding payment of the liquidation value to the dissenting creditors. With the 2019 Amendment, the requirement has been introduced in the Code itself and cannot be challenged on the grounds of being *ultra vires*.

The 2019 Amendment has come into effect after the above judgments of the NCLAT and the SC. Section 30(2)(b)(ii) introduced by the 2019 Amendment, together with the explanation to the section provides that distribution of any amounts under a resolution plan in accordance with the liquidation waterfall in terms of section 53 would be fair and equitable distribution. Accordingly, the principle of vertical equity has been statutorily recognised.

#### HORIZONTAL EQUITY

Section 30 of the Code does not expressly make any provision for 'horizontal equity'. The question has arisen whether resolution plans may provide for differences in treatment within the classes of FCs or OCs. For instance, in *Binani Industries*,<sup>12</sup> it was observed that:

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<sup>11</sup> Company Appeal (AT) (Insolvency) No. 526 of 2018.

<sup>12</sup> *Supra* note 8

‘...it will be evident that the ‘Financial Creditors’ such as, ‘Edelweiss Asset Reconstruction Company Limited’, ‘IDBI Bank Limited’, ‘Bank of Baroda’, ‘Canara Bank’, ‘Bank of India’ and ‘State Bank of India’ has been provided with 100% of their verified claim, the ‘Resolution Applicant’ (‘Rajputana Properties Private Limited’) has given lesser percentage to Export-Import Bank of India (72.59%) and State Bank of India-Hong Kong (10%). Discrimination has been made on the ground that some of the ‘Financial Creditors’ are direct exposure to the ‘Corporate Debtor’ or some of the ‘Financial Creditors’ to whom the ‘Corporate Debtor’ was guarantor. Even the guarantors who are treated to be the ‘Financial Creditors’, such as ‘IDBI Bank Limited (Dubai Branch)’, ‘Bank of Baroda (London)’, ‘State Bank of India (Bahrain)’, ‘Syndicate Bank’ have been provided with 100% proposed payment of their verified claim but the ‘Export-Import Bank of India’ and the ‘State Bank of India (Hong Kong)’ who are similarly situated have been discriminated.’

Taking into account the above facts, the NCLAT held that *‘but such ground cannot be taken to discriminate between two same sets of the Creditors namely the ‘Financial Creditors’ who are similarly situated as guarantors.’*

However, in the case of *State Bank of India v. Adhunik Alloys & Power Ltd.*<sup>13</sup> the resolution plan provided for a distinction between FCs based on the nature of the security interest held by them. The NCLT, Kolkata Bench observed that *‘creation of class amongst the financial creditors is known in law and being applied in cases in which successful resolution plan was approved’*. The Tribunal distinguished the *Binani Industries* case by noting that:

‘Hon’ble Appellate Tribunal has discussed at length about the discrimination amongst similarly situated creditors and not unequal creditors. What is held in the said judgment is that “two same set of the creditors namely financial creditors cannot be discriminated”. So, unsecured creditors who are financial creditors cannot be equated with financial creditors who had first charge by creating security interest and the creditors who had 2<sup>nd</sup> charge or 3<sup>rd</sup> charge etc. the challenge in the case in hand is not similar to the facts set out in the above said case.’

The Tribunal further noted that *‘...reading of the Hon’ble Appellate Tribunal’s judgment as a whole, it appears to me that different categories of financial creditors respective to their security interest cannot be held equal.’*

The approach of the Tribunal was consistent with the approach taken in other jurisdictions. *In re Palisades-on-the-Desplaines Seidel v. Palisades-on-the-Desplaines et al.*<sup>14</sup>, the US Circuit Court of Appeals had observed as follows:

‘All creditors of equal rank with claims against the same property should be placed in the same class. This is natural, logical, and a simple basis of division. Conversely, creditors of different ranks, or creditors of the same rank but with claims against different properties, should be placed in different classes. The owners of a mortgage which is a first lien on certain property should be in a class other than one containing the owners of a mortgage which is a second lien on the same property. So, also, the holders of a mortgage, which is first lien on certain property should be in a class other than the one containing the holders of a mortgage which is a first lien on other property. We have no hesitancy in accepting that lucid and cogent statement as a general rule, but after all, it is an interpretation of a very general expression of the law-making power which, of necessity, must be construed in the light of the respective circumstances surrounding each case in which the question arises. This fact essentially may give rise to exceptions to the rule.’

<sup>13</sup> C.A. (IB) No. 1086/KB/2018 & C.A. (IB) No. 1092/KB/2018 in C.P. (IB) No. 387/KB/2017.

<sup>14</sup> 89 F.2d 214 (7th Cir. 1937).

The 2019 Amendment, in section 30(4), provides that while considering the resolution plan, *'the committee of creditors may approve a resolution plan by a vote of not less than sixty-six per cent of voting share of the financial creditors, after considering its feasibility and viability, the manner of distribution proposed, which may take into account the order of priority amongst creditors as laid down in sub-section (1) of section 53, including the priority and value of the security interest of a secured creditor, and such other requirements as may be specified by the Board...'*. This could ensure that primacy of security and priority of the creditors is maintained. Additionally, on a reading of section 30(2)(b) with section 30(4) of the Code, it becomes clear that the value of the security of a secured creditor over an asset is maintained as the creditor is afforded an option to dissent and realise the liquidation value of the security held by such creditor. Hence, the creditors who have a better value of security would not be forced to receive a lesser payment under the resolution plan.

From the language of Explanation 1 to section 30(2) which clarifies that *'a distribution in accordance with the provisions of this clause shall be fair and equitable to such creditor'*, it appears that the courts would deem distribution in accordance with section 30(2) to be fair and equitable.

#### CONCLUSION

It is evident that the Indian insolvency law has adopted the principles of vertical equity and horizontal equity in the evaluation of resolution plan. While vertical equity is derived from the provisions of the Code itself, horizontal equity is a product of case law, particularly judgments of the NCLAT. The principles of vertical equity and horizontal equity are vital for the credit market. In light of the objective of the Code to promote availability of credit, these principles must be adhered to as these are core to the foundation of the credit markets.

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# 8

## *Liquidation and Voluntary Liquidation Process*

Sunil Mehta

**L**iquidation has been defined as a process of bringing a business to an end and distribution of the assets of the company between persons having claims over the company. Liquidation is a consequence of being insolvent and / or having no realistic prospect of a going concern. Liquidation could be compulsory or voluntary. Compulsory liquidation usually occurs when a company is unable to pay its dues to its obligor in part or full, not only when it is due, but also as a deferred payment in future based on the available assets as against the liabilities of corporate entity. This liquidation is generally forced by the creditors. Voluntary liquidation usually occurs when a company has no realistic prospects to remain a going concern. The inability of payment of dues is not the case when situation of voluntary liquidation arises. Voluntary liquidation is forced by the entity itself through its board of directors. Businesses need efficient and speedy procedures for exit as much as for start-up. World over, insolvency procedures help entrepreneurs close down unviable businesses and start up new ones. This ensures that the human and economic resources of a country are continuously channelised to efficient use, thereby increasing the overall productivity of the economy. Considering the importance, many countries have reformed the insolvency processes. India is no exception to this.

### LIQUIDATION UNDER THE CODE

Before the enactment of Insolvency and Bankruptcy Code, 2016 (Code), the option of liquidation was available to bankers even in the days of the Board for Industrial and Financial Reconstruction (BIFR), which had been set up under the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA). The route, however, involved considerable delay as promoters would often declare themselves sick and avail of a moratorium period over which recovery could not be initiated.

It was essential to provide for a sound framework for restructuring and rehabilitation of companies along with a framework for winding up and liquidation. The framework should seek to preserve the estate and maximise the value of assets; recognise *inter se* rights of creditors and provide equal treatment to similar creditors, while dealing with small creditors equitably. This resulted in framing of the Code .

Liquidation has gradually gained momentum since the enactment of Code which aims at preservation as well as maximisation of value of assets created by an entity by keeping an organization as a going concern and simultaneously resolving the financial stress on the entity. Under the Code, a large number of companies have been liquidated or are under liquidation.

As per quarterly newsletter of the Insolvency and Bankruptcy Board of India (IBBI), till quarter ending June 2019, 2162 cases were admitted for Corporate Insolvency Resolution Process (CIRP), out of which 475 cases have ended with commencement of liquidation. In addition, 452 cases of voluntary liquidation were also admitted, of which, 56 firms have so far been dissolved, final reports have been submitted in 114 cases and 338 are at different stages of the process.

The liquidation process, especially voluntarily liquidation, has become the thrust area for the financial creditors (FCs), other stakeholders, investors and professionals.

### LEGAL FRAMEWORK

The provisions regarding liquidation contained in Chapter III (section 33-54) of the Code came into effect from December 15, 2016 and provisions regarding voluntary liquidation contained in Chapter V (section 59) of the Code came into effect from April 1, 2017. The legal framework is mainly covered by separate regulations issued by the IBBI as per power conferred by section 196 of the Code.

In pre-Code regime, the winding up was governed by the Companies Act, 1956. However, new provisions of winding up were provided in the Companies Act, 2013 (the Act of 2013) under Chapter XX, but the same were not notified till effective date of the Code. The Code has amended Companies Act, 2013 by virtue of section 255, as per schedule XI of the Act. Accordingly, winding up was defined under the Act of 2013 as 'Winding up under this Act or liquidation under Insolvency and Bankruptcy Code, 2016, as applicable'. Further, at the same time the provision regarding voluntary winding up was omitted from the Act of 2013. Accordingly, it could be interpreted that while the winding up will be governed by both Companies Act and the Code, liquidation and voluntary liquidation will be governed by the Code.

### FINE LINES BETWEEN WINDING UP, LIQUIDATION, VOLUNTARY LIQUIDATION

In general understanding, winding up, liquidation and voluntary liquidation are the same thing. All these processes end up with the dissolution of the corporate entity. However, in legal arena all three differ in terms of applicability, procedure & processes.

#### **Winding Up**

'Winding up' in terms of the Act of 2013 is to be decided by the National Company Law Tribunal (NCLT), where:

- Company has decided the same by virtue of special resolution; or
- Company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality; or
- Affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose or the persons concerned in the formation or management of its affairs have been guilty of fraud or misconduct in connection therewith; or
- Company has defaulted in filing of its financial statements / annual returns with

- registrar for the immediately preceding consecutive five financial years; or
- It is just and equitable that the company should be wound up.

### **Liquidation**

By virtue of Schedule XI of the Code, reason 'if the company is unable to pay its debts' was removed from the above list. Accordingly, it is clear that in case of default of payment of dues, the creditors cannot directly refer the company for liquidation / winding up but has to undergo CIRP first. Liquidation will be the last resort if resolution under CIRP fails. Liquidation under the Code is to be initiated by Adjudicating Authority (AA) if:

- No resolution plan is received or approved by the Committee of Creditors(CoC)and submitted by the Resolution Professional (RP) to AA within the timeline applicable to CIRP / Fast Track Insolvency Process; or
- Resolution plan submitted by RP is rejected by AA due to non-compliance; or
- CoC decides to liquidate the corporate debtor (CD) even before confirmation of resolution plan (even before preparation of information memoranda).
- Contravention by CD after approval of resolution plan by AA.

Since, CIRP could be initiated by any operational creditor (OC), CD or financial creditor (FC), the liquidation is effectively initiated by the company itself or its creditors in cases where any default was committed by the CD, obviously after assessing the possibility of resolution.

### **Voluntary Liquidation**

'Voluntary liquidation' as the name suggests, means liquidation at own will. However, a corporate entity which is incorporated by a law subject to certain permissions and process could not be liquidated *suo motu* without safeguarding the interest of its stakeholders. Voluntary liquidation is to be initiated by the CD, when there is no default. As per Section 59(6) of the Code, the provisions of section 35 to 53 (applicable in case of liquidation) shall also apply to voluntary liquidation proceedings. Accordingly, for entering into voluntary liquidation the following compliances are required to be done:

- Declaration by majority of the designated partners of Limited Liability Partnership (LLP) / individual consisting of a governing body by an affidavit that (i) Either the corporate has no debt or that it will be able to pay its debt in full from the proceeds of assets to be sold under liquidation; (ii) the corporate person is not being liquidated to defraud any person. Such declaration is to be supported by audited financial statements and record of business operations of two years and a report of valuation of the assets;
- Passing of resolution within 4 weeks of declaration, by special majority of LLP Partners or contributories, appointing the liquidator or to voluntarily liquidate the company due to expiry of its duration as fixed by constitution documents;
- In case the company owes any debt, the resolution is to be approved by the creditors representing two-third of the debt value within 7 days;
- The resolution to be notified to IBBI and Registrar of Companies (ROC) within 7 days of passing resolution or approval, as the case may be.

Thus, the major difference between liquidation and voluntary liquidation is applicability and the party eligible to initiate.

## ROLE OF LIQUIDATOR

The entire process of liquidation/voluntary liquidation relies on the liquidator and accordingly, the liquidator has been given significant powers. As powers and responsibilities go side by side, the liquidator carries legal as well as moral responsibilities.

The major powers and duties of the liquidator which are to be performed along with compliance of the Act, Rules and Regulations include the following:

- invite, verify and settle the claim of all the creditors;
- to take the custody / control of all assets including actionable claims;
- to measure the assets and prepare the reports;
- protection and preservation of assets;
- carry the business of the CD for its beneficial liquidation;
- sale of assets, realisation of actionable claims;
- power to transfer the assets to other person and giving lawful right to person acquiring the assets;
- to become signatory for all valid purposes;
- to institute or defend any suit or other legal proceedings;
- to take out, in its official name, letter of administration of any deceased contributory;
- to engage professionals to assist him/ her in the discharge of his duties;
- to submit the Preliminary Report, Progress Report, Asset Sale Report and Final Report to AA.

The liquidator carries all the powers of the board of directors /key managerial personnel of the CD. For performance of the duties, the liquidator has to charge the fees as may be decided by the CoC. However, IBBI (Liquidation Process) Regulations, 2016 also define the schedule of fees. The schedule of fees is designed in such a way that clearly links the liquidator's compensation with its timely and effective performance. The more effectively and efficiently the liquidator performs its duties, more the payable fees.

Since the liquidator is entrusted with significant duties and powers, it is expected that liquidator will perform its duties with morals and ethics along with compliance of law. Accordingly, any related party of the CD, auditors or legal or consulting firm (including its employees, partners / directors) are not eligible for becoming the liquidator subject to certain conditions given in the regulations.

### **Liquidation Estate**

During the process of liquidation, the liquidator shall form an estate of assets, which is termed as the liquidation estate of the CD. The assets to be included and not to be included in liquidation estates are as under:

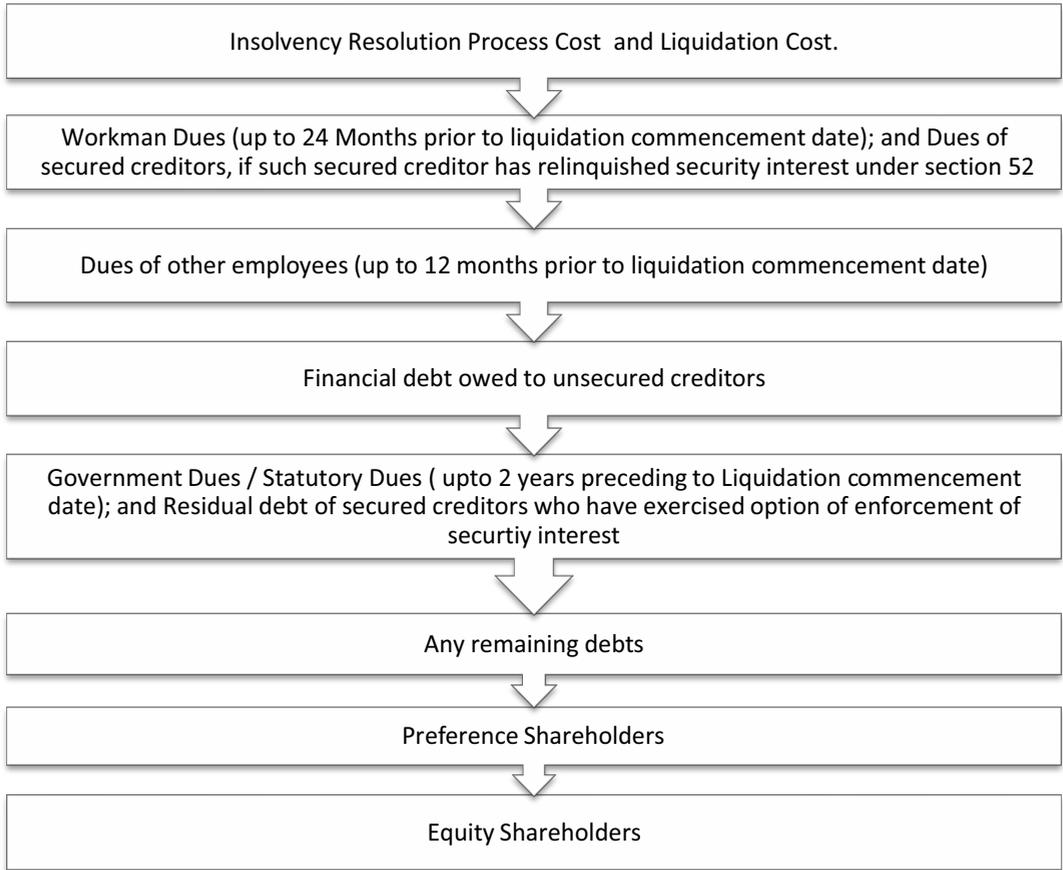
Included Assets	Excluded Assets
Assets on which the CD has the ownership rights, including assets not under possession or encumbered assets	Assets held in trust for any third party which are in possession of CD
Tangible assets, whether movable or immovable	Collateral held by financial services providers which are subject to netting and set-off in multi-lateral trading or clearing transactions
Intangible assets including shares held in subsidiaries of CD	Provident Fund, Pension Fund or Gratuity fund to the extent it is due
Assets subject to determination of ownership by the court	Contractual arrangement for use of asset which does not transfer the title
Any assets recovered through proceeding of avoidance of transactions	Personal assets of shareholders / partners
Any other assets as on liquidation commencement date	Bailment contracts
The assets on which secured creditors relinquished security interest	The assets on which secured creditors opted to realise their charge under section 52

When it comes to liquidation estate, one of the important terms is 'Contributory' which means a person liable to contribute towards the assets of the company in the event of it being wound up. In common terms, the shareholder / member is the contributory. However, the holder of partly paid share is the contributory with liability as holder of fully paid up share does not carry any liability. The contributory not only includes the present members but also includes any member who was the holder of unpaid share, within one year from the liquidation commencement date, for the liabilities incurred till it was the member of the company. The role of contributory is not only practical but also very important especially when there is a company with partly paid up share or limited by guarantee as it may be a source of significant funds.

#### WATERFALL MECHANISM UNDER THE CODE

Secured creditors are given option either to stand outside the liquidation process by realising their dues from sale of assets charged to it or to relinquish their security interest in favour of the liquidator's estate. It may be stated that it is the secured creditor's commercial call to select any option which may be based on certain factors such as possibility of realisation of security, ease of control and possession, sharing of security or possible demarcation.

Subject to the option considered by the secured creditors, the distribution of the amount realised from liquidation estates will be done in the figure below:



### LIQUIDATION PROCESS AND TIMELINES

Liquidation process is described in IBBI (Voluntary Liquidation Process) Regulations, 2017 and IBBI (Liquidation Process) Regulations, 2016. The regulations prescribe the indicative timelines for timely completion of liquidation process. Liquidation process includes the following steps:

- Commencement of liquidation along with appointment of liquidator. The liquidation commencement date is the deciding factor of further timelines and position of assets and liabilities;
- Public announcement calling stakeholders to submit their claims, to be published in one English and one regional newspaper, website of CD and IBBI;
- The claim of all the stakeholders will be received and verified and correct classification of the same will be done for the purpose of distribution of proceeds from realisation of assets;
- A Stakeholders' consultation committee shall be constituted within 60 days from liquidation commencement date which will include members from secured FCs, unsecured FCs, workmen and employees, Government, OCs, shareholders as per weightage and maximum members defined in regulations subject to a minimum of

one member representing each class of stakeholders. The meeting of stakeholders' consultation committee shall be convened as and when necessary or when request is received from at least 51 per cent of the representatives. However, the advice of stakeholders' consultation committee will be non-binding on liquidator;

- The early dissolution of the company may be requested to AA if it is felt that the cost of liquidation will exceed the estimated realizable value of assets;
- The liquidator shall prepare list of contributories for unpaid capital and realise the contribution to the extent of unpaid value of shares by sending a notice to make the payment within 15 days;
- Preliminary report is to be submitted by liquidator to AA within 75 days from liquidation commencement date which shall include capital structure, estimates of asset and liabilities based on books of CDs or reliable records, as may be available, decision regarding desired inquiry on any matter of CD and proposed plan of liquidation process;
- Asset Memorandum shall be prepared by liquidator within 75 days from the liquidation commencement date which shall include the assets intended to be realised along with valuation supported by registered valuer report, mode of realisation, expected realisation amount and other related information relating to assets;
- Progress reports are to be submitted by the liquidator within 15 days from the end of quarter in which he is appointed and further reports within 15 days from end of each quarter during liquidation. The report shall include all developments taken during the quarter and accounts maintained by liquidator. The reports for last quarter of the financial year also include audited accounts of receipts and payments. The progress report shall also include the asset sale report wherever in any preceding quarter any sale has taken place containing description of asset sold and facts regarding mode and value of sale;
- With respect to assets charged with secured creditors, where the secured creditors have not relinquished their security interest and not proposed to exercise their rights under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI), or the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDBFI), the liquidator may find a possible buyer at a proposed value (or better value) indicated by secured creditor within 21 days from the days of receipt of intimation from secured creditor;
- In case, the liquidator fails to sale any asset, the same may be distributed to stakeholders with the permission of AA;
- Final Report before dissolution will be prepared with complete details of liquidation proceedings and liquidation costs and submitted to AA with necessary formalities for order of dissolution;
- Any unclaimed proceeds of liquidation or undistributed asset are to be kept into Companies Liquidation Account in the Public account of India which shall be further transferred to general revenue account of Central Government, if remains unclaimed for 15 years;

## SALE OF ASSETS UNDER LIQUIDATION

The liquidator may sell the assets on standalone or collectively, slump sale/parcels or going concern basis. Further, the mode of sale may be by way of auction or private sale. Further, the auction process may be either electronic or physical depending upon the likelihood of maximising the realisation from the sale of assets. The liquidator may sell only such encumbered assets on which relinquishment of charge by secured creditors is extended in favour of liquidator's estate.

The sale is to be ordinarily executed by way of transparent auction process. However, sale may be held on private sale basis if asset is of perishable nature or value likely to deteriorate, or price higher than the reserve price of failed auction if realised or with the approval of AA. However, prior permission of AA is to be taken in any case if the asset is proposed to be sold to related party of CD, related party of liquidator or any professional appointed by liquidator.

The sale of assets is the main pillar of the liquidation process and 'timely and equitable realisation' from the asset sale is the backbone of the successful resolution process. The major challenges faced by the liquidation process, presently are lack of bidding during auction, long implementation period and delayed processes. Thus, the sale of assets under liquidation is a more challenging area for the professionals i.e. liquidators as compared to the RP. The failure of CIRP lends a company to liquidation but failure of liquidation has no conclusive ending and is a time lagging process. The reason behind such liquidation process may be either inadequate marketing or deterioration in the asset.

Thus, when an asset is to be sold through auction the liquidator needs to prepare a proper marketing strategy which is not limited up to preparing asset information sheet and releasing advertisement. The liquidator carries the independent responsibility equivalent to key managerial personnel of the company and there is a need of proactive approach and aggressive marketing strategy for the overall interest of all stakeholders and preserving economical value of assets.

## WAY FORWARD

The successful conduct of liquidation process is the primary responsibility of liquidator and efforts are required to be made by liquidator for maximum realization from the liquidation estate. However, the role of other stakeholders is equally vital for the success of liquidation process. Towards this, the Code has made a legal framework for creation of 'Stakeholder's Consultation Committee'. This committee can contribute significantly by way of developing marketing strategy for sale of assets as well as finding the prospective buyers.

Another practical issue observed in liquidation process is the lack of a common portal/platform for publicity of auction notices under liquidation unlike available in case of invitation of resolution plan on IBBI portal. It leads to lack of awareness among the prospective buyers as the current source of publicity of auction notices are mainly newspapers or company's website. In case of CD which are not well known in market, the auction notices get unnoticed. Accordingly, a common portal for displaying liquidation notices is the need of the hour so that assets under liquidation may reach maximum eye balls beyond geographical boundaries.

To conclude, it is desired that the liquidation process should not result in death of the assets of the company. Therefore, there is a need of developing a secondary market which will go a long way in preserving the economic assets and their revival.

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## *Criminal Jurisprudence and the Code*

Virender Ganda<sup>1</sup>

**T**he Insolvency and Bankruptcy Code, 2016 (Code) was introduced with an objective to consolidate and amend the laws relating to reorganisation of the insolvency resolution of corporate persons, partnership firms and individuals in a time-bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and to balance the interests of all stakeholders. Although the provisions of the Code assume a civil nature, it is significant not to overlook provisions that identify certain actions of persons *viz.* corporate debtor (CD), resolution professionals etc. as criminal offences. Chapter VII of Part II of the Code enumerates such criminal offences and calls for initiation of criminal actions by the Adjudicating Authority (AA), once they come to light.

### SECTIONS FOR PUNISHMENT

Chapter VII provides for offences that otherwise adversely affect the corporate insolvency resolution process (CIRP), when it is initiated against a CD. Sections 68 to 77 explicitly layout punishments for certain actions like concealment of property of CD (section 68), transactions defrauding creditors (section 69), for any misconduct in course of CIRP (section 70) as well as for falsification of books of CD (section 71). Nevertheless, any wilful and material omission from statements related to affairs of CD (section 72) and false representation to creditors (section 73) are also treated as offences under this Chapter. Besides, a contravention of moratorium or the resolution plan would constitute an offence (section 74) as in the case of furnishing false information in an application (section 75 and 77). Also, any non-disclosure of dispute or payment of debt by operational creditors (OC) is also considered as an offence (section 76) under the Code. To strengthen the restraints mentioned above, the Code provides for punishment with fine (section 235A) if any contravention escapes the clutches of express provisions for penalty/punishment. Such offences mentioned under this Code are to be tried by a Special Court (section 236), notwithstanding anything in the Code of Criminal Procedure, 1973, established under Chapter XXVIII of the Companies Act, 2013 (the Act of 2013).

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<sup>1</sup> The author would like to thank Ms. Chandreyee Maitra and Mr. Rahul Menon, for their invaluable assistance during the drafting of this article.

The offences (in brief) and their respective punishments under Chapter VII of the Code are tabulated below:

Section of the Code	Offence	Imprisonment	Fine
68	Concealment of property of the CD	Not less than three years and may extend up to five years	Not less than one lakh rupees but may extend to one crore rupees
69	Transactions defrauding creditors	Not less than one year and may extend up to five years	Not less than one lakh rupees but may extend to one crore rupees
70	Misconduct in course of CIRP	Not less than three years and may extend up to five years	Not less than one lakh rupees but may extend to one crore rupees
71	Falsification of books of the CD	Not less than three years and may extend up to five years	Not less than one lakh rupees but may extend to one crore rupees
72	Wilful and material omissions from statements relating to affairs Of the CD	Not less than three years and may extend up to five years	Not less than one lakh rupees but may extend to one crore rupees
73	False representation to creditors	Not less than three years and may extend up to five years	Not less than one lakh rupees but may extend to one crore rupees
74	Contravention of moratorium or the resolution plan	Not less than one year or three years [as the case may be, under sub-section (1), (2) or (3)] and may extend up to five years	Not less than one lakh rupees but may extend to three lakh rupees or one crore rupees, as the case may be, under sub-section (1), (2) or (3)
75	False information furnished in application	No imprisonment	Not less than one lakh rupees but may extend to one crore rupees
76	Non-disclosure of dispute or payment of debt by operational creditor	Not less than one year and may extend up to five years	Not less than one lakh rupees but may extend to one crore rupees
77	Providing false information in application made by the CD	Not less than three years and may extend up to five years	Not less than one lakh rupees but may extend to one crore rupees

In 2001, the Report of Dr. N. L. Mitra Committee on Legal Aspects of Bank Frauds expressed concerns over the growing corporate offences of criminal nature. It emphasised upon the procedural complexities and confusion arising out of it. An excerpt of the report in this regard is as follows:

It is true that modern Criminal law in advanced countries has made corporate entities also subject to criminal liabilities. In India we are experimenting in the same line but not through classical Criminal law that is, through amendment to Indian Penal Code and Criminal Procedure Code. In some cases, criminalizing through business law, say, Companies Act or by Negotiable Instrument Act has backfired creating confusion in the administration of Criminal law. Criminal law as a matter of fact, has to attain definitional perfection and at the same time delimit the area of offence with proper care. Police, prosecution, criminal courts and the prison are the ones to act in unison to maximise the effect of criminal justice.'

However, the scenario changed in a decade with more corporate actions being brought under the ambit of criminal offences. A cue regarding the same can be drawn from Report of the Committee to review offences under the Act of 2013, where, while discussing the classification of offences under this Act, it has been stated that certain act/defaults are of serious nature which require the rigours of criminal trial. Such act may affect larger public interest,

shareholder's interest, creditor's interest or it may affect the going concern nature of the company itself. There may also be an element of deceit, an intent to siphon out funds etc. Thus, it can be understood that the aforesaid offences were drawn on similar lines, even though no detailed explanation was given for such classification either in the Code or in the report of the Parliamentary Joint Committee on the Insolvency and Bankruptcy Code, 2015.<sup>2</sup>

### SPECIAL COURTS

Historically, the establishment of Special Courts under the Act of 2013 was a long step overdue, in dealing with the corporate offences. The foremost recommendations in this regard was made by Dr. J. J. Irani in its Committee Report on Company Law.<sup>3</sup> These recommendations were approved by the Ministry of Corporate Affairs and found its way to the Fifty-Seventh Report of the Standing Committee on Finance. Finally, the provision for establishment of Special Courts was introduced into the Companies Bill, 2009. The major objective behind creation of Special Courts, under the Act of 2013 was to ensure speedy disposal of cases, so that the usual long-time gap between the commission of fraudulent activities and final hearing of the cases is done away with. This idea was rightly imported for dealing with the aforesaid offences in the Code as well.

While the procedural aspects of the Code maintain that the AA is empowered to arrive at a finding or observation and that certain action comes under the purview of Chapter VII of Part II of the Code, once such finding or observation is made, the power to initiate a trial shifts to a Special Court. The Special Court shall be deemed to be a Court of Session and the person conducting the prosecution shall be deemed to be a public prosecutor (section 236 of the Code). Section 236 of the Code thus lays down that the offences shall be tried by a Special Court established under Chapter XXVIII of the Act of 2013 as mentioned above. Under section 435 of the said Act, it is the Central Government which must establish or designate a Special Court for the purpose of speedy trial of offences. Accordingly, Ministry of Corporate Affairs, Government of India has issued several notifications from time to time thereby vesting jurisdiction of Special Courts in Courts of Session.

However, the corporate offenders in the above-mentioned cases undergo a trial only when prescribed authorities approach the Court of law with a complaint. This has been underlined in the Act of 2013 as well. For example, under section 58AAA of the Companies Act, 1956 (the Act of 1956), it was only the Central Government, or any person authorised by it, who could make complaint for any offence committed under section 58A or section 58AA of the Act of 1956. The intention behind vesting the power to make a complaint only upon the Central Government or the regulatory authority may have been to prevent the abuse of power or process. The same is also evident from perusal of the Report of the Joint Committee on the Insolvency and Bankruptcy Code, 2015, wherein it has been stated that the powers of making a complaint was given to the Insolvency and Bankruptcy Board of India (IBBI) or Central Government to do away with any issues relating to recording of statement and filing of police report. A parallel to section 58AAA of the Act of 1956 can be drawn in the Bankruptcy laws *vide* section 236 of the Code. The Special Court may proceed to try the offence made out in the complaint as a summons case or a warrant case as stipulated under the Code of Criminal Procedure, 1973.

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<sup>2</sup> Report of the Parliamentary Joint Committee on the Insolvency and Bankruptcy Code, 2015, Lok Sabha, April 2016.

<sup>3</sup> Report on Company Law, Dr. J. J. Irani Expert Committee on Company Law, (May 31, 2005).

The Special Courts, thus, can take cognisance of the offences only when a complaint is made by the Central Government, the IBBI or an authorised person as the case may be, as laid down by section 236 (2) of the Code.

Section 236 (2) is as follows:

'(2) No Court shall take cognisance of any offence punishable under this Act, save on a complaint made by the Board or the Central Government or any person authorised by the Central Government in this behalf.'

Thus, cognisance of offences can be made only upon a complaint made by the IBBI, the Central Government or by any person authorised by the Central Government. The said parties can make a complaint only when there is an information dissemination in this regard. This necessitates impleadment of the IBBI and/or the Central Government or any other person authorised by the Central Government, in such applications moved before the AA. In the absence of the IBBI or Central Government as parties to the proceedings, the observation/finding of the AA may remain confined to the files of the AA only. Only after the IBBI or the Central Government are impleaded as parties, the AA may direct the IBBI or Central Government to investigate into any alleged commission of offence and thereafter make a complaint before the Special Court. This in turn ensures that the complainant or the prosecutor is the 'State' thereby upholding the prosecuting responsibilities of the State. The idea of State being a prosecutor sprouts from the responsibility of a welfare state to prevent crimes against its subjects. However, the Code remains silent on whether AA can direct the Central Government or the IBBI to make a complaint in this regard and whether such directions are mandatory or directory in nature.

#### COGNISANCE OF OFFENCES

As mentioned above, the cognisance can be taken only by the Special Court pursuant to a complaint made by the designated entities. The Code although makes implied reference to finding or observation made by the AA to form a basis of the said complaint, it does not clarify as to whether it constitutes a cognisance. At this point, it would be helpful to investigate a few case laws where the Hon'ble Supreme Court (SC) explained the meaning of the term cognisance. In *Subramanian Swamy v. Manmohan Singh and Anr.*,<sup>4</sup> the SC explained the meaning of the word 'cognisance' holding that:

'...In legal parlance cognisance is taking judicial notice by the court of law, possessing jurisdiction, on a cause or matter presented before it so as to decide whether there is any basis for initiating proceedings and determination of the cause or matter judicially.'

In *CREF Finance Ltd. v. Shree Shanthi Homes (P) Ltd. and Anr.*,<sup>5</sup> the SC has laid out the meaning of taking cognisance. The Court held as follows:

'...Once the court on perusal of the complaint is satisfied that the complaint discloses the commission of an offence and there is no reason to reject the complaint at that stage, and proceeds further in the matter, it must be held to have taken cognisance of the offence. One should not confuse taking of cognisance with issuance of process. Cognisance is taken at the initial stage when the Magistrate peruses the complaint with a view to ascertain whether the commission of any offence is disclosed.

<sup>4</sup> (2012) 3 SCC 64

<sup>5</sup> (2005) 7 SCC 467

The issuance of process is at a later stage when after considering the material placed before it, the court decides to proceed against the offenders against whom a prima facie case is made out...'.<sup>6</sup>

The SC further in *S.R. Sukumar v. S. Sunaad Raghuram*<sup>6</sup> emphasised upon the satisfaction of the Court to the commission of offence as a condition precedent for taking cognizance of offence. The SC held:

'..."Cognizance" therefore has a reference to the application of judicial mind by the Magistrate in connection with the commission of an offence and not merely to a Magistrate learning that some offence had been committed. Only upon examination of the complainant, the Magistrate will proceed to apply the judicial mind whether to take cognizance of the offence or not. Under Section 200 Code of Criminal Procedure, when the complainant is examined, the Magistrate cannot be said to have ipso facto taken the cognizance, when the Magistrate was merely gathering the material on the basis of which he will decide whether a prima facie case is made out for taking cognizance of the offence or not. "Cognizance of offence" means taking notice of the accusations and applying the judicial mind to the contents of the complaint and the material filed therewith. It is neither practicable nor desirable to define as to what is meant by taking cognizance. Whether the Magistrate has taken cognizance of the offence or not will depend upon facts and circumstances of the particular case.'

In the light of the mentioned cases it becomes clear that cognizance of an offence is established by way of application of judicial mind. Therefore, when a magistrate takes cognizance of an offence it is implied that a *prima facie* case has been made out. The scheme of the Code, thus, has been so drafted that the opinion formed by the AA forms the basis of a *prima facie* case being made out in the complaint made by the IBBI or Central Government. Under section 236 (3) of the Code, the provisions of the Code of Criminal Procedure, 1973 are made applicable to the proceedings before a Special Court.

#### AMBIGUITY IN ROLE OF ADJUDICATING AUTHORITY

Notwithstanding anything mentioned above, the Code leaves grey areas while ascertaining the role of the AA in respect of the aforesaid offences and subsequent proceedings. This can be explained with reference to section 33 (3) of the Code.

According to Section 33 (3) of the Code:

'(3) Where the resolution plan approved by the AA is contravened by the concerned corporate debtor, any person other than the corporate debtor, whose interests are prejudicially affected by such contravention, may make an application to the AA for a liquidation order as referred to in sub-clauses (i), (ii) and (iii) of clause (b) of sub-section (1)

Sub-section 1 (b) of section 33 states:

1) Where the AA, --

(a) ...

(b) rejects the resolution plan under section 31 for the non-compliance of the requirements specified therein,

it shall --

- i. pass an order requiring the corporate debtor to be liquidated in the manner as laid down in this Chapter;
- ii. issue a public announcement stating that the corporate debtor is in liquidation; and
- iii. require such order to be sent to the authority with which the corporate debtor is registered.'

<sup>6</sup> (2015) 9 SCC 609

Section 33 (3) also talks about the contravention of approved resolution plan by the concerned CD. While this section by itself, provides an opportunity for affected persons to move an application for liquidation, when read with section 74 (3) constitutes an offence, the cognizance of which shall be taken by a Special Court upon a complaint made either by the IBBI, the Central Government or any person authorised by the Central Government in this behalf. It is pertinent to mention that the power for arriving at a finding that the action of the CD is punishable is vested in the AA. However, once its finding is done/observation is made on a *prima facie* reading, the AA will have to issue notice to the Central Government or the IBBI as the case may be, thereby impleading them as parties to the proceedings. As already explained, the Code remains silent as to whether the AA can direct the Central Government or the IBBI as the case may be, to make a complaint, although section 236 (2) rightly upholds the role of State in Criminal Jurisprudence. In the event of AA being powerless to direct the parties to make a complaint, its role confines to making observation or finding in this regard.

It could be understood that in the absence of a complaint made by the IBBI or the Central Government as the case may be, the AA and its findings remains dormant with respect to the offence committed. Further, it is relevant to mention that the said complaint is to be made by the Central Government or the IBBI as the case may be, to the Court which can take cognizance in the matter. Even in this case, the finding/observation made by the AA remains relevant only to the extent that the information dissemination to the complainant is ensured.

In a situation where a complaint is registered by the IBBI or the Central Government, the procedure of preparation of charge sheet and a subsequent fair trial based on the principles of natural justice appreciating available evidence is not detailed in the Code. In such a scenario, the general law, i.e., provisions of Code of Criminal Procedure, 1973 is presumed to be followed. A basic understanding of the Code of Criminal Procedure, 1973 suggests that such a complaint made by the IBBI or the Central Government as the case may be, triggers the proceeding right from issue of summons to investigation and report, charge and subsequently a trial, appreciation of evidence and judgment.

The National Company Law Appellate Tribunal (NCLAT) has considerably clarified the role of the AA and the procedure to be followed before initiating any criminal procedure under the Code, in its very recent consolidated judgment dated August 16, 2019, in the matters of *Committee of Creditors of Amtek Auto Ltd. through Corporation Bank v. Mr. Dinkar T. Venkatasubramanian and Others, Liberty House Group Pte Ltd. v. Mr. Dinkar T. Venkatasubramanian and Others, Liberty House Group Pte Ltd. v. the Committee of Creditors of Amtek Auto Ltd. and Another.*<sup>7</sup>

The NCLAT has set aside an order passed by the AA, which had granted liberty to the resolution professional and the committee of creditors to move before the IBBI or the Central Government. After discussing in detail the procedure which ought to be followed to enable the IBBI or Central Government to initiate a criminal proceeding, the NCLAT has concluded that the resolution professional or the committee of creditors or any creditor should make an application under section 213 of the Act of 2013 read with the relevant provision of the Code,

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<sup>7</sup> Company Appeal (AT) (Insolvency) No. 219 of 2019 with Company Appeal (AT) (Insolvency) No. 442 of 2019, Company Appeal (AT) (Insolvency) No. 443 of 2019

before the AA. In disposing the said application, the AA has to decide if the matter ought to be referred to the IBBI or the Central Government for taking any action under section 213 of the Act of 2013 and the relevant provision of the Code. Upon satisfaction, the AA may request the Central Government to investigate the matter and the basis of opinion formed after the investigation, the Central Government may decide whether to make a complaint under the provisions of the Code or not. From the judgment it appears that the NCLAT has prevented any party from approaching the IBBI or Central Government, directly, to prevent possible violations of the principles of natural justice before the executive and regulatory authorities such as IBBI or Central Government.

#### CRIMINAL JURISPRUDENCE UNDER THE CODE AND THE ACT OF 2013

Nonetheless, the lack of clarity with respect to the role of AA does not confine to the provisions of the Code. This becomes evident on a plain reading of section 74(3) of the Act of 2013.

Section 74 (3) states:

'If a company fails to repay the deposit or part thereof or any interest thereon within the time specified in sub-section (1) or such further time as may be allowed by the Tribunal under sub-section (2), the company shall, in addition to the payment of the amount of deposit or part thereof and the interest due, be punishable with fine which shall not be less than one crore rupees but which may extend to ten crore rupees and every officer of the company who is in default shall be punishable with imprisonment which may extend to seven years or with fine which shall not be less than twenty-five lakh rupees but which may extend to two crore rupees, or with both.'

Similarly, section 76A of the Act of 2013 deals with punishment of contravention of section 73 or section 76. Section 76A says that:

'Where a company accepts or invites or allows or causes any other person to accept or invite on its behalf any deposit in contravention of the manner or the conditions prescribed under section 73 or section 76 or rules made thereunder or if a company fails to repay the deposit or part thereof or any interest due thereon within the time specified under section 73 or section 76 or rules made thereunder or such further time as may be allowed by the Tribunal under section 73,—

- (a) the company shall, in addition to the payment of the amount of deposit or part thereof and the interest due, be punishable with fine which shall not be less than 2[one crore rupees or twice the amount of deposit accepted by the company, whichever is lower] rupees but which may extend to ten crore rupees; and
- (b) every officer of the company who is in default shall be punishable with imprisonment which may extend to 3[seven years and with fine] which shall not be less than twenty-five lakh rupees, but which may extend to two crore rupees.

Provided that if it is proved that the officer of the company who is in default, has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or depositors or creditors or tax authorities, he shall be liable for action under section 447.'

As mentioned earlier, the role of AA is not explicitly delineated in the Act. Alienation of Civil Courts with respect to the jurisdiction when coupled with establishment of Special Courts for the offences so laid out implies that the role of AA cannot be extended to trial of criminal offences. In a case where offences committed by the stakeholders in corporate cases increasingly knock the doors of AA, such lacunas and grey areas need to be removed and clarified so as to achieve the objectives of Corporate Laws in the country.

## CONCLUSION

While the AA can be recognised as a judicial body essentially vested with civil jurisdiction, the Special courts are vested with criminal jurisdiction arising out of offences as laid out in Chapter VII of the Code. It is pertinent to note that there may arise numerous situations where there can be an overlap between the findings of the two distinct legal forums. Reliance can be placed on the judgment of the apex court in *Kishan Singh (D) through LRs. v. Gurpal Singh and Others*.<sup>8</sup> In this judgment, the SC considered a catena of judgments on the issue of civil and criminal proceedings arising out of same cause of action. It has been concluded that the proof being different in civil and criminal proceedings, findings of fact recorded by Civil Court do not have any bearing so far as the criminal case is concerned and vice versa. However, based on factual and contextual circumstances, provisions of section 41 to 43 of the Indian Evidence Act, 1872 dealing with the relevance of provisions of judgments in subsequent cases may be taken into consideration.

The AA under the provisions of the Code makes its own finding or observation while, the Special Court must form its independent opinion after trial. The opinion or finding of the Special Court, which has all the trappings of a Court of Session/criminal court, is based on the principles of criminal jurisprudence. One major tenet of criminal jurisprudence being presumption of innocence until proved guilty posits that the finding of the AA shall have no bearing on the entire procedure of trial. As such, it renders the role of AA irrelevant.

The Code, in its present form, clearly envisages the complaint to be made to the special court, by the IBBI or the Central Government. Even though the NCLAT in the judgment referred to as above,<sup>9</sup> has resolved issues and doubts to some extent, the procedure to be followed by any person having knowledge/apprehension is far from clear, particularly as to whether such person should directly move the Central Government or IBBI or it has to necessarily approach the AA to procure the *prima facie* finding with respect to commission of an offence.

Since, the Code came into force in December, 2016 and most proceedings before the AA are now reaching stage of invoking the provisions of the Code inviting criminal prosecution, it is hoped that things would be clearer in times to come.

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<sup>8</sup> AIR 2010 SC 3624

<sup>9</sup> *Committee of Creditors of Amtek Auto Ltd. through Corporation Bank v. Mr. Dinkar T. Venkatasubramian and Others, Liberty House Group Pte Ltd. v. Mr. Dinkar T. Venkatasubramian and Others, Liberty House Group Pte Ltd. v. The Committee of Creditors of Amtek Auto Ltd. and Another.*

## *The Non-Obstante Clause in the Code*

U. K. Chaudhary

**H**ailed as one of the biggest legal reforms in the economic progress of the country, aimed at resolving the alarming non-performing assets (NPAs) of the banking sector, the Insolvency and Bankruptcy Code, 2016 (Code) has seen a litigious, yet impactful journey in its less than three-year history. Time and again, the Code has undergone a comprehensive assessment and consequent amendments to reconcile and adapt the working of its provisions to suit the pragmatic needs of the banking and finance industry. Much of the success that the Code has had, in resolving the insolvencies in a timely manner, can be accredited to judicial supplements which fill in the gaps in the working of the Code. The Code, being still in the nascent stage, owes a lot to judicial interpretations that makes its working meaningful and effective.

The Hon'ble Supreme Court of India (SC) is now faced with yet another task of determining an important question in the evolving jurisprudence of the country's insolvency law. The issue is whether the provisions of the Code will prevail over the Securities and Exchange Board of India Act, 1992 (SEBI Act). The question is one which will require maintaining a fine balance between the two laws and allowing a harmonious interplay of the two so as to not render either one nugatory.

The dispute that escalated to the SC stems from the attachment of properties of one HBN Dairies and Allied Limited (HBN Dairies), which was found by the regulatory authority being Securities and Exchange Board of India (SEBI) to have illegally collected close to Rs. 1,136 crore from various stakeholders under an unauthorised scheme known as 'Collective Investment Schemes'. The orders of SEBI, under section 28A of the SEBI Act, directing attachment and consequent sale of assets, were upheld by the Securities Appellate Tribunal (SAT). However, frustrated by the long delay in the recovery under the procedure prescribed under the SEBI Act, some unit holders approached the adjudicating authority, National Company Law Tribunal (NCLT), Principal Bench, New Delhi, seeking initiation of insolvency proceedings under the Code. The NCLT admitted the petition and order moratorium under section 14 of the Code. The NCLT was of the view that provisions of the Code will prevail over section 11 and 11B of the SEBI Act read with regulation 65 of the SEBI (Collective Investment Scheme) Regulations, 1999, in view of section 238 contained in the Code, which gives the Code an overriding effect over any other law for the time being in force. The foundation for the observations lay in an earlier judgment of the SC in the case of *Pr. Commissioner of Income Tax v. Monnet Ispat and Energy*

*Ltd.*,<sup>1</sup> in which it was categorically held that given section 238 of the Code, it is obvious that the Code will override any other law, including the Income Tax Act, 1961.

As a consequence of the order of the NCLT, Principal Bench, SEBI was prevented from recovering any money from the sale of assets of HBN Dairies or taking any coercive action under the SEBI Act. SEBI assailed the order of the NCLT before the National Company Law Appellate Tribunal (NCLAT) which upheld the order of the NCLT and dismissed the appeal. The issue, therefore, is now pending consideration on appeal before the SC.

In the background of the above observations of the NCLT, Principal Bench, on the non-obstante clause contained in the Code, the position of law that emerges is that the Code will have an overriding effect on any other legislation that is found to be inconsistent with the provisions of the Code. This position of law, as reiterated by the NCLT, Principal Bench, is completely in conformity with the SC's decisions on this point as on the date of the order.

The question of overriding effect has been a subject of judicial interpretation for quite some time and there has been a consistent view adopted by the courts in India. This question was first considered by the SC in the case of *Innoventive Industries Ltd. v. ICICI Bank and Anr.*<sup>2</sup> Court was faced with the task of reconciling the provisions of the Maharashtra Relief Undertaking (Special Provisions) Act, 1958 (MRUA) and the Code. While orders granting relief from repayment of debt were passed under the MRUA by the Government, the financial creditor (ICICI Bank) approached the NCLT for initiating insolvency proceedings against the corporate debtor (CD). The SC took the view that the non-obstante clause contained in section 238 of the Code, has been couched in very wide terms and the purpose for the same is that any right of the CD under any other law cannot come in the way of the Code.

The SC elaborately dealt with the provisions of the Code and the scheme and object of the Act and contrasted it with the insolvency laws of other countries, and concluded that there is a paradigm shift in the law that has been enacted through the Code. It further observed that the Code has been passed after great deliberations and discourse.

It may not be out of place to mention here that both the SEBI Act and the Code are special legislations governing their respective fields of operations. While the SEBI Act aims to protect the interest of investors in securities and promotes the development, regulation and the sanctity of the securities market, the Code consolidates and amends the laws relating to reorganisation and insolvency resolution of corporate persons in a time bound manner. The aim of the Code is the maximum realisation of the value of assets of corporate persons.

While the two legislations do not appear to have any overlapping spheres of operation, yet in case of a conflict between the two, the question that begs consideration is that which of the two should prevail over the other? The first course of action should naturally be to give a harmonious interpretation to the provisions of the two legislations. This is so because the underlying objects governing the two legislations are different. While the Code aims at achieving the resolution of an entity by keeping it as a going concern, the SEBI Act seeks realisation of the value of assets by attachment and consequent sale. However, in case the interpretation is one that leads to a conflict, then the latter legislation must prevail.

This view is in conformity with the law laid down by the SC in the case of *Solidaire India*

<sup>1</sup> SLP (C) No. 6483/ 2018

<sup>2</sup> (2018) 1 SCC 407

*Ltd. v. Fair growth Financial Services Ltd. and Others.*<sup>3</sup> The position of law, as it emerges from this case, is that in case of conflict between two special legislations, the latter piece of legislation must prevail. This is because at the time of enactment of the later statute, the legislature is deemed to be aware of the earlier legislation.

The determination of the question of overriding effect of the provisions of Code, by the SC, assumes even more significance in view of the fact that it is likely to have a bearing on the interplay of Code with other legislations such as the Prevention of Money Laundering Act, 2002 (PMLA), the Companies Act, 2013 and the Advocates Act, 1961 etc.

#### THE CODE AND PREVENTION OF MONEY LAUNDERING ACT, 2002

The overriding effect of the non-obstante clause, contained in the Code, was also a subject of judicial determination by the NCLT, Mumbai Bench in the case of *Sterling SEZ Infrastructure Ltd. v. Deputy Director, Directorate of Enforcement*.<sup>4</sup> This case pertained to the interplay of Code with PMLA. In this case, proceedings under PMLA were initiated against the Applicant (Sterling SEZ Infrastructure Ltd.) by the Enforcement Directorate on account of certain fraudulent loan transactions by its holding company. Accordingly, the assets of the Applicant were attached under section 2(1)(u) of the PMLA. However, soon after the attachment order, an application under section 7 of the Code came to be filed against the Applicant/CD. The same came to be admitted and accordingly, an order under section 14 of the Code, imposing moratorium came to be passed. Accordingly, the CD made an application to the NCLT, Mumbai Bench, for a direction to the Enforcement Directorate for release of the provisionally attached assets. The question for determination before the NCLT, Mumbai Bench was whether the provisions of the Code have an overriding effect on the provisions of PMLA?

The NCLT, Mumbai Bench, declared the attachment order of the Enforcement Directorate under the PMLA, as null and void. The reasoning that prevailed with the NCLT, Mumbai Bench, was that the purpose and object of the Code is the resolution of the CD by maximising the value of assets under a regime of strict enforcement of time lines. Whereas, the object of PMLA is to recover properties from wrong doers and compensate the affected. The resolution under the Code being far quicker than under the PMLA, the economic aspect of the same lent support to the conclusion that Code must prevail over PMLA. The NCLT, Mumbai Bench, concluded by holding that the provisions of section 238 of the Code give an overriding effect to the order of moratorium under section 14 of the Code, and thus, the order of attachment was squarely hit by the moratorium. Interestingly, one of the criteria for reaching the conclusion that the provisions of the Code must prevail over the PMLA, was the economic implication of proceedings under the two apparently conflicting pieces of legislation. The NCLT, Mumbai Bench, was of the view that the quicker resolution under the Code was economically more viable than the long-drawn proceedings under the PMLA. If this view of the NCLT also finds favour with the SC, in its determination of the conflict between the Code and the SEBI Act, then it may be inclined to hold in favour of the Code, considering the long-drawn proceedings under the SEBI Act.

In contradiction to this, the Hon'ble High Court (HC) of Delhi also had the occasion to deal

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<sup>3</sup> (2001) 3 SCC 71

<sup>4</sup> M.A. No. 1280/2018 in C.P. No. 405/2018

with the conflict between the provisions of the Code and the PMLA, in the case of *The Deputy Director, Directorate of Enforcement, Delhi v. Axis Bank & Ors.*<sup>5</sup> The HC in that case was dealing with the interplay of PMLA with Recovery of Debt Due to Banks and Financial Institutions Act, 1993 (RDDBFI), Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI) and the Code. After going through the objects and reasons for enactment of the four legislations, the HC noted that all these laws are distinct and operating in different fields. They must co-exist with each other and each to be construed and enforced harmoniously, without one being in derogation of the other. This view taken by the HC is different from the view taken by the NCLT, Mumbai Bench. The reasoning that prevailed with the HC was that the object and purpose of these legislations being very different from each other, there was no overlap and therefore, none of the legislations was in derogation of the other.

The views of the two forums being different, the decision of the SC will aid in interpreting the interplay of these two enactments and ultimately, put a quietus to the issue.

#### THE CODE AND COMPANIES ACT, 2013

Before the advent of the Code, it was solely the Companies Act, 1956 and thereafter, the Companies Act, 2013 (the Act), that dealt with all issues related to companies, right from incorporation to dissolution. However, with the advent of the Code, a company can be wound up either under the Companies Act or under the Code, based on the fact and circumstances of the case. Now, the Code comprehensively deals with the aspect of a company's insolvency and its resolution. Matters that are exclusively under the purview of the Code, will in case of any conflict with the provisions of the Act prevail by virtue of section 238 contained in the Code.

The NCLAT, in the case of *Jagmohan Bajaj v. Shivam Fragrances Private Limited & Anr.*<sup>6</sup> had the occasion to deal with an apparent conflict of the provisions of the Code with the Companies Act, 2013. In this case, the order granting admission of an application for initiating corporate insolvency resolution process against the CD, was assailed on the ground that a serious dispute of oppression and mismanagement of the CD was pending adjudication under sections 241 and 242 of the Act, before the NCLT, New Delhi. The NCLAT, not finding any merit in the contention, rejected the same holding that internal dispute of directors of the CD and the pendency of a Petition under sections 241 and 242 of the Act, does not construe a valid defence to triggering the CIRP. The Code is a special legislation having an overriding effect on any other law as mandated under section 238 of the Code. The statutory right under the Code cannot be made subservient to adjudication of a Petition under the Act.

In yet another case dealing with the interplay of the Code with the Act, the SC clarified that proceedings for insolvency resolution under the Code are independent proceedings and have nothing to do with the winding up proceedings pending before a HC against the same entity. The case in consideration is *Jaipur Metals & Electrical Employees Organization Through General Secretary Mr. Tej Ram Meena v. Jaipur Metals & Electricals Ltd. Through its Managing Director & Ors.*<sup>7</sup> The facts leading up to the foregoing conclusion were that during the pendency

<sup>5</sup> CrI. A. 143/2018 & CrI. M.A. 2262/2018

<sup>6</sup> Company Appeal (AT) (Insolvency) No. 428 of 2018

<sup>7</sup> Civil Appeal No. 12023 of 2018

of winding up proceedings in the Hon'ble HC of Rajasthan, but before the order of liquidation was passed, one of the creditors of the company filed an Application under section 7 of the Code. The same came to be admitted by the NCLT and an order of moratorium was passed under section 14 of the Code. The HC passed an order refusing to transfer the winding up proceedings to the NCLT and further ordered a stay of those proceedings. Against this order of the HC, the present proceedings before the SC came to be filed. The SC, referring to the provisions of section 238 of the Code held that in view of the provisions of the non-obstante clause read with section 7 of the Code, it was open for the creditor to apply under section 7 to the NCLT at any time before the winding up order was passed.

This view was again reiterated by the SC, in the case of *Forech India Ltd. v. Edelweiss Assets Reconstruction Co. Ltd.*<sup>8</sup> The SC reiterated the position of law that in view of section 238 of the Code, proceedings initiated under the Code are independent of the proceedings for winding up under the Act.

Thus, as can be seen from the decisions of the NCLAT and the SC, although, the proceedings under the two statutes are independent of each other, however, in case of a conflict between the provisions of one with the other, it is the Code that prevails in view of the non-obstante clause contained in section 238 of the same. This view is also supported by the fact that the Code being a later legislation than the Act, its framers were deemed to be aware of its provisions.

#### THE CODE AND THE ADVOCATES ACT, 1961

The interplay of the Code with the Advocates Act, 1961 came into consideration of the SC in the case of *Macquarie Bank Ltd. v. Shilpi Cable Technologies Ltd.*<sup>9</sup> The question for consideration before the SC was whether a demand notice of unpaid operational debt can be issued by a lawyer on behalf of the operational creditor?

The SC referred to the provisions of the Advocates Act, 1961 more particularly section 30 of the Act, to state that the term 'practise', appearing in that section, is a term of wide import and would include all steps leading up to the filing of an application before the Tribunal and that the doctrine of harmonious construction applies to all statutes made by the Parliament. Therefore, in case of any conflict between the provisions of the Code with those of the Advocates Act, 1961, the doctrine of harmonious construction should apply. However, in the present case, there being no inconsistency between the provisions of the Code with those of the Advocates Act, 1961, the non-obstante clause contained in section 238 of the Code, will not have any application.

#### CONCLUSION

The position of law that emerges from the discussion of the law enunciated by various judicial pronouncements, as noted above, is that the non-obstante provision, contained in section 238 of the Code, gives the Code an overriding effect over any other law, for the time being in force, only if there is any inconsistency between the provision of the Code and the provisions of any other law.

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<sup>8</sup> Civil Appeal No. 818 of 2018  
<sup>9</sup> (2018) 2 SCC 674

Naturally, the first course to be adopted by the courts in case of a conflict should be to harmoniously construe the conflicting provisions so as to not render either one of them nugatory. The normal presumption should be in favour of drawing a consistency and it should not be assumed that what is given with one hand by the legislature is sought to be taken away by the other. This is particularly true if the statements of object and reason of each enactment are examined and no inconsistency is noticed. Each legislation has been enacted to operate in its own sphere and to deal with the specific issues that it seeks to address. Where, however, the rule of harmonious construction cannot effectively be applied, the Code, being a later special enactment of the Parliament than the SEBI Act, PMLA, Companies Act, 2013 and the Advocates Act, 1961, will prevail by virtue of the non-obstante clause contained in the Code, in the event of an apparent conflict.

This is also true in view of the favourable economic aspect or the time factor associated with resolution of insolvencies under the Code. The Code has so far been more efficient and speedier in resolving insolvencies as compared to the resolutions under other enactments specified above. This has led the courts to lean in favour of the Code for a faster resolution of issues because ultimately, prompt redressal of issues is the real need of the hour and the ultimate test of the judiciary, as also famously stated, 'justice delayed is justice denied.'

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## *Employees of Distressed Companies*

Ritesh Kavdia and Shweta Vashishtha

A key characteristic of a good insolvency regime is its ability to maximise an economy's growth and employment prospects by differentiating between viable and unviable businesses. The Bankruptcy Law Reforms Committee (BLRC)<sup>1</sup> noted that if a business is sustainable, this determination prevents premature liquidation, thus preserving the firm as an agent of future growth, protecting employees' jobs, and safeguarding the network of suppliers and customers. For a business deemed unviable, a fast and low-cost liquidation proceeding permits an effective re-allocation of resources to more productive and efficient sectors of the economy. Therefore, determining the viability of a business is the crucial first stage in resolving insolvency: keeping viable firms in existence and helping unviable firms make way for new firms, thereby promoting healthy competition in the economy.<sup>2</sup>

The US Chapter 11 legislation, the Japanese Bankruptcy Reform of 2003 and the Swedish 2010 Bankruptcy legislation are designed to weed out bankrupt firms deemed unproductive when re-organisation is not likely to result in increased project.<sup>3</sup> All these countries understand the need to recycle resources from bankruptcies, i.e., fixed assets in the firm and employees' human capital.

Employees and workmen are among the strongest pillars of the economy. Hence, adequate safeguards are required to protect helpless employees in situations of insolvency and bankruptcy of their employers. Also, concentrating on the need to recuperate jobs of employees—the so called human and social capital, from an unviable to a viable enterprise, becomes indispensable.

The International Association of Restructuring, Insolvency and Bankruptcy Professionals (INSOL International)<sup>4</sup> made the following comments on the inability of insolvency regimes to resolve the problems employees experience when their company becomes insolvent:

'For employees of a financially distressed company, there is seldom a more emotionally wrenching issue than the treatment of their wage and benefit claims in a restructuring process. Employees, who are the lifeblood of the enterprise, too often find that they are treated as expendable and their pension or retirement savings may have evaporated. Stories about the loss of employee benefits and resulting hardships abound in the newspapers throughout the world. The legacy costs associated

<sup>1</sup> Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, November 2015.

<sup>2</sup> International Finance Corporation, Saltane V., Chen R., Guzmán MN, Measurable Results! Doing Business Project Encourages Economies to Reform Insolvency Frameworks, January 2013

<sup>3</sup> Lee, S.-H., Peng, M. W., & Barney, J. B. (2007). Bankruptcy law and entrepreneurship development: a real options perspective. *Academy of Management Review*, 32(1), 257–272.; Peng, M. W., Yamakawa, Y., & Lee, S. H. (2010). Bankruptcy laws and entrepreneur-friendliness. *Entrepreneurship Theory and Practice*, 34(3), 517–530.; White, M. J. (2001). Bankruptcy and small business. *Regulation*, 24(2), 19–20.

<sup>4</sup> International Association of Restructuring, Insolvency and Bankruptcy Professionals, 2005

with employee wages, benefits and pension claims can be enormous and are often among the most intractable issues confronted in a restructuring company.'

The Code not only empowers the employees with necessary legislative mechanism to recover their unpaid salaries and wages in the course of resolution process of the corporate debtors but also provides opportunities to keep alive their source of livelihood.

#### EMPLOYEES OR WORKMEN UNDER THE CODE

The Code differentiated between two categories of persons: workmen and employees. For insolvency process, both employees and workmen qualify as operational creditors (OCs). Since the term employee is not defined under the Code, a general definition of employee has been referred to. An employee can be said to be a person who is hired by the employer to perform a particular job or specific labour of the employer. The employee is entitled to a specific wage or salary and performs the work under the control or regulation of the employer.<sup>5</sup>

Section 3 (36) of the Code mentions that the term workmen shall have the same meaning as provided under the Industrial Disputes Act, 1947<sup>6</sup> which under its section 2(s) defines a workman as '*a person who is employed in any industry to do any manual, unskilled, skilled, technical, operational, clerical or supervisory work, for hire or reward, terms of employment be express or implied and includes any such person who has been dismissed, discharged or retrenched in connection with, or as a consequence of dispute.*'

#### Ranking of Employee and Workmen in Waterfall Mechanism

Section 53 of the Code contains provisions for priority of payment of debts from the proceeds from the sale of the liquidation assets. It reads that notwithstanding anything to the contrary to any law for the time being in force, while distributing the assets, the order of priority as mentioned in section 53 has to be followed. Sub-section (1) clause (b) mentions that the workmen's dues for the period of 24 months preceding the liquidation commencement date shall be treated equally with the debts owed to secured creditors. Clause (c) provides priority to wages and unpaid dues owed to employees other than workmen for the period of 12 months preceding the liquidation commencement days over the dues unpaid to Central or State Governments and unsecured debts.

Unless the first category is paid in full, the second or subsequent category does not get any amount if the assets of the bankrupt company are insufficient to meet them. The claimants as specified in the same category or rank take it *pari passu*.

#### Assumption on Methodology of Resolving Insolvency- Ease of Doing Business<sup>7</sup>

The World Bank in Doing Business, Measuring Business Regulations makes a common basic assumption while studying the methodology to resolve insolvency of various countries that financial creditors (FCs) want to recover as much as possible of their loan, as quickly and cheaply as possible. The unsecured creditors will do everything permitted under the applicable laws to avoid a piecemeal sale of the assets. The majority shareholder wants to keep the company operating and under her/his control. Management wants to keep the company operating and preserve its employees' jobs.

<sup>5</sup> Ibid.

<sup>6</sup> Industrial Disputes Act, 1947 (Act 14 of 1947)

<sup>7</sup> World Bank (2019), Resolving Insolvency Methodology. Doing Business.

## LEGISLATIVE PROTECTION TO EMPLOYEES

### **Role of Adjudicating Authorities in Protecting Rights of Employees through Recent Judgments**

For the matters relating to insolvency and liquidation proceeding against companies, the National Company Law Tribunal (NCLT) and the National Company Law Appellate Tribunal (NCLAT) are the competent judicial bodies under the Code.

The following orders clearly reflect the role that Adjudicating Authorities (AA) have played over the three years of existence of the Code empowering employees and workmen under the Code.

#### ***Issue 1: Unpaid dues of salary form part of Operational Debt under the Code***

*Nitin Gupta v. M/s Applied Electro-Magnetic Pvt. Ltd.*,<sup>8</sup> NCLT New Delhi

This case dealt with the admissibility of application under section 9 of the Code by an employee for non-payment of salary amounting to roughly Rs. 47 lakh. The corporate debtor (CD) accepted the non-payment of salary amounting to Rs. 29 lakh but raised objections regarding the balance amount. NCLT admitted the case citing that it fell under the definition of operational debt as mentioned under section 5 (21) of the Code and in such a case the employee is an OC as mentioned under section 5 (20).

#### ***Issue 2: Recovery of dues against former employer***

*Mr. N. Subramanian v. M/s Aruna Hotels Limited*<sup>9</sup>, NCLT Chennai

In this case, the employee approached NCLT for recovery of his dues against former employer. The employee had left his job in the year 2013 and in spite of multiple assurances by the CD regarding the payment of the dues, in form of letters and correspondences, the amount was not settled. The employee, thereafter, sent a demand notice to the CD on June 29, 2017 and the CD replied to it on July 6, 2017 stating that the salary had been paid by it and only a gratuity amount of around Rs. 6 lakh was due as on that date. In the meantime, the CD approached the City Civil Court in Chennai on July 6, 2017 and filed a suit against the employee with a prayer to declare that previous letter, notice and communications be declared as null and void.

NCLT held that such a civil suit was instituted by the CD in order to circumvent the initiation of the insolvency process by the OC against the CD. The claim of employee was admitted by NCLT for payment of the unpaid dues.

#### ***Issue 3: Single application by collective workers through Authorised Representative***

*Mr. Suresh Narayan Singh v. Tayo Rolls Ltd.*,<sup>10</sup> NCLAT

The appeal in this case was filed by Mr. Suresh Narayan Singh, who was the authorised representative of 284 workers of the CD against an order dated January 3, 2018 passed by the NCLT, Kolkata. The NCLT had rejected an application filed by Mr. Suresh Narayan Singh under section 9 of the Code against the CD on the ground that the application under section 9 of the CD has to be filed individually and not jointly. The NCLT also noted that it is not practicable for more

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<sup>8</sup> [2018] 142 CLA 527 (NCLT), IB 334(ND)/2017

<sup>9</sup> C.P. No. 597/(IB)/CB/2017.

<sup>10</sup> Company Appeal (AT) Insolvency No. 112 of 2018.

than one OC to file a joint petition as they will have to issue individual demand notices under section 8 of the Code.

However, the NCLAT held that there is a clear existence of all the required factors, i.e., a debt and a default, which were not disputed by the CD, and the application made under section 9 was complete. NCLAT held that NCLT should have admitted the application instead of rejecting it on a technical ground that it was filed by the authorised representative on behalf of 284 workmen.

#### **Issue 4: Right Sizing/ Down Sizing of employees as per Resolution Plan**

*Edelweiss Asset Reconstruction Company Ltd. v. Bharati Defence and Infrastructure Ltd*<sup>11</sup>, NCLT Mumbai  
NCLT rejected the resolution plan providing for right-sizing of employees, without mentioning the approximate number of employees to be terminated or to be retained, without complying with labour laws, and held not to be permissible under law. The extract from the order reads:

'The resolution applicant wants all powers to decide the fate of employees/workmen/consultants of the company and further seeks exemption from complying with the applicable laws and immunity from any claims from the employees/workmen/consultants so terminated. We are of the strong opinion that it would be inappropriate to approve such a plan, which contravenes the law, and which is prejudicial and causing injustice to the existing employees/workers/consultants.'

#### **Issue 5: Priority of Payment of Provident Funds against the unpaid dues of the creditor**

*Precision Fasteners Ltd. v. EPFO, Thane; EPFO, Vapi; EPFO Vashi in ARC (India) Ltd. v. Precision Fasteners Ltd.*<sup>12</sup> NCLT Mumbai

In this case, NCLT observed that any amount due to the workmen/ employees from the provident fund/ pension fund or gratuity will not be included within the purview of liquidation asset. It was further clarified by NCLT that provident fund dues are excluded from the liquidation assets<sup>13</sup> enabling the workmen/ employees to realise their savings as well as the employer's contributions as a part of their fundamental right to life while the right of the creditors is merely a property right.<sup>14</sup> Provident Fund payable were held to be deemed assets of employee/workmen.

### EMPLOYEE PARTICIPATION UNDER THE CODE

Employee participation in management is not commonplace in India, but the model could be explored for some companies hauled before insolvency courts, where affected staff-members at units without hopes of a revival have urged courts to liquidate the entities as going concerns.<sup>15</sup> There is a growing tendency among employees and workers to save their companies going into liquidation.

On November 14, 2017, a Kolkata-based company namely *Keshav Sponge and Energy Pvt. Ltd.*<sup>16</sup> was liquidated as a 'going concern'. NCLT approved the plan taking in to account interest of all stakeholders and in the interest of welfare of workmen around 150 persons

<sup>11</sup> MA 170 of 2018 in CP 29I&B/NCLT/MAH/2017.

<sup>12</sup> MA 576 & 752/2018 in CP (IB) 1339 (MB)/ 2017.

<sup>13</sup> *Ibid.*

<sup>14</sup> Mondaq, 'India : NCLT directs PF to be paid before clearing dues.' (August 20, 2019).

<sup>15</sup> Saikat Das (January 17, 2018). Now, employees step in to save bankrupt companies. *The Economic Times*.

<sup>16</sup> Company Petition (I.B.) No. 40/KB/2017.

and nearly 600 persons who are directly or indirectly dependent upon the operation of the company for their livelihood. This case manifested a path to a new chapter in the evolving Code.

This move of NCLT served two benefits. Firstly, it helped lenders recover more money against the unpaid loans, and secondly, it created future job opportunities for those employees who used to work for the company.

In the matter of *Gujarat NRE Coke*,<sup>17</sup> employees including workers intervened to liquidate the company as going concern. Considering that 1178 employees including workers, their families, numerous small vendors, suppliers, contractors, job workers and transporters totalling about 10,000 people were getting affected, the NCLT asked the liquidator to sell the company's assets within three months from the date of order without disrupting operations.

In the matter of *Reid and Taylor*,<sup>18</sup> the Mumbai bench of the NCLT accepted a proposal by an unregistered union of the premium apparel brand to take over the firm thereby obstructing liquidation. The company had around 1,200 employees and has a plant in Mysuru, which was running at under 30 percent of its installed capacity and thus incurring cash losses.<sup>19</sup> Accepting the interest of the employees to take over the company and thus stall liquidation which the creditors want, NCLT noted that '*...liquidation will get only a meagre value, the creditors will be most affected and the workmen will be losing their livelihood...*' NCLT ordered for liquidation as going concern.

In wake of widespread job losses and these series of rulings, the introduction of sale of a company as a going concern in liquidation, was primarily motivated by the objective of keeping employment potential and economic activities intact.<sup>20</sup>

The amendments to the IBBI (Liquidation Process) Regulations, 2016 (Liquidation Regulations), introduced on July 29, 2019 by incorporating regulation 32A of the Liquidation Regulations, made it explicitly possible for the liquidator to transfer a company in liquidation as a going concern.<sup>21</sup>

## CONCLUSION

The Code is a socially beneficial legislation and a great measure in the corporate arena to empower the employees and workmen and mitigate their losses in adverse situations like insolvency or liquidation of companies.

The Code provides the workmen and employees of the companies with an opportunity to recover their unpaid dues from the CD, by approaching the NCLT in a systematic and time-bound manner. Within a strict time-limit to resolve or liquidate the CD, the Code is an effective mean to reform debtor behaviour in India. It empowers employees with the right to initiate insolvency proceedings against the CD as an OC and places them in a higher priority during the payment of the unpaid debts from the liquidation of assets of the liquidating company.

The AAs have regarded this empowerment as a necessary measure and this has been reflected in the progressive and positive decisions upholding the rights and interests of the workmen and employees as cited in forestated judgments. In spite of all said above, it cannot be denied that the occupational hazard hovering the employees persists.

<sup>17</sup> C.P. (I.B.) No. 182/KB/2017.

<sup>18</sup> C.P. No. 382/IB/MB/MAH/2018.

<sup>19</sup> PTI (January 6, 2019). Reid and Taylor: NCLT stalls liquidation, accept union bid for the Company. *Bloomberg | Quint*.

<sup>20</sup> Vinod Kothari and Shikha Bansal (2019). Enabling Going Concern Sale in Liquidation. *India Corp Law*.

<sup>21</sup> IBBI (Liquidation Process) (Amendment) Regulations, 2019 notified on July 25, 2019.

Looking at other jurisdictions, it was found that the Marcora Law in Italy was instrumental in facilitating employee buyouts<sup>22</sup> to overcome such situation of employee rescue from distressed company. The Marcora Law of Italy provided a framework that enabled collaboration among various stakeholders and also by making available financial support schemes that helped these distressed enterprises navigate the difficult economic conditions they often faced. It also often involved the workmen participation in the running of the firm. When worker buyouts in Italy took off, it led to the creation of 257 new employee-owned firms and saved or created 9,300 jobs.<sup>23</sup> Almost all of these were set up as worker co-operatives, owned and managed by their employees. In Italy, the phenomenon has been accelerated by a favourable legal framework and different mechanisms that enabled employees to raise capital.

In UK, the transfer of an insolvent business is conducted under corporate or commercial law, peculiar insolvency matters are addressed exclusively by insolvency law while matters affecting employees in the context of a business transfer are governed by employment law, i.e., Transfer of Undertakings (Protection of Employment) Regulations (TUPE).<sup>24</sup> To rescue a financially distressed business, some jobs might have to be sacrificed. But, TUPE limits the employer's ability to do this. It impinges on managerial decision-making powers. TUPE reduces, rather than increases, entrepreneurial freedom.<sup>25</sup>

Every regime is somewhere struck between creating a balance between the employment protection goals on the one hand and the rescue of insolvent companies on the other.

In similar scenario being faced in India, where reconstruction is posed with ongoing challenges, a different model can be thought as one that will also accommodate the bottom up process of an employee buyout. Employees buy-out has been used as a reactive strategy by workers, trade unions and labour governments in a number of countries to rescue companies, save jobs and preserve communities in economic downturns. In most instances it has sprung from direct action by the employees to prevent plant closure and save their jobs. It is expected that the buyout attempts by employees can pave way for future deals to resolve distressed companies.

In the conclusion, while the AA and IBBI are playing their roles effectively, other areas must be explored as possible options for resolution. Though there are substantial challenges in terms of limited knowledge and information about employee buyouts and their potential in business rescue however if developing employee buyouts as part of a cluster of employee-owned companies networked with trade unions has proven to be the best method of maximising company survival in other countries then it might be an option for India as well.<sup>26</sup> Nevertheless, the study on success or failure of this model in India necessitates further in-depth research.

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<sup>22</sup> An employee buyout is part of a business restructuring or conversion process whereby employees purchase an ownership stake in the entire business

<sup>23</sup> Voinea Anca (September 7, 2015). The path to worker buyouts: Does the UK need its own 'Marcora Law'?

<sup>24</sup> Etukakpan, Samuel Edwin (2012). A Thesis on Transfer of Undertakings: The Tension Between Business Rescue and Employment Protection in Corporate Insolvency.

<sup>25</sup> Hardy and Adnett (n 69); Jeffery (n 90) 670

<sup>26</sup> Jensen Anthony. (2006). A report on Insolvency, Employee Buy Rights and Employee Buyouts, A strategy for Restructuring. Ithaca Consultancy.

# 12

## *Directors' Duties in the Twilight Zone*<sup>1</sup>

Utsav Mitra

*'Insolvency is about financial death and ...financial rebirth'*

Elizabeth Warren

The directors of a company are integral to the everyday functioning of the company, being responsible for its management. Due to their stature and importance, they owe fiduciary duties towards the company, and are accountable to all of the stakeholders. This duty is well-recognised under common law, and has been codified under the Companies Act of 2013 (the Act) in India. With the rise in non-performing assets and credit repayments in the country, there arose a need to make the directors more diligent, prudent and aware of decision making. It is in this backdrop that the Insolvency and Bankruptcy Code, 2016 (Code) introduced specific duties that are owed by directors towards the creditors of their companies which are in financial distress. This period of distress, i.e., the twilight zone, where there exists reasonable cause to believe that insolvency may commence, and actual insolvency proceedings commence against the company, the directors are duty-bound to minimise the losses to the creditors, and protect the assets of the company. These directors must now act in the bonafide interests of their creditors, and not indulge in any fraudulent or wrongful trading.

In the course of this article, the author will reflect on the shift in the director duties from a financially sound/stable company to a company in financial distress. This essay also seeks to highlight the various responsibilities that the directors now have towards the creditors of their companies, and the liabilities they may incur if they do not take cognisance of such responsibilities. It raises a pertinent question, i.e., whether the directors of companies have any special duties/responsibilities during the twilight zone, or do they have to carry out the same responsibilities as bestowed upon them under the Act? If there indeed exist special duties during the twilight zone, when exactly do such duties arise? Some of these questions are answered by discussing and analysing the existing international jurisprudence on insolvency laws, and examining similar provisions that have been adopted in the legal framework in India.

### FINANCIAL DISTRESS : WHAT IS THE TWILIGHT ZONE?

The term 'twilight zone' or 'twilight period' has not been defined in any particular legislation, but in common business parlance, is referred to the period of trading when the company has insufficient funds to pay its debts, and is on the verge of insolvency. This situation may arise due to a number of reasons, most common of which include an immediate cash-flow crisis, or if

<sup>1</sup> This is an updated version of an award-winning essay of a research writing competition organised by National Law Institute University, Bhopal in collaboration with the IBBI in January, 2018.

the company has an unfavourable balance sheet, having incurred substantial losses for a significant period of time. In both the United Kingdom (UK) and the United States (US), the twilight period is considered to be *'the period between the point of knowledge or awareness of no real prospect of avoiding an insolvency proceeding against the company, and its actual commencement.'*<sup>2</sup> Thus, the twilight zone is that period where there exists no possibility of avoiding the liquidation of a company due to insolvency, and the commencement of actual insolvency proceedings against the company under the insolvency laws of the country. During this period, the transactions that are entered into by the company are vulnerable to scrutiny, and might give rise to several liabilities on the part of the directors.

In India, although under the Code<sup>3</sup>, the powers of the board of directors are suspended after the commencement of insolvency proceedings, section 66 of the Code identifies the twilight zone as the starting point of the period from the time when the director *'knew or ought to have known that there was no reasonable prospect of avoiding the commencement of corporate insolvency resolution'*<sup>4</sup> This provision recognises the specific duty of the directors towards the corporate creditors of the company when the company is on the verge of insolvency. The unique feature about section 66 is the responsibility it imposes on the exercise of due diligence.<sup>5</sup> It imposes a duty upon the directors to act in the best interests of such creditors, regardless of whether they are voluntary or involuntary creditors.<sup>6</sup> Voluntary creditors include those creditors who voluntarily enter into transactions with the company, such as trade creditors, institutional lenders, employees and debenture holders. Involuntary creditors on the other hand are those creditors who have entered into transactions with the company on a non-consensual basis, such as the State when it comes to levying corporate taxes on the company.<sup>7</sup> Further, the creditors are also categorised as secured or unsecured creditors, depending on whether a charge is created over the assets of the company when lending money to the company. Quite obviously, the twilight zone has serious business implications for any company, because it determines whether the company will eventually emerge from this situation of insolvency, or perish. Under section 66 (1) of the Code, if a corporate debtor (CD) has been found carrying on business with the intent of defrauding creditors of the company for fraudulent purposes, the Adjudicating Authority (AA) can pass an order to make such persons liable to make contributions to the assets of the Company as it may deem fit.<sup>8</sup> Thus, the decisions taken by the directors on behalf of the company significantly impact the outcome of the insolvency process when the company or its creditors formally commences it.<sup>9</sup> In fact, the company will continue to be in the twilight zone unless the directors take initiatives of restructuring and re-financing, and appoint professionals who will help implement turn-around techniques to ensure the corporate renewal of the company. Hence, in this situation, the acts of

<sup>2</sup> D. Milman (2004). Strategies for regulating managerial performance in the 'twilight zone' – Familiar Dilemmas & New Considerations. *Journal of Business Law*, 4, pp. 493.

<sup>3</sup> Section 17 of the Code.

<sup>4</sup> Section 66 (2) of the Code.

<sup>5</sup> Radhika Merwin (April 22, 2018). Resolution via IBC endeavours to keep a firm alive. *The Hindu Business Line*.

<sup>6</sup> P. O Mulbert (2006). A synthetic view of different concepts of creditor protection, or a high level framework for corporate creditor protection. *European Business Organization Law Review* 7 pp. 357, 365.

<sup>7</sup> S. Preetha (2011). The Fraudulent Trading Offence: Need for a Relook. *NUJS Law Review*, 4, pp. 231, 233.

<sup>8</sup> Section 66 (1) of the Code

<sup>9</sup> Sudipto Dey (October 22, 2017). Why directors should be wary of the Insolvency & Bankruptcy Code. *The Business Standard*

the directors become very important for the sustenance of the company. If the directors fail to address the insolvency of the company during the twilight zone, the company will inevitably end up facing eventual bankruptcy.

Further, upon specifically analysing sections 17, 43, 46 and 66 of the Code, it is arguable that the twilight period may be two years preceding from the date of commencement of insolvency when the preference is given to a related party, or one year preceding from the date of commencement of insolvency when the preference is given to a person other than a related party as stated in the Code.

#### DIRECTORS AND THEIR FIDUCIARY DUTIES

The term 'director' in the Act is defined under section 2 (34)<sup>10</sup> as a director appointed to the Board of a company, wherein the Board of Directors (Board) means the collective body of the directors of the company. Directors have also been defined to mean the Chief Executive Officer or the managing director or the manager; the company secretary; the whole-time director; the Chief Financial Officer; and such other officer as may be prescribed.<sup>11</sup>

These directors are the decision makers in the company, and their actions are attributable to the company itself, and its best interests, being responsible for the promotion of the success of the company.<sup>12</sup> In the case of *Tristar Consultants vs. M/s. V Customer Services India Pvt. Ltd. & Anr*<sup>13</sup> the Delhi High Court had held that directors are the agents of the company to the extent they have been authorised to perform certain acts on behalf of the company.

It is well-established that these directors owe a fiduciary duty to the company<sup>14</sup>, and the nature and extent of the duty depends on the business of the company, along with the knowledge and experience of the directors.<sup>15</sup> The fiduciary duties that are owed by the directors are namely, duty of good faith; duty to avoid conflict with the company; duty to exercise reasonable care, skill and diligence and independent judgment, and duty to avoid undue gain or advantage. Under the Indian law, section 166 of the Act codifies the duties of the directors towards the company, including its employees, shareholders and all other stakeholders.<sup>16</sup> These duties are owed by the directors, executive directors or non-executive directors, and even independent directors. Any breach of these duties invoke penal consequences.<sup>17</sup> To elucidate further, section 166 stipulates that when the company is solvent, the directors are expected to act in good faith, taking objective decisions in the interests of all the concerned stakeholders of the company. Thus, for a company that is in a solvent state, the directors are expected to fulfil their general fiduciary duties, and take bona fide, well-reasoned and objective decisions considering the beneficial interests of the company.

In light of the aforementioned provisions, a pertinent question that now arises is whether the directors in the company have any special or additional duties bestowed upon them during the twilight zone, as they already have certain responsibilities towards the

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<sup>10</sup> Section 2(34) of the Companies Act, 2013.

<sup>11</sup> Section 2 (53) of the Companies Act, 2013.

<sup>12</sup> *Dale & Carrington Invnt. Pvt. Ltd. and Ors. v. P.K. Prathapan and Ors.* (2005) 1 SCC 212.

<sup>13</sup> AIR 2007 Delhi 157

<sup>14</sup> *In Re: Lee Behrens & Co Ltd* [1932] 2 Ch 42

<sup>15</sup> B. Hanton (2011). *International Comparative Legal Guide to: Corporate Governance*. London: Global Legal Group.

<sup>16</sup> Section 166 of the Companies Act, 2013.

<sup>17</sup> Section 166(7) of the Companies Act, 2013.

company from the time they were appointed on the board as directors. Some insolvency experts are of the opinion that there exists no such additional obligation or responsibility on the board during the twilight zone, as it is a continuing and ongoing responsibility from the time they join the board itself. Some experts have also interpreted the existence of both such duties simultaneously due to a dearth of significant case laws on this point. However, a point of distinction which must be brought to light is that under normal circumstances, the directors of a company enjoy only a fiduciary relationship<sup>18</sup> with the company, where they are responsible for protecting the interests of the shareholders as a whole.<sup>19</sup> This is because so long as the company is solvent, the shareholders are in substance, the primary stakeholders in the company.<sup>20</sup> Hence, the nature of this fiduciary relationship revolves around the directors acting for or on behalf of these shareholders, thereby giving rise to a relationship of trust and confidence.<sup>21</sup> However, once the company is under financial distress, and has entered the twilight zone, there is an additional responsibility on the directors to prioritise the interests of the creditors above the shareholders. Further, as per section 46 of the Code<sup>22</sup>, a director can also be held responsible for actions taken up to one year preceding the commencement of insolvency proceedings, and two years in case of related party transactions. Moreover, AA can declare void, set aside undervalued transactions and preferences which were entered by the company up to two years before the commencement of insolvency process under section 45 of the Code<sup>23</sup>.

#### SHIFT IN DUTIES: FROM SHAREHOLDER- CENTRIC TO CREDITOR-CENTRIC

Once the company has entered the twilight zone, the duties of the directors are affected as a result of the uncertainty involved regarding the company's financial conditions.<sup>24</sup> These directors are now expected to exercise reasonable skill, care and diligence,<sup>25</sup> and have a duty to protect the interests of the corporate creditors<sup>26</sup> and preserve the assets of the company so that the creditor may ultimately realise the debt out of those assets.<sup>27</sup> It is said that the protection of creditor interests in a company that is fast approaching insolvency is based on ethical considerations and notions of fairness.<sup>28</sup> For example, in the UK, during the twilight period, the directors are expected to ensure that the company does not trade recklessly, and that they act in good faith, for the best interests of the creditors of the company.<sup>29</sup> This is because during the twilight period, the interests of the company primarily coincide with the economic interests of their creditors.<sup>30</sup> Hence, the directors have an additional responsibility to *ensure that the affairs of the company are in order, and its property is not dissipated or exploited to the prejudice of such*

<sup>18</sup> *Mothew v. Bristol and West Building Society*, EWCA Civ 533, Ch 1, (1998, Court of Appeals).

<sup>19</sup> *Sangarmsinh P. Gaekwad v. Shantadevi P. Gaekwad*, (2005) 11 SCC 314.

<sup>20</sup> *Multinational Gas & Petrochemical Co v. Multinational Gas & Petrochemical Services Ltd*, Ch. 258 (1983, Court of Appeals).

<sup>21</sup> *Supra* note 12.

<sup>22</sup> Section 46 of the Code.

<sup>23</sup> Section 45 of the Code.

<sup>24</sup> *Directors and the Twilight Zone* Law Essay., Law Teacher. Online resource

<sup>25</sup> *Re City Equitable Fire Insurance Co. Ltd* (1925) Ch. 407.

<sup>26</sup> *Walker v. Wimborne* [1976] 50 ALJR 446.

<sup>27</sup> Lipson (2007). The Expressive Function of Director's Duties to Creditors, *Stanford Journal of Law Business and Finance*. Vol. 12, pp. 5.

<sup>28</sup> A. Keay (2003). Directors' Duties to Creditors: Contrarian Concerns relating to Efficiency and Over-protection of creditors. *Modern Law Review*, Vol. 66, pp. 665, 667.

<sup>29</sup> S. Barker (2016). Director Duties during the Twilight Zone and what they mean for Financiers. *BFSLA Annual Conference*.

<sup>30</sup> *Lonrho Ltd. v. Shell Petroleum Co. Ltd*, 1 WLR 627 (1980, House of Lords).

creditors.<sup>31</sup>

Presently, there already exists a wide range of jurisprudence which confirms that 'when a company is insolvent, or of doubtful insolvency or on the verge of insolvency and it is the creditors' money which is at risk the directors, when carrying out their duty to the company, must consider the interests of the creditors as paramount and take those into account when exercising their discretion.'<sup>32</sup> In the US, a Delaware Court had held in the famous *Credit Lyonnais Bank Nederland, N.V v. Pathe Communications Corp*<sup>33</sup> case, that when a company is operating on the verge of insolvency, the board of directors owes its duty to the creditors, who in essence, become the residue risk bearers in the company. The Court goes on to clarify that when the company is solvent, it is the shareholders who are the residue risk bearers, and hence the primary stakeholders in the company. However, once the company is insolvent, or facing insolvency, it is the creditors who become the primary risk bearers, and hence their interests cannot be ignored.<sup>34</sup> Thus, this remarkable shift in the focus of the directors' duties from shareholders to creditors during the twilight period, is due to the fact that during insolvency, the creditors have an economic interest in the company,<sup>35</sup> and such interests must be protected by the law. This insolvency based creditor-centric approach ensures that the company does not incur any further liabilities, and maximum effort is directed towards ensuring that the company successfully emerges out of insolvency. If subsequently, the company fails to come out of insolvency, only then will the liquidation process take place, and the creditors will be able to realise the monies owed to them from the assets of the company.

It is important to note that the law is still unclear and there exists a certain ambiguity as to when exactly this shift in interests from shareholders to creditors occur. This is because there exists no specific requirement on the directors to automatically place the company into a formal insolvency process at the point at which they become aware that the company's cash flow has turned negative.<sup>36</sup> It was observed in *Nicholson v. Permakraft (NZ) Ltd.*<sup>37</sup> that the creditors' interests are to be considered by the directors when the company was either 'insolvent, or near insolvent, or of doubtful insolvency, or if a contemplated payment or other cause of action would jeopardise its solvency.' Quite similarly, in the landmark decision of *Brady v. Brady*<sup>38</sup> it was confirmed that the interests of the creditors started from when the 'company was insolvent, or even doubtfully solvent'. Therefore, although it becomes very difficult to identify with precision the exact circumstances that trigger insolvency, as per section 66 of the Code, the threshold appears to be whether or not the circumstances of the company are such that the director knows, or can reasonably expect, that any action they take could result or lead to the insolvency of the company. Hence, it can be argued that although there exists no clearly demarcated point after which the directors of the company should prioritise the interests of their creditors, a reasonable expectation of insolvency coupled with the knowledge that

<sup>31</sup> *Winkworth v. Edward Baron Development Co. Ltd.*, 1 AIIER 114 (1987, House of Lords).

<sup>32</sup> *Geyer v. Ingersoll Publications Co*, 621 A 2d 784 (Del Ch 1992) [Geyer] at 178; *Kinsela v. Russell Kinsela Pty Ltd (in liq)*, (1986) 4 NSWLR 722 at 730 (CA, NSW).

<sup>33</sup> 1991 WL 277613 (Del. Ch. 1991).

<sup>34</sup> *Lonrho v. Shell Petroleum* [1980] 1 WLR 627.

<sup>35</sup> *West Mercia Safetywear Ltd (in Liquidation) v. Dodd*, BCLC 250 (1988, Court of Appeal).

<sup>36</sup> *Re Marini Ltd (The Liquidator of Marini) v Dickenson & Ors*, EWHC 334 (2003, England & Wales High Court).

<sup>37</sup> [1985] 1 NZLR 242 (Court of Appeal Wellington).

<sup>38</sup> 2 AII ER 617 (1988, House of Lords).

insolvency may be near, will cause this shift in directors' duties. After all, at this point, the directors also have a responsibility to act in accordance with insolvency laws, and not in any arbitrary manner.

#### SPECIAL DUTIES AND RESPONSIBILITIES IN THE TWILIGHT ZONE

In English jurisprudence, the responsibilities of the directors towards the creditors during the twilight zone are well known. The directors of a company have been found to be liable for acts that take place during the twilight zone, as a consequence of specific insolvency related offences.<sup>39</sup> For example, these directors have been held to be liable if they have completely disregarded the interests of the creditors. In *Yukong Lines Ltd of Korea v. Rendsburg Investments Corporation*,<sup>40</sup> the Court held that although a director does not owe a direct fiduciary duty towards their creditors, indirectly, the creditors interests are represented through the official liquidator, and the directors must have regard to the creditor's interests. Furthermore, it is well settled that the directors must not engage in fraudulent trading when the company is in the twilight zone. The UK Companies Act of 2006 specifically penalises persons who knowingly taking part in wrongful and fraudulent trading with an intention of defrauding the creditors.<sup>41</sup> Such wrongful/fraudulent trading has been defined to mean the incurring of further debts when there are reasonable grounds for suspecting that a company would not be able to pay off its principal debt.<sup>42</sup> The liability of the directors for such fraudulent trading during the twilight period will only be determined once the company goes into liquidation. In that case, in order to determine the said liability, the director's conduct in the period leading up to the insolvency will be taken into consideration.<sup>43</sup> Thus, the Courts will hold the directors liable if '*the directors closed their eyes to the reality of the company's position, and carried on trading long after it should have been obvious to them that the company was insolvent and that there was no way out for it.*'<sup>44</sup> In order to construe this intention, it will be necessary to prove that the debtor never intended to pay the creditor, and carried on trading even after such trading was prejudicial to their interests.<sup>45</sup> Hence, an intention to defraud creditors arises if the company carries on business and incurs debt when to the knowledge of the directors, there is no reasonable prospect of the company being able to pay them. Thus, one of the primary duty which arises against the directors is to prevent wrongful and fraudulent trading during the twilight zone.

In India, when a company continues to operate in financial distress and is unable to recuperate, the Code provides for an insolvency resolution process to be undertaken by the creditors or the company itself. In this process, once the insolvency application is admitted, and the insolvency resolution professional (IRP) is appointed, the Code suspends the powers of the board of directors.<sup>46</sup> The Code then bestows authority on the IRP to protect and preserve the value of the property of the CD, and manage his operations.<sup>47</sup> Since the directors are not empowered to act beyond this period, they cannot be made liable for any further actions.

<sup>39</sup> V. Patnaik (2017). Directors in the Twilight Zone. *INSOL International*.

<sup>40</sup> 4 All ER 82, 884 (1997, Queens Bench Division).

<sup>41</sup> Section 993 of the Companies Act, 2006 (UK).

<sup>42</sup> Thomas Bachner (2004). Wrongful Trading – A new European model for creditor protection. *E.B.O.R* 5 pp.293.

<sup>43</sup> Section 66 of the Code.

<sup>44</sup> *Re Continental Assurance Company of London Plc*, All ER (D) 229 (2001, High Court of England and Wales).

<sup>45</sup> J Dine (1994), Punishing Directors, *Journal of Business Law* pp. 325, 333

<sup>46</sup> Sections 17(1)(b) & 23(2) of the Code.

<sup>47</sup> Section 20(1) of the Code.

However, the Code clearly warrants additional responsibilities and duties on the part of the directors during the twilight period, and if these responsibilities/duties are ignored, the directors can be held liable.

For instance, section 66(2) of the Code recognises a specific duty of the directors towards the creditors, when the company is near insolvent. The directors are now obligated to conduct due diligence, and minimise the loss to the creditors. Due diligence is considered to have been conducted if it was reasonably expected of a person carrying out the same functions as that of such director.<sup>48</sup> A breach of this provision makes the director personally liable to contribute to the assets of the distressed company.

Moreover, section 45 of the Code carves out an implied duty on the directors to undertake prior transactions carefully,<sup>49</sup> and provides for a 'look back' provision where the directors can still be held liable for past actions. Such a period of look back encompasses the prior 12 months for regular transactions, and the prior 24 months for related party transactions. Hence, the directors are now duty bound to ensure that the transactions which the company undertakes are bona fide, or they are liable to be set aside. Therefore, it could be argued that the legislative intent behind these provisions is to make the directors more responsible, and to prevent fraudulent activities during the twilight zone. Furthermore, the National Company Law Tribunal (NCLT) also has the power to examine the affairs of the company, and may impose liability on the directors for fraud on creditors or wrongful disposal of assets. The legal position in India seeks to undo any transaction entered into by the company during the twilight period when it is prejudicial to the interests of the company. Under section 66 of the Code, the directors of a company that has entered the process of insolvency could be held liable for any insolvency related transactions, which not only include fraudulent and wrongful trading, but also preferential transactions towards certain persons, concealment of property, undervalued transactions that are considered prejudicial to the interests of the creditors, or even fudging the books of accounts and not making disclosures. Even for sick industrial companies in India, the board of directors have a responsibility to submit a scheme of rehabilitation of the company to the NCLT. Once the winding up order is passed, any further disposition of property is void as the company ceases to be the beneficial owner of the assets, and it is the official liquidator who deals with the company's properties.<sup>50</sup>

Section 66 of the Code thereby requires that the directors exercise reasonable due diligence for any function carried out by the director in order to minimize the potential loss to creditors of the CD. It states that, in order to determine the sanctity of the directors' conduct, (a) before the insolvency commencement date, such director or partner knew or ought to have known that there was no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process in respect of such corporate debtor; and (b) such director or partner did not exercise due diligence in minimising the potential loss to the creditors of the corporate debtor. Thus, when the directors knew or ought to have known that there was no reasonable prospect of avoiding the commencement of corporate insolvency resolution process (CIRP), they are obligated to conduct due diligence to minimise potential

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<sup>48</sup> Section 66(2)(b) and Explanation to section 66 of the Code.

<sup>49</sup> Section 45 of the Code.

<sup>50</sup> *Official Liquidator v. P.A. Tendolkar*, AIR 1973 SC 1104.

loss to the creditors. A breach of these provisions makes the director personally liable to contribute to the assets of the distressed company. This criteria laid down by section 66 has been taken from English law, and carries with it both objective and subjective requirements. The objective requirements stipulate that the knowledge, skill and experience must be exercised of a reasonable person in his capacity as director towards the company.<sup>51</sup> The subjective requirement means that the knowledge, skill and experience of that particular director shall be factored in by the Court, when deciding these questions.<sup>52</sup> Finally, section 69 of the Code also recognises stringent criminal penalties for defrauding creditors if the defaulting person is an officer of the company.<sup>53</sup> The maximum stipulated punishment is 5 years imprisonment and/or maximum fine of Rs. 1 crore. Therefore, section 69 adds an additional responsibility on the directors to be more vigilant in their conduct, and seeks to deter fraudulent behaviour by imposing such steep punishments.

Hence, in order to prevent any personal liability from arising, it is expected that the directors should act with a view of minimising the potential loss to the creditors, by conducting reasonable due diligence. These directors are also expected to disclose any material information, and inform the creditors of any further loss that may arise. They must also prevent any arbitrary and fraudulent trading from taking place, thereby preventing exposure to any further risks. Thus, in addition to the general fiduciary duties prescribed under the Act, the Code clearly seeks to impose special duties on the directors, to ensure that there is proper conduct on their part prior to the actual insolvency, and prevent them from fraudulently trading with the creditors' money. The Code clearly lays these additional responsibilities on the directors during the twilight zone, in order to protect the bona fide interests of the creditors. Hence, it can be said that if a director breaches any of these provisions and engages in any fraudulent or wrongful activity during the twilight zone, then it will be 'akin to walking a legal tightrope'.<sup>54</sup>

## CONCLUSION

At the very outset of this article, the author had propounded a simple, yet significant question, i.e., whether the directors of a company have any special duties/responsibilities when the company is in the twilight zone? The answer to this question has been found to be in the affirmative. Although the directors owe a fiduciary relationship towards the company under section 166 of the Companies Act, the directors have additional obligations towards the creditors during the twilight zone. This is because although there existed no codified duties of the directors of a company towards its creditors, the Code has identified certain responsibilities of the directors when the company is insolvent, or fast approaching insolvency. In addition to the various duties of the directors under the Companies Act, the Insolvency Code bestows additional responsibilities on the directors towards their creditors during the twilight zone. The simple rationale behind this is to ensure that the directors do not engage in any wrongful or fraudulent activity, and do not mis-utilise the money that they owe to the creditors. Since the twilight zone means that the company is already in a precarious

<sup>51</sup> *Bishopsgate Investment Management Ltd. (in liq) v Maxwell* (No.2), BCLC 1282 (1993, Court of Appeal).

<sup>52</sup> *Re D'Jan of London Ltd.*, BCC 646 (1993, High Court of Justice Chancery Division)

<sup>53</sup> Section 69 of the Code

<sup>54</sup> H Hansenn (2009). Tough Insolvent Trading Laws Hinder Corporate Restructuring. *McCullough Robertson Lawyers*.

position, the directors must act in the bona fide interests of the creditors, and ensure that the company steers away from insolvency.

Another question which the author had raised subsequently, was when exactly does this shift in director's duties occur? It is the opinion of the author that section 66 of the Code does well to highlight that if there exist any external circumstances which causes the directors to have knowledge that the company may be on the verge of insolvency based on their actions. Hence, reasonable knowledge of insolvency of the company in the minds of the directors appear to be the point at which the directors should prioritise the interests of the creditors, over the shareholders. Although this point is difficult to identify, and may vary based on the mindset of each director, the directors of a company should constantly review the company's position and determine whether the company is in a zone of insolvency or not. If this identification can be made at an early stage, the directors will be better equipped to deal with the situation of insolvency, and take the requisite measures.

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## *Re-designing the Fast Track Insolvency Process*

Shreya Prakash

Chapter IV of Part II of the Insolvency and Bankruptcy Code, 2016 (Code) provides a fast-track process for the resolution of insolvency of small companies, start-ups, and unlisted companies with total assets below Rupees. one crore. The fast-track insolvency resolution process (fast-track process) essentially provides for the insolvency resolution process of such debtors to be conducted within a period of 90 days (extendable by a further 90 days), instead of one hundred and eighty days (extendable by a further 45 days) allowed under the regular corporate insolvency resolution process (CIRP) under Chapter III of Part II of the Code.

The Bankruptcy Law Reforms Committee (BLRC), which recommended the enactment of the Code, also recommended that a special process be put in place for those entities whose insolvency could be resolved in less than 270 days. Consequently, the fast track process was designed with a view to provide a shorter process for entities that have a less complex structure of liabilities and assets or a smaller size of operations. While the report of the BLRC does not explicitly state that this fast-track process is targeted towards improving the insolvency resolution process for Medium, Small and Micro Enterprises (MSMEs), the World Bank in its Report on the Treatment of MSME Insolvency, categorises the fast track process as a process that shortens timelines to make general insolvency law more suitable for MSMEs.<sup>1</sup> As such, this process has been designed for 'small corporate debtors'.

Despite the clear objectives underpinning the enactment of the fast track process, and its potential utility in providing a framework for the insolvency resolution of small corporate debtors, the process has had few takers. The Economic Survey of 2017-18 noted that only one fast track process had been initiated under the Code.<sup>2</sup>

In this background, this essay first analyses the case to have a separate, shorter process for the insolvency resolution of certain entities. Secondly, it examines the reasons due to which the fast-track process has not been implemented successfully in India. Finally, it makes suggestions to redesign the process to enable it to serve its objectives better.

### NEED FOR A DIFFERENT PROCESS

CIRP is a 270 day process during which the committee of creditors (CoC), comprising of the financial creditors (FCs) of the corporate debtor (CD), assesses its viability and invites

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<sup>1</sup> World Bank Group, Report on the Treatment of MSME Insolvency (Insolvency & Creditor/ Debtor Regimes Task Force, 2017). (hereafter "World Bank Group")

<sup>2</sup> Economic Survey, Ministry of Finance, Government of India, 2017-18, pp. 50.

resolution plans for the CD. If the CoC believes the business is viable, it approves a resolution plan. If no resolution plan is approved, the CD goes into liquidation.

However, like most standard insolvency resolution processes for CDs, this process is better suited to larger companies, with more complex capital structures. Where the CD is a small company or a small limited liability partnership, recourse to the CIRP and liquidation processes under the Code may not be suitable since they require an ability to pay for a public and complex process, active creditor participation, an active market for the assets of the debtor and timely detection of distress, to be successful. These factors may not operate in the same manner for small CDs as discussed below.

### **Ability to Pay for a Public and Complex Process**

CIRP is a costly procedure that requires the appointment of an insolvency professional (IP), a detailed and public claims collection process, meetings of creditors and a public marketing exercise of the CD. Further the public nature of the CIRP means that a company has to shoulder the loss of goodwill associated with the initiation of insolvency proceedings against itself.<sup>3</sup> The process of liquidation too has various formalities, including obligations to carry out various valuations, prepare various reports and conduct meetings of stakeholders.

This works well, when incurring the costs of these public processes enable a transparent and fair marketing exercise that results in the most value maximising use of the assets of the CD. However, these processes may be *'too complex, lengthy and expensive for micro and small business debtors, which are characterized by low value, low sophistication and low complexity.'*<sup>4</sup> For instance, the utility of a public marketing exercise may not be high in case of small companies where the number of interested buyers are small. In these cases, processes are only likely to reduce recoveries for creditors. In some cases, small companies may not be able to withstand the costs of running this process and there is a high risk that the value of their business would *'evaporate'*<sup>5</sup> on the advent of insolvency proceedings. This is especially likely since small CDs often have a lower proportion of fixed assets, higher turnover on total assets and lower assets per employee.<sup>6</sup> This may lead to closing of businesses even when it is not the most commercially desirable outcome.<sup>7</sup>

### **Active Creditor Participation**

The CoC of the CD (which comprises of their FCs) is expected to take the commercial decisions under the CIRP.<sup>8</sup> The key responsibility of the committee is to assess if the CD is viable, and to approve an appropriate resolution plan. In addition to this, however, decisions such as raising of interim finance, sale of assets during the CIRP, related party transactions, change in the

<sup>3</sup> Armour, J. (2012). The Rise of the 'Pre-Pack': Corporate Restructuring in the UK and Proposals for Reform', published in Austin, R.P. and JG Aoun, Fady. (eds.), Restructuring Companies in Troubled Times: Director and Creditor Perspectives, 43-78. (Sydney: Ross Parsons Centre of Commercial, Corporate and Taxation Law, 2012) p. 43.

<sup>4</sup> United Nations Commission on International Trade Law (UNCITRAL), Insolvency of Micro, Small and Medium-sized enterprises: Draft text on a Simplified Insolvency Regime. Working Group V, (V.19-01938 (E), 2019), Para 24. (hereafter 'Working Group V')

<sup>5</sup> Polo, Andrea. (2012). Secured Creditor Control in Bankruptcy: Costs and Conflict (Job Market Paper) *Saïd Business School*, p. 20. <https://pdfs.semanticscholar.org/8731/1f37705f153b10cdb9bf02a72e6139985e21.pdf>

<sup>6</sup> Ministry of Micro, Small and Medium Enterprises, Annual Report (2017-18), Para 1.1 <https://msme.gov.in/sites/default/files/MSME-AR-2017-18-Eng.pdf>

<sup>7</sup> Zweiten, K. Van. Principles of Corporate Insolvency Law (5<sup>th</sup> edn., 2018), p. 495.

<sup>8</sup> *K. Sashidhar v. Indian Overseas Bank & Ors.*, 2019 (3) SCALE 6

terms of appointment of the CD etc. all have to be approved by the CoC.<sup>9</sup> The decisions of the CoC, including on how the CD's assets are to be sold, are also relevant in liquidation. Further, there is now an obligation to form a stakeholder consultation committee comprising of the creditors of the CD, which would provide advice to the liquidator on a multitude of issues.<sup>10</sup>

This model works best when creditors believe that collective action would be most value maximising and that the costs of participating in the process will be outweighed by the returns they get from the process. However, in case of small CDs, especially those that house micro and small businesses, secured creditors may prefer individual enforcement of their security interest over the main assets of the company, outside of a collective process. Indeed, the BLRC also noted anecdotal evidence that *'banks are too quick to initiate recovery proceedings against MSMEs in the event of a default (irrespective of the viability of the entity)'*,<sup>11</sup> despite guidelines of RBI that incentivise them to consider restructuring debts due from viable enterprises. On the other hand, unsecured creditors may find that the unencumbered assets of the company would not give them enough realisation to outweigh the costs of participating in the process.<sup>12</sup> Thus, there may not be enough incentives for creditors to participate in the CIRP or liquidation processes of such debtors.

### Active Market for the Assets of the Debtor

CIRP displaces the management of the CD, and requires that a public marketing exercise be conducted for the assets of the debtor. While the Code originally provided that any person may propose a resolution plan for the CD, section 29A of the Code added *vide* an amendment in 2018, effectively bars a promoter from applying as a resolution applicant in the CIRP or purchasing the assets of the debtor in liquidation. This means that initiation of proceedings under the Code effectively results in the control of the CD being wrested from the hands of the promoters permanently.

While section 240A of the Code exempts the application of certain provisions of section 29A on MSMEs, the definition of MSMEs is likely to be too restrictive<sup>13</sup> and may not cover all instances where the best chance of the small company's rescue would be to keep it in the hands of the existing promoter. Similarly, while section 230 of the Companies Act, 2013 enables the promoters to enter into a compromise with the creditors of the CD in liquidation, and regain control of their enterprise, the use of schemes may prove extremely cumbersome and costly for small debtors. Thus, the chance of the promoter regaining control of the CD is minimal.

This may be useful in building a market for corporate control of strategic/large assets, especially since Indian corporates are typically closely held. However, in cases of small CDs, such a market may not exist for multiple reasons. First, in many cases, smaller companies suffer from poor record keeping. Such information asymmetry is likely to make it harder for a third party to purchase the business of the company. Secondly, smaller companies are likely to have fewer fixed assets, and may be heavily dependent on the promoter-manager and his

<sup>9</sup> Section 28 of the Code.

<sup>10</sup> Regulation 31A, Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2019.

<sup>11</sup> Bankruptcy Law Reforms Committee, Interim Report of the Bankruptcy Law Reforms Committee, (2015), pp. 31

<sup>12</sup> Working Group V. *supra* note 4 at Para 17.

<sup>13</sup> Radhika Merwin. (April 18, 2019). Why leeway under IBC eludes many MSMEs. *Hindu Business Line*

employees, which may not be so easily transferred. Consequently, the best likelihood of resolving insolvency may be to keep the business in the hands of the existing promoters/managers.

### **Timely Detection of Distress**

CIRP can be initiated by an operational creditor (OC), FC or the CD itself on a 'default' in payment of a debt due to a FC or OC. The test of 'default' was chosen to ensure the timely detection of distress and recourse to a rescue procedure.

However, in case of smaller companies where the nexus between promoters and the management is likely to be more,<sup>14</sup> the fact that the promoter is likely to lose control on the initiation of the CIRP, and is unlikely to be able to bid for the CD, means that promoters are less likely to initiate the CIRP promptly.<sup>15</sup> In addition to this, the provisions of the Code dealing with personal insolvency have not been implemented yet, which means that in those cases where the promoter has given personal guarantees, which is likely to be common in case of small companies, the promoter is unlikely to be guaranteed a discharge. This further disincentivises promoters from initiating proceedings under the Code.

Further, the promoter-managers of such companies are more likely to act recklessly in the wake of insolvency to preserve their business, especially since they are less concerned about getting into the job market again.<sup>16</sup> It may be harder to suitably apply provisions such as those preventing wrongful trading or fraudulent trading, in the context of small CDs since it would be difficult to judge '*what the correct behavior of the director should have been*'<sup>17</sup> retrospectively. This may lead to prolonged litigation that creditors may be less interested in funding due to the limited assets of the promoter-managers of such debtors, which would further reduce the efficacy of such provisions.<sup>18</sup>

If creditors of such a company are also passive, as may be the case as discussed above, they are also unlikely to identify distress sufficiently early, and trigger the CIRP. This means that such companies do not enter the CIRP till an advanced stage of distress.

Given these fundamental mismatches between the corporate insolvency resolution regime and the needs of small CDs (that may have less complex balance sheets, fewer creditors, small scale of operations, or high 'evaporation risk'), there is a need to have a different insolvency resolution process for such debtors.

### **AN ASSESSMENT OF THE FAST-TRACK PROCESS**

As discussed above, there is a need to have a different insolvency resolution process for small CDs, which the fast-track process could have served. However, first, the fast track process barely differs from the CIRP. It primarily reduces the time period within which the insolvency of the debtor may be resolved to ninety days, extendable by another 45 days. Other than reducing the timelines, the fast-track process only recommends a variation in the number of valuers to be appointed. As such, the fast-track process, which was meant to provide an

<sup>14</sup> World Bank Group. *supra* note 1 at p. 11

<sup>15</sup> Gilson, Stuart C. Managing default- Some evidence of how firms choose between workouts and Chapter 11. in Bhandari, Jagdeep S., Weiss, Lawrence A., & Posner, Richard A. *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge University Press, 1996)

<sup>16</sup> World Bank Group. *supra* note 1 at Pg 11

<sup>17</sup> Davis *et al*, *The Modular Approach to Micro, Small, and Medium Enterprise Insolvency* (July 2016), p. 82.

<sup>18</sup> Williams, Richard. (2015). What Can We Expect to Gain from Reforming the Insolvent Trading Remedy? *Modern Law Review* 78(1), 55.

alternate framework for the insolvency resolution of small CDs offers no significant deviation from the CIRP.

Secondly, the fast-track process applies only to the 'resolution' stage. However, in many cases, it may be hard to rescue small CDs. In such cases, they would have to undergo the liquidation process, which could be value destructive in a disproportionate manner due to the extensive formalities and costs of the process. Given this, there is a need to have a simplified and low-cost liquidation process as well, which the fast-track process does not cover.<sup>19</sup> Considering that the fast-track process does not factually simplify the process for small CDs, even the Insolvency Law Committee recommended the repeal of the fast-track process in 2018.<sup>20</sup>

Thus, the Code does not offer the most effective regime for the insolvency resolution of smaller CDs. This is particularly damaging since MSMEs *'form the foundation of the Indian economy, and are key drivers of employment, production, economic growth, entrepreneurship and financial inclusion.'*<sup>21</sup> As such, the lack of a suitable insolvency resolution and liquidation process is likely to affect credit availability to and entrepreneurial activity for this sector, and undermine the objectives of the Code.

Accordingly, there is a need to reconceptualise the fast track insolvency resolution process framework to enable maximisation of value for all stakeholders of such special types of debtors.

#### REDESIGNING THE PROCESS

To redesign the fast-track process one of two approaches can be followed. First, the CIRP and Liquidation Process can be applied to small CDs with additional modifications. Secondly, an entirely new scheme, which is significantly different from the current process may be integrated into the Code.

#### **CIRP and Liquidation Processes can be applied with additional modifications**

Most jurisdictions treat the insolvency of small CDs by making certain modifications to their insolvency resolution process. For instance, the UK makes certain exemptions, including exemptions from holding physical meetings, exemptions from providing proof of small debts and deemed approval of routine decisions of creditors.<sup>22</sup> Argentina, on the other hand, provides for lower documentation requirements, and removes the requirement to mandatorily constitute a creditors' committee.<sup>23</sup> The Organization for the Harmonization of Business Laws in Africa's uniform insolvency law also provides for a simplified reorganisation and liquidation process. The simplified reorganisation process has lower documentation requirements, and allows for the preparation of a simpler reorganisation plan. The simplified liquidation process provides for sale of properties through private agreements.<sup>24</sup>

<sup>19</sup> Davis *et al. supra* note 17 at p. 24.

<sup>20</sup> Insolvency Law Committee, Report of the Insolvency Law Committee. (2018). Para 22.3. [http://www.mca.gov.in/Ministry/pdf/ReportInsolvencyLawCommittee\\_12042019.pdf](http://www.mca.gov.in/Ministry/pdf/ReportInsolvencyLawCommittee_12042019.pdf).

<sup>21</sup> *Id.* at Paras 22.1-22.3.

<sup>22</sup> Small Business, Enterprise and Employment Act, 2015 (UK). (August 2019) [http://www.legislation.gov.uk/ukpga/2015/26/pdfs/ukpga\\_20150026\\_en.pdf](http://www.legislation.gov.uk/ukpga/2015/26/pdfs/ukpga_20150026_en.pdf).

<sup>23</sup> World Bank Group. *supra* note 1 at p. 23.

<sup>24</sup> World Bank Group. *supra* note 1 at p. 26-27.

Similarly, in India too, the fast-track process could be redesigned to include a further simplified CIRP and liquidation process. The CIRP and liquidation processes could be simplified for this purpose by:

- basing the interface with the Adjudicating Authority on online means,<sup>25</sup>
- reducing documentation requirements,
- deeming that the approval of the CoC has been received in some cases,
- making the formation of the stakeholders' consultation committee in liquidation optional in some cases,
- providing for a template resolution plan for small CDs, that may even be generated using appropriate software,<sup>26</sup>
- making further exemptions for small CDs under section 29A both in resolution and liquidation,
- allowing for private sales in a larger number of circumstances in liquidation, and
- providing for a duty to file in limited circumstances to incentivise timely filing, as opposed to relying purely on wrongful trading provisions which are difficult to apply.<sup>27</sup>

### **A New Scheme can Replace the Fast-Track Process**

Alternatively, the fast-track process could be redesigned to include a new scheme for resolution and liquidation, whose fundamental features would be different from those of the CIRP and liquidation under the Code. A new scheme for resolution could include:

- Initiation of the process before actual default on the instance of the debtor in addition to the commencement on default on the instance of the creditor;
- Debtor in possession, with the potential of having a supervisor;
- Reducing the involvement of courts, including by deemed approval of a resolution plan where creditors approve of it; and
- Allowing the debtor to propose a resolution plan, which if approved, could bind minority creditors.<sup>28</sup>

Example of such procedures include:

*Company Voluntary Arrangements (CVAs), United Kingdom:* In a CVA, the directors may propose a voluntary debt arrangement, which needs to be agreed to by the creditors of the company. Where the directors of the company propose a CVA, they must approach an insolvency professional to act as a nominee, whose role is to opine if the proposal has a reasonable

<sup>25</sup> Davis et al. *supra* note 17 at p. 47.

<sup>26</sup> Davis et al. *supra* note 17 at p. 47, 64.

<sup>27</sup> 'Poor corporate governance and insufficiently trained and skilled directors, a rather widespread phenomenon in the MSME context, might require a clear-cut, and even easier to apprehend rule on which to base the liability of directors. Indeed, the insufficiency and inadequacy of accounting information, particularly common in the context of MSME, makes it difficult to judge retrospectively and when it should have been executed. Judges in jurisdictions with little practice of holding directors liable for misbehaviour, again, a not uncommon situation, could find it difficult to conduct an assessment, on the merits, of the actions of the debtor's management on the eve of insolvency. While more rigid, the duty to file constitutes a somewhat clearer rule that works as a stricter ex ante corporate governance incentive, although the experience in systems that subscribe to the duty to file regime (e.g. Germany) show that uncertainty still exists with regard to the point in time when the duty arises. When opting for one system or the other, the legislator would do well to take all considerations into account.' World Bank Group, *supra* note 1 at p. 82.

<sup>28</sup> Working Group V. *supra* note 4. See also: European Commission, Commission Staff Working Document Impact Assessment: Accompanying the document Commission Recommendation on a New Approach to Business Failure and Insolvency, [C (2014) 1500 final, 2014], [https://ec.europa.eu/smart-regulation/impact/ia\\_carried\\_out/docs/ia\\_2014/swd\\_2014\\_0061\\_en.pdf](https://ec.europa.eu/smart-regulation/impact/ia_carried_out/docs/ia_2014/swd_2014_0061_en.pdf)

prospect of being approved and implemented. After this, the proposal is put for approval of the creditors. If at least 75 per cent of the unsecured creditors of the company approve of the CVA, broadly, the company and its unsecured creditors are bound. Secured creditors are bound only if they approve of the CVA. However, creditors may apply to the court if the CVA's terms are unfairly prejudicial or if there was some material irregularity in the procedure leading up to its approval.<sup>29</sup> The CVA scheme itself has had 'very little take up'<sup>30</sup> and is subject to criticism since it doesn't provide an automatic moratorium, except in case of small companies, and doesn't bind secured creditors unless they consent. Further, in many cases, the terms of the CVA are not met by the debtor.<sup>31</sup> Despite this, it is estimated that the average value that would be foregone if the CVA was not available, and all debtors had to resort to the administration procedure would amount to £167,500 per case.<sup>32</sup>

*Small Business Rehabilitation Procedure, Korea:* Other jurisdictions such as Korea also have a special procedure for Small Businesses. In this procedure, the CD retains management of the business. However, an examiner is to be appointed to assess the debtor's financial condition using a simplified accounting method. Further the requirements for approval of a resolution plan are also simplified in this case to ensure that one major creditor is unable to block the approval of the resolution plan.<sup>33</sup> This process is common for small companies as well as unincorporated entities.

*Personal Insolvency under the Code:* Closer home, this process appears to be similar to the insolvency resolution process for unincorporated entities in the Code as well, in which the debtor remains in possession of the business assets, and proposes a repayment plan which the creditors may approve in their meetings. While this process has not yet been implemented and does not comprehensively contain all the elements discussed above, some elements from this process could potentially be looked to while designing the framework for small CDs.

The new scheme for resolution could also be redesigned to allow for a cost-effective business sale, which may even be concluded to existing parties. Examples of such a procedure could include:

*Pre-packaged sales of the business (including to connected parties), United Kingdom:* A pre-packaged sale in jurisdictions such as the United Kingdom involves the 'pre-negotiated sale of the debtor's assets which is executed soon after' the initiation of formal insolvency proceedings, and without requiring prior statutory approval of creditors.<sup>34</sup> Since the negotiation of the sale takes place before formal insolvency processes are initiated, the indirect costs of insolvency and the direct costs of following a statutory procedure are not incurred by firms that take resort to these procedures. Further, since the negotiation of the sale takes place when the management is still in control, (although insolvency professionals advise while the deal is negotiated) and even connected parties may purchase the business, management is

<sup>29</sup> Olivares-Caminal, *Debt Restructuring* (Oxford University Press, 1<sup>st</sup> edn., 2011) pp.136-137.

<sup>30</sup> *Ibid.*

<sup>31</sup> R3 Association of Business Recovery Professionals, *Company Voluntary Arrangements: Evaluating Success and Failure*. (2018).

<sup>32</sup> *Supra* note 28 (European Commission).

<sup>33</sup> World Bank Group. *supra* note 1 at p. 31.

<sup>34</sup> Kastrinou, A., & Vullings, S. No Evil is Without Good': A Comparative Analysis of Pre-pack Sales in the UK and the Netherlands, p. 2.

incentivized to take recourse to this simple restructuring procedure. Moreover, evidence suggests that such sales result in better job preservation and recoveries for both secured and unsecured creditors when they are employed in those cases where there is high evaporation risk, which applies to small CDs described above, even when the sale is made to connected parties.<sup>35</sup>

*Voluntary auctions, Sweden:* In jurisdictions such as Sweden, an auction process can be availed of on the instance of the debtor or individual creditor. This auction is conducted by the court-appointed trustee on the basis of a cash-only deal, where payments are made on the basis of the priority of creditors. The BLRC, in its Interim Report, also recommended that '*a small business seeking rescue protection could be subjected to voluntary auction of the entire business... Auctions, either as pre-packs or in bankruptcy, have been utilized under the Swedish bankruptcy system with success- they have been found to be a speedy, low-cost bankruptcy procedure.*'<sup>36</sup> While this does not provide for the debtor-in-possession, these firms may also be repurchased by the original owner in these auction processes. Indeed, '*firms sold as going concerns are repurchased by the original owner in 54% of the cases.*'<sup>37</sup> Additionally, the auction may also take place in a pre-packaged deal, meaning that incentives may continue to exist for promoter-managers to initiate such proceedings.

In addition to the new scheme for resolution, a new scheme for liquidation may be provided. The new scheme could make liquidation more speedy and less costly by:

- Allowing direct recourse to liquidation on an application by the CD,
- Enabling publicly funded authorities such as the Official Liquidator, and a new cadre of low cost insolvency professionals to carry out this process,<sup>38</sup>
- Enabling distribution of assets (as opposed to proceeds from sale of assets) to stakeholders in a larger variety of circumstances, and
- Simplifying the liquidation process by reducing documentation/ reporting requirements, making the formation of the stakeholders' consultation committee optional and enabling private sales in a larger number of circumstances (as discussed previously).

There is therefore, a suite of options to choose from while redesigning the fast-track process. Policy-makers may choose one or a mix of any of these options in the interests of a value maximising insolvency resolution of small CDs, based on a detailed analysis of the costs and benefits of each of these options.

## CONCLUSION

This essay argues that the current fast-track process which was meant to provide a scheme for insolvency resolution of small CDs is not designed to optimally resolve their insolvency since, like the CIRP, it is premised on active creditor participation, an active market for distressed enterprises, timely detection of distress and an ability to pay for a complicated and public

<sup>35</sup> *Supra* note 5.

<sup>36</sup> Bankruptcy Law Reforms Committee. *supra* note 11 at pp.129-130.

<sup>37</sup> Thorburn, Karin. (2000) Bankruptcy auctions: costs, debt recovery and firm survival, *Journal of Financial Economics* 58, 337, p. 344.

<sup>38</sup> Davis et al. *supra* note 17 at pp. 64-65..

process. Instead, the fast-track process should be redesigned more comprehensively, to either provide exemptions from the extensive requirements of the CIRP and liquidation, or to provide an entirely different scheme.

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## *Insolvency in Aviation Sector*

Bahram Vakil and Gausia Shaikh

The period between the 1980s and 1991 saw multiple airline insolvencies in the United States of America (US). Referring to the time, it has been said that the US air carrier industry had conclusively proven the oldest adage of aviation: '*what goes up, must come down*'.<sup>1</sup> On October 2, 2017, Monarch Airlines of the United Kingdom (UK) was placed into administration with over 1,10,000 passengers stranded overseas, and more than 3, 00,000 bookings for future holidays lost, affecting a further three quarters of a million people.<sup>2</sup> Closer home, Kingfisher Airlines discontinued its operations in 2012 and 2013 saw its licenses being revoked by the Directorate General of Civil Aviation (DGCA), with multiple allegations of willful default of loans against the promoters. Advocates of the implication of a political economy on the law of the land argue that this hastened the enactment of the Insolvency and Bankruptcy Code, 2016 (Code). Three years since the enactment of the Code, we have another major airline in insolvency. On April 17, 2019, Jet Airways (India) Limited (Jet Airways) announced that it would cease its operations and on June 20, 2019, the corporate insolvency resolution process (CIRP) of the company began. This is the first airline insolvency under the Code and is bound to bring forth unique issues arising out of an insolvency in the aviation sector.

In this article, we look at some of these issues, observe the treatment of such insolvencies in other jurisdictions such as the UK and the US and analyse the Indian scenario to give an overview of the way forward.

### A GLIMPSE OF THE INDIAN AVIATION SECTOR

The airline industry in India is a major contributor to the Gross Domestic Product (GDP). It presently contributes USD 72 billion to GDP.<sup>3</sup> A 20-year forecast made by the International Air Transport Association (IATA) suggests that the growth of the Indian aviation industry will surpass the UK and India will become the third largest aviation industry with 278 million passengers in 2026. The IATA has further predicted that by the year 2035, the Indian aviation industry will have to cater to 442 million passengers.<sup>4</sup> These predictions seem believable when we see that India has already seen a 14.1 per cent growth in passenger traffic in the last five years.<sup>5</sup>

<sup>1</sup> Sabino, A. (1992), Flying the Unfriendly Skies: A Year of Reorganizing Airlines, Aircraft Lessors, and the Bankruptcy Code, *J. Air L. & Com.* 57, 841

<sup>2</sup> Department of Transport, London, Airline Insolvency Review, (March 2019) .  
[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/800219/airline-insolvency-review-report.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/800219/airline-insolvency-review-report.pdf).

<sup>3</sup> National Investment and Promotion Facilitation Agency, (August 2019) <https://www.investindia.gov.in/sector/aviation>.

<sup>4</sup> International Air Transport Association, Realizing India's Aviation Potential (October 21, 2016)- Press Release No.: 63.

<sup>5</sup> Economic Diplomacy and States Division, Ministry of External Affairs, India Surging Ahead, (August 2019)  
[https://static.investindia.gov.in/s3fs-public/2019-07/India%20Surging%20Ahead\\_0.pdf](https://static.investindia.gov.in/s3fs-public/2019-07/India%20Surging%20Ahead_0.pdf).

Further, the central government has also introduced the RCS – UDAN (Regional Connectivity Scheme – *Ude Desh ka Aam Nagrik*), which proposes to connect 27 currently served airports, 12 currently underserved airports and 31 currently unserved airports while also setting an airfare cap of Rs. 2500 for approximately one hour of flying. Flights have already commenced from 28 airports under the scheme. Despite the above, India is among the costlier places in the world to run a fleet of planes because of higher taxes, aviation turbine fuel charges and airport charges.<sup>6</sup> Added to the fray, is the growing competition of low-cost airlines which further erodes the margins for full service airlines. Not only have low-cost airlines led to increased demand for air travel but have also compelled full service carriers to provide competitive pricing while incurring significant costs. In the past few years, researchers such as Kolte et al. (2017) have used the Altman Z Score Model to predict airline insolvencies in India and have found Kingfisher Airlines and Jet Airways to be the airlines which were most likely to go bankrupt.<sup>7</sup> The Code, like most cornerstone commercial legislations like the Companies Act, 2013, Indian Contract Act, 1872 or the Sale of Goods Act, 1930, has been designed to be a generic law applicable to all industries (barring financial service providers) across the board. However, as companies in diverse sectors enter the insolvency process, the flexibility and adaptability of the CIRP is being tested. Meeting the strict timelines under the Code, running of an airline business as a going concern during the CIRP or dealing with the multitude of lessor claims arising out of such insolvencies have posed new questions of law before the Code.

#### ISSUES IN AIRLINE INSOLVENCIES IN INDIA

Be it the nature of operations or the complexities of aircraft financing and asset preservation, multiple issues contribute to the difficulties in dealing with insolvencies in the aviation sector. In this section, we discuss some of these issues.

##### **Aircraft Financing**

The primary assets of an aviation company are aircrafts. However, owning an aircraft is often not economically feasible for such companies. This leads to airlines engaging in rather complicated financing arrangements not only with financial institutions, but also with the aircraft manufacturers themselves.<sup>8</sup> Being at the shorter end of the deal, airline companies tend to provide heavy collateral to the financiers in such arrangements thereby adding to the encumbrances on its limited assets. The other method of acquiring aircrafts is through leasing. Such leases may either be financial leases or operational leases. The title to the aircraft may or may not pass to the airline company upon entering into a financial lease, depending upon the terms of the lease agreement. Therefore, it is likely that upon default, the lessor would exercise its proprietary interest over the aircraft and obtain possession of such aircraft, thereby further limiting the scope of assets available with the airline.

Further, when the company is undergoing CIRP, there is also the issue of categorising claims under such leases as financial and operational debt and verifying claims which may

<sup>6</sup> Kingfisher - King of Good Times Forced to Leave the Sky Castle, *MarketLine* (2014).

<sup>7</sup> Kolte et al. (2017). Predicting Financial Distress of Firms. A Study on Bankruptcy of Kingfisher Airlines, 10<sup>th</sup> Annual Conference of the EuroMed Academy of Business, euroMed Press.

<sup>8</sup> Ripple, G. (2002). Special Protection in the Airline Industry] The Historical Development of Section 1110 of the Bankruptcy Code, 78. *Notre Dame Law Review*. 281.

include accelerated payment of rent. There is also a lack of clarity as to the treatment of costs, expenses and future losses when dealing with such claims. During the CIRP, all claim amounts are admitted as on the insolvency commencement date. However, this may be in conflict with contractual rights of the lessors and the question remains as to whether the Code will override contractual rights of the lessors.

### **Legal Requirements for Running the Company as a Going Concern**

The aviation industry requires a niche set of skills, training and knowledge. This has, in turn, led to the development of licenses, rules, regulations and other requirements essential for running an airline as a going concern. For instance, the Aircraft Rules, 1937 (Aircraft Rules) requires an airline to obtain an Air Operator Certificate subject to compliance with Schedule XI of the Aircraft Rules.

This certificate may be cancelled by the DGCA, in its discretionary powers, when the aircraft stops operating. The airline cannot operate without such certificate. Further, for continuing to be eligible to hold such certificate, the airline requires the appointment of an Accountable Manager (AM). The AM is a person who has full financial authority over the airline. During CIRP, since the Resolution Professional (RP) has such authority, she becomes the AM and has to take over the corresponding risks and liabilities as stipulated by the DGCA. The AM is also required to have a team of skilled, specialised and qualified personnel who must be appointed during CIRP if they cease to provide their services upon commencement of CIRP. It is critical for the RP to have access to a team of skilled professionals and ensure compliance with all applicable laws and regulations to perform its duty of running the Company as a going concern. Very often, the RP or the firm she is associated with may not have in-house expertise in this sector at which stage it becomes critical for the RP to be able to persuade senior management of the airline company to continue to be in employment of the entity so as to ensure regulatory compliances.

### **Assets Preservation**

The most critical assets for an airline are its aircrafts, airport slots and traffic rights. There are various concerns with respect to each of these assets which must be dealt with for preservation of their value.

For instance, every aircraft is required to be registered with the Central Government for it to operate. The primary concern with respect to such aircrafts during the CIRP is the issue of deregistration during the CIRP. Under Rule 30(7) of the Aircraft Rules, registration of the aircraft may be cancelled within five working days, without seeking consent or any document from the operator of the aircraft or any other person, if an application is received from a holder of an Irrevocable Deregistration and Export Request Authorization (IDERA). It is essential for the courts to conclusively decide whether the exercise of such an IDERA would fall within the scope of prohibition under the moratorium under the Code.

In respect of the other assets of the airline, slots and traffic rights are allocated to an airline company pursuant to a fixed process and are not owned by the airline company as such. Once the operation of the airline ceases, there is a risk of these slots and traffic rights being allotted to competing healthy airlines. The civil aviation rules currently do not provide for a due process for reversion of those rights to the restructured airline. Therefore, the RP is

required to initiate discussions with the DGCA, the Ministry of Civil Aviation and airport authorities for preservation of such slots and traffic rights on an ad hoc basis. If a viable business plan is plausible for the airline company then the Ministry of Civil Aviation and DGCA are more likely to consider protecting these assets of the airline company. However, the unavailability of these assets during the CIRP and related uncertainty may discourage potential resolution applicants and may adversely affect the resolution of the airline company. It is, therefore, a circular problem where the possibility of asset preservation depends on the preservation of the asset in the first place.

### **Treatment of Claims**

In addition to the claims arising out of debts owed to financiers and lessors, a major portion of the claims against an insolvent airline company are claims of consumers. In the event of insolvency of airline business, consumers face two types of losses – (a) financial loss (because they have paid for tickets that become worthless); and (b) personal welfare losses if they are left stranded abroad (this could be on account of delay and disruption, discomfort, anxiety and stress, and in some cases even health and employment problems).<sup>9</sup> A consumer may suffer further loss on the basis of her specific circumstances. Further, in terms of filing of claims one must look at the source of purchase of the ticket to verify and examine such claims. There are two ways for a consumer to purchase an airline ticket – (a) purchase of a ticket from the airline itself through its physical counters or its website / mobile application; and (b) through a travel agency. If a consumer has purchased a ticket from the airline itself, the consumer will herself have a claim against the insolvent airline company. However, if the consumer has purchased a ticket through a travel agency, it may seek a refund and compensation for loss from the travel agency (subject to the cancellation policy of the travel agency). In such a case, the travel agency will, in turn, file a claim with the airline company for the amount claimed by the consumer. In addition to the above, travel agents in India also have the option of seeking a refund from the IATA. IATA settlement service between airlines and travel agents (known as the BSP or Billing and Settlement Plan), may allow IATA<sup>10</sup> to reimburse travel agents for monies submitted to the airline, depending on the national bankruptcy legislation and the specifics of the airline's participation with IATA. IATA may then file a claim against the airline company. Another entity from which the consumer may claim refund / compensation is the credit card company, if she has purchased the ticket using a credit card. The credit card company may then file a claim with the airline company.

Assessing the scope, nature of debt and amount of such claims may prove to be an onerous task for the RP under the Code, especially in view of the sheer volume of such claims and of the possibility of duplication of claims for the same transaction.

### **Cross-Border Implications**

The very nature of the business of an airline company leads to a situation where the assets of the company may be located in more than one jurisdiction. In such case, it may be possible that insolvency proceedings are initiated in more than one jurisdiction. Such is the case in the

<sup>9</sup> *Supra* note 2.

<sup>10</sup> Airline Bankruptcy and Passenger Protection (2018). International Air Transport Association <https://www.iata.org/policy/consumer-pax-rights/Documents/airline-bankruptcy-position-paper.pdf>

insolvency of Jet Airways. If the jurisdictions involved have a legal framework for dealing with cross-border insolvency, it is easier to ascertain how such issues will be dealt with. However, this will be subject to the mutual relationship between such jurisdictions. Where a legal framework for cross-border insolvency is itself not available in either of the jurisdictions, the proceedings rely heavily on voluntary cooperation between the RPs/administrators/judicial fora of such jurisdictions. Matters further complicate when aircrafts of the airline are lying in either jurisdiction. In such case, not only are the operations of the company adversely affected but there is also a possibility that the creditors of the jurisdiction where the aircraft is grounded obtain returns from the proceeds of sale/ auction of such jurisdiction while the estate of the insolvent vis-à-vis the other creditors diminishes.

### **Sensitive Timelines**

Aircrafts depreciate rapidly if not operated and maintained regularly, they lose value at tremendous speed. Further, pilots as skilled workmen with niche technical knowledge have high demand in the market and delays in resolution may cause these pilots to be hired by competing airlines. Both these elements of operating an airline are likely to adversely affect the value of the company from the perspective of potential resolution applicants. Therefore, protection of these two vital elements of running an airline business must be the top priority of all stakeholders. In addition to the above, data suggests that 8 million jobs are supported by the aviation industry.<sup>11</sup> Protection of interests of such employees should also be prioritised during CIRP. If we look at the example of Jet Airways itself, 20000 employees have been adversely affected by the insolvency of the company. The National Company Law Tribunal (NCLT) has also observed this to be a matter of national importance.<sup>12</sup> In view of the above, it is imperative that a decision to resolve / liquidate an airline is taken expeditiously.

Identifying the unique issues mentioned above, various jurisdictions have developed or are in the stage of developing legal provisions focused specifically on dealing with insolvencies in the airline sector. In the next section, we look at the legal framework and practice in some of these jurisdictions.<sup>13</sup>

## **THE GLOBAL EXPERIENCE**

### **US and Protection of Secured Creditors**

The US Congress identified that the great expense of transportation equipment combined with the relative financial instability of the transportation industry justified greater protection for secured creditors and lessors of aircraft.<sup>14</sup> Consequently, section 1110 of the Federal Bankruptcy Code (US Code) forces debtor airlines to make decisions very early in their reorganisation efforts regarding their most important asset - their aircraft.<sup>15</sup> The section also covers aircraft engines, propellers, appliances, or spare parts.<sup>16</sup> It states that the right of a secured party with a security interest in the aircraft and other equipment as mentioned above, or of a lessor or

<sup>11</sup> *Supra* note 5.

<sup>12</sup> *State Bank of India v. Jet Airways (India) Limited*, C. P. 2205 (IB)/MB/2019.

<sup>13</sup> This section only covers legal provisions / recommendations for legal provisions to be made specifically in the context of airline insolvencies. All other provisions of the existing insolvency and bankruptcy laws which are not specific to the airline industry have not been described.

<sup>14</sup> *Supra* note 8.

<sup>15</sup> *Supra* note 8

<sup>16</sup> Section 1110(3), US Code.

conditional vendor of such equipment, to take possession of such equipment in compliance with a security agreement, lease, or conditional sale contract, and to enforce any of its other rights or remedies, under such security agreement, lease, or conditional sale contract, to sell, lease, or otherwise retain or dispose of such equipment, is not limited or otherwise affected by any other provision of the US Code, 1978.<sup>17</sup> The exception to such exercise of rights by the secured creditor is the fulfilment of all obligations by the airline company under the security agreement, lease or conditional sale contract, within 60 days of the order for relief under the US Code.

### **UK and Treatment of Consumers**

Post the Monarch airline debacle, the UK constituted an Airline Insolvency Review (Review) to assess consumer protection in the event of an airline or travel company failure.<sup>18</sup> As discussed above, insolvency of an airline causes loss to consumers who have purchased flight tickets in advance. The final report of the Review makes recommendations seeking, among other things:

- establishment of a formal repatriation protection scheme to protect any air passenger whose journey began in the UK, and who has a ticket to return on an airline that becomes insolvent while they are already overseas;
- improvement of the availability of rescue fares and enhancement of passengers' ability to claim them;
- the introduction of a more complete regulatory toolkit which would provide for, among other things:
  - Annual certification to confirm financial fitness of the company;
  - Development of repatriation plans and access to data as required;
  - Requirement for the Board of a UK airline to notify the Civil Aviation Authority when there is a material adverse change in its financial situation; and
  - Ability to grant a temporary special purpose license to enable an airline to conduct a repatriation operation, even where the airline does not have a future.
- enhancement of existing refund protection by increasing consumer awareness and uptake of refund protection; minimising unnecessary duplication of protection; and helping passengers to make a claim swiftly and easily.

While the recommendations have not yet been transposed into law, India may derive from the observations made in the Review when dealing with consumer claims.

### **Cape Town Convention and Opposable Rights to High-Value Aviation Assets**

The Convention on International Interests in Mobile Equipment was concluded in Cape Town on November 16, 2001 (CT Convention), as was the Protocol on Matters Specific to Aircraft Equipment (Protocol).<sup>19</sup> The primary aim of the Convention and the Protocol is to resolve the problem of obtaining certain and opposable rights to high-value aviation assets, namely airframes, aircraft engines and helicopters which, by their nature, have no fixed location.<sup>20</sup> Since these assets have no fixed location, there is negligible predictability of outcomes for the

<sup>17</sup> Section 1110(1) of the US Code.

<sup>18</sup> *Supra* note 2

<sup>19</sup> International Civil Aviation Organisation (ICAO) and International Institute for the Unification of Private Law (UNIDROIT) (2001), *Cape Town Convention and Protocol*, <https://www.icao.int/sustainability/Pages/Capetown-Convention.aspx>.

<sup>20</sup> *Ibid*.

financier / lessors in terms of the enforcement of their rights to such assets. Owing to the differences in laws pertaining to leases and security interests across the globe, the enforcement of rights by such financiers / lessors may depend on multiple factors such as (a) where the asset is located; (b) where the insolvency proceedings are conducted; and (c) what is the level of coordination of proceedings between the jurisdictions where the asset is located and the insolvency proceedings are being conducted, if not conducted in the same place. These uncertainties hamper the provision of financing for such aviation assets and increases the borrowing cost.<sup>21</sup>

The CT Convention read with the Protocol permits chargees to enforce the following remedies:

- take possession or control of any object charged to it;
- sell or grant a lease of any such object;
- collect or receive any income or profits arising from the management or use of any such object;
- procure the de-registration of the aircraft (to the extent that the debtor has at any time so agreed and in the circumstances specified in the CT Convention); and
- procure the export and physical transfer of the aircraft object from the territory in which it is situated (to the extent that the debtor has at any time so agreed and in the circumstances specified in the CT Convention).

65 countries are parties to the CT Convention and are adopting its provisions by way of legislation. While India is also a signatory of the CT Convention, it has not yet adopted its provisions in the domestic law.

#### THE INDIAN SCENARIO AND WAY FORWARD

In terms of changes in the laws dealing with airlines post the CT Convention, the Ministry of Civil Aviation decided to make suitable changes in the Aircraft Rules, 1937 in line with the provisions of the CT Convention and Protocol. These changes provide for deregistration and export of aircrafts in accordance with the provisions of the CT Convention/Protocol.<sup>22</sup> Further, owing to some conflict between existing laws and the CT Convention and Protocol, the Ministry of Civil Aviation has also proposed the enactment of the Cape Town Convention Bill. However, while the Bill was proposed in 2018, it has not yet been passed. As discussed above, the Code is sector agnostic which poses its own set of challenges. Each passing day in the CIRP of Jet Airways is likely to raise issues in the context of insolvencies in this sector and there is a need to devise specific solutions to some of these issues. Consultations with stakeholders and the resolution professional dealing with the insolvency of an airline may be helpful to the policy and law makers in deciding whether this sector requires any specific insolvency related legislative framework like the US or as contemplated in the UK for dealing with the issues unique to the aviation sector. However, what is critical is the need to appreciate the unique nature of this sector. The Code contains a non-obstante clause which clarifies that to the extent there is any conflict with any other law, then the Code shall prevail.

However, perhaps for the aviation sector there is a need to go beyond the non-obstante

<sup>21</sup> Ibid.

<sup>22</sup> Ministry of Civil Aviation. Proposal for enactment of the Cape Town Convention Act, 2018 for implementation of the Cape Town Convention/Cape Town Protocol in India (October 08, 2018)<http://www.civilaviation.gov.in/sites/default/files/Cape%20Town.pdf>.

clause and there is a need for amendments to civil aviation rules and regulations to ensure that an airline is able to continue trading as a going concern even during insolvency proceedings.

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## *Dooray Paved Doorway*

M. S. Sahoo

**T**he Hyderabad Bench of the Adjudicating Authority (AA) comprising learned Members, namely, Mr. Rajeswara Rao Vittanala and Mr. Ravikumar Duraisamy created history on August 2, 2017 when it approved the first resolution plan under the Insolvency and Bankruptcy Code, 2016 (Code) on finding that *'it meets all parameters, including legal and moral'*. While approving the resolution plan, the AA observed: *'..and the Resolution Applicant is from South, Resolution Professional is from East, Banks/financial institutions/EARC are from West and an ARC and most of the counsels are from North, therefore we further observe that Pan India efforts were involved to revive the Corporate Debtor ..'*

The corporate insolvency resolution process (CIRP) yielding the above resolution plan for resolution of the corporate debtor (CD), Synergies Dooray Automotive Limited (Dooray) was conducted under the stewardship of CS Mamta Binani, who incidentally is the first insolvency professional (IP) registered with the Insolvency and Bankruptcy Board of India (IBBI). The run-up to approval of the resolution plan, the onslaught on the Code based on the plan, and the post-approval intense litigations were nothing short of spectacular. The resolution plan, however, came out unscathed. Dooray paved the doorway for thousand others to follow and changed the trajectory of insolvency resolution forever. Dooray saga is now a part of insolvency folklore.

### THE RESOLUTION PROCESS

Dooray, which had its registered office in Ameerpet and factory in Vishakhapatnam, was incorporated on June 14, 1995. It had a negative net worth at the end of March, 2004 and consequently was declared a sick company by the Board for Industrial and Financial Reconstruction (BIFR) on February 14, 2007. As on September 30, 2004, Dooray had an outstanding debt of Rs. 212 crore. Some creditors of Dooray assigned their debts constituting a substantial amount of the outstanding debt on the balance sheet to a related party, Synergies Castings Limited (Castings) over 2008-11. Years later, Castings assigned a substantial amount of debt at a discounted consideration to Millennium Finance Limited (MFL), a Non-Banking Financial Company (NBFC), on November 24, 2016.

The Central Government, *vide* notification dated November 25, 2016, appointed December 1, 2016, as the date on which the provisions of the Sick Industrial Companies (Repeal) Act, 2003 shall come into force. Accordingly, any reference made to BIFR, any inquiry pending before BIFR, any appeal preferred to Appellate Authority for Industrial and Financial Reconstruction (AAIFR), or any proceedings pending before BIFR/AAIFR automatically stood abated with effect from December 1, 2016. Dooray applied for CIRP under section 10 of the

Code. The application was admitted and CIRP commenced on January 23, 2017. Dooray had total assets of Rs. 11.95 crore in the books with a liquidation value of Rs. 8.17 crore at the commencement of the CIRP. On the same date, it had an outstanding debt of Rs. 972.15, including interest, as under:

Sl. No.	Financial Creditor	Amount of Debt (Rs. crore)		Percentage Share in	
		Before November 24, 2016	After November 24, 2016	Debt	Voting Power
1	Alchemist Asset Reconstruction Company Ltd. (AARC)	122.06	122.06	12.56	13.83
2	Edelweiss Asset Reconstruction Company Ltd. (EARC)	86.92	86.92	8.94	9.84
3	Millennium Finance Limited (MFL)	00.00	673.91	69.32	76.33
4	Synergies Castings Limited (Castings)	763.17	89.26	9.18	0.00
<b>Total</b>		<b>972.15</b>	<b>972.15</b>	<b>100.00</b>	<b>100.00</b>

Three resolution applicants, namely, SMB Ashes Industries, Suiyas Industries Private Limited and Castings submitted resolution plans. The committee of creditors (CoC) unanimously rejected the resolution plans submitted by SMB Ashes Industries and Suiyas Industries Private Limited. It approved the resolution plan submitted by Castings with 90.16 per cent voting share, with certain modifications, in its second meeting on June 24, 2017. The minority creditor, EARC abstained from voting. The AA approved the plan on August 2, 2017. The plan provided for amalgamation of the Dooray with Castings, a related party with effect from March 31, 2017. It provided for similar treatment to all financial creditors (FC), whether they voted in favour of the plan or abstained from voting. It provided for realisations by claimants as under:

Sl. No.	Claimant	Amount of Claim (Rs. lakh)	
		Admitted	Realisations (Over time)
1	Insolvency resolution process cost	NA	50.00
2	Financial Creditors	97215	5469.68
2(a)	Alchemist Asset Reconstruction Company Ltd. (AARC)	12206	686.77
2(b)	Edelweiss Asset Reconstruction Company Ltd. (EARC)	8692	489.00
2(c)	Millennium Finance Limited (MFL)	67391	3791.75
2(d)	Synergies Castings Limited (Castings) (Notional being resolution applicant)	8926	502.16
3	Deferred Sales Tax	NA	351.69
4	Current Liabilities	NA	1.16
5	Statutory Dues	NA	43.13
6	Shareholders	NA	93,275 shares of face value of Rs.10 each, accounting for 0.37 per cent of shares of Castings.

#### DOORAY SAGA

The Code kicked in with no precedents to fall back upon. There were no formats and practices to rely on nor was there any experience with any of the constituents of the insolvency ecosystem. Elements, namely, IBBI, IPs, AA, CoC, resolution applicants were as new as the enactment itself. They dealt with the matter for the first time, while the corporate world and its stakeholders had only begun reading about the new enactment. However, at stake was the

future of Dooray and its stakeholders, including 1800 employees, and the credibility of the Code in resolving corporate insolvencies.

Throughout the CIRP, several applications were made to the AA under section 60(5)(c) of the Code raising contentious issues. The AA disposed each such application of. Several acts of omission and commission of the Resolution Professional (RP) were also challenged. The AA, however, found that the RP had acted strictly in accordance with law and followed the extant procedure and principles of natural justice. Despite these, the CoC approved resolution plan in about 150 days and the AA approved the resolution plan in about 190 days of the commencement of the CIRP. This seemed nothing short of a miracle, when similar cases under the erstwhile regime took ages to conclude. The cost of resolution was under one percent of realisation.

### **Realisations by Creditors**

The FCs realised less than six percent of their claims under the resolution plan. It set the alarm bells ringing. It was argued that if the very first resolution plan was any indication, the banks should just write off the non-performing assets (NPAs) rather than realise only about six per cent after a '*tortuous legal process and fat process costs*'. Or, the Code should be junked. It is, however, important to note that the FCs realised about six times the liquidation value. In the absence of the Code, Dooray would have continued with BIFR for 'n' years more and liquidation value would have depleted further. After 'n' years, Dooray would have been liquidated, which would have returned the liquidation value of Rs. 8.17 crore minus depletion minus cost of liquidation. Consequently, the FCs would have realised less than one percent of their claims, after 'n' years, as against realisation of about six per cent under the resolution plan. More importantly, realisation for FCs was a secondary outcome while the primary outcome was revival of Dooray.

This kind of realisation is consistent with the expectation under the Code in initial days of its implementation. The CIRP yields good outcomes when it is initiated in early days of default and concluded expeditiously. If it is initiated very late, as happened in this case, after decades of sickness, the corporate is only worth its liquidation value, which decays further with time. When that is not done, the CIRP yields either liquidation or abysmal recovery. A few years down the line, CDs would come up for resolution at the earliest instance of default of threshold amount, that is, when they have reasonably good health and hence the outcome then would be good. There have been a few instances where process was initiated in early days of default and the FCs have realised 100 per cent of their claims, in addition to revival of the CD.

### **Section 29A**

In this CIRP, Castings, a related party, took over Dooray, where the FCs took a haircut of about 94 percent. It was argued that the promoters, who drove the CD into the ground, wrested control of the CD through a process under the Code, while the only outcome of the process was haircut for FCs. This was not acceptable that the Code would reward unscrupulous persons at the expense of creditors. The Code made course correction with promulgation of an Ordinance on November 23, 2017, which inserted section 29A to prohibit certain persons from submitting resolution plans, who on account of their antecedents, may adversely impact the credibility of the process under the Code. This ensured that only capable and credible people take control of

the CD in the interest of sustainable resolution.

While replying to the debate on the Insolvency and Bankruptcy Code (Amendment) Bill, 2017 in Lok Sabha,<sup>1</sup> the Finance Minister stated:

'In the case of resolution also, all type of creditors may take some haircut and the man who created the insolvency pays a fraction of the amount and comes back into management. Should we allow that to continue? The overwhelming view, as expressed by the Members, is that it should not be allowed. This was a gap which was there in the original Bill and by binging in 29A we have tried to fill in that gap. That is the objective. In order that this provision must apply to all existing cases of resolution which are pending, that is the case for urgency. If we had not done this, then all such defaulters would have rejoiced because they would have merrily walked back into these companies by paying only a fraction of these amounts. That is something which besides being commercially imprudent would also be morally unacceptable. That is the real rationale behind this particular Bill.'

Section 29A did not prohibit promoters as such. It prohibited any person, who does not have a credible track record, from submitting a resolution plan. Consequently, the existing promoter and management stood to lose the CD for ever if they suffered from any of the disabilities under section 29A. Since then, the debtors have been begging, borrowing, and stealing to settle the default prior to filing of applications for initiation of CIRP or admission of the application by the AA or restructuring the debt at the earliest sign of default, which helps in preservation of value. The Code thus brought in significant behavioural changes and thereby redefined the debtor-creditor relationship. The defaulter's paradise was lost.<sup>2</sup>

### Related Party

A substantial amount of outstanding debt was assigned by Castings, a related party, to a third party NBFC, MFL, on November 24, 2016, one day before the notification of the SICA (Repeal) Act, 2003. While Castings being a related party was not eligible to be a member of the CoC, MFL found a seat in the CoC with more than 75 per cent of voting share. At that time, the resolution plan required approval by 75 per cent of voting share. If the debt was not assigned, Castings as well as MFL would have remained outside the CoC. It was alleged that the debt was assigned with the ulterior motive of including a related party in the CoC to control the process as well as outcome of the process and, therefore, such assignment was illegal. Therefore, the resolution plan approved by the CoC, which included Castings through MFL having more than 75 per cent of voting share, was in contravention of the Code. The AA dismissed these contentions.

On an appeal, the National Company Law Appellate Tribunal (NCLAT) considered whether assignments made by Castings on November 24, 2016 in favour of MFL were legal. It noted that the appellant was as much an assignee as Castings and MFL and that the three assignments were duly executed with the concerned authorities. It observed that the appellant did not have any *locus standi* to question the assignments in the insolvency proceedings and MFL, not being a related party, was fully competent to join the CoC.

### Amalgamation of Corporate Debtor

The resolution plan provided for amalgamation of Dooray with Castings. It was argued that the Code did not envisage amalgamation, which has the effect of extinguishment of the CD itself.

<sup>1</sup> Lok Sabha. Synopsis of Debates. Proceedings other than Questions and Answers. (December 29, 2017). August 6, 2019. <http://loksabhaph.nic.in/Debates/Synopsis.aspx>.

<sup>2</sup> *Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.*, (2019) 4 SCC 17.

Further, amalgamation of Dooray with Castings violated sections 230-232 of the Companies Act, 2013 (the Act) and thus, failed to satisfy section 30(2)(e) of the Code. The NCLAT held that there is no question of filing an application before the NCLT under sections 230-232 of the Act, at the stage of filing of the resolution plan as it is not known as to which resolution plan would be approved. It further held that the Code is a Code by itself and section 238 provides overriding effect of it over provisions of other Acts in case of conflict. Therefore, it rejected the argument that merger and amalgamation of the companies cannot be proposed in the resolution plan or such proposal is violative of section 30(2)(e) of the Code.<sup>3</sup> Subsequently, the Insolvency and Bankruptcy Code (Amendment) Act, 2019 has clarified that a resolution plan may provide for restructuring of the CD, including by way of merger, amalgamation and demerger.

### Government Dues

The Income Tax Department appealed against the order of the AA approving resolution of Dooray on the ground that the AA has granted huge income tax benefits to Castings without impleading the appellant. The NCLAT considered whether the income tax, value added tax or other statutory dues, such as municipal tax, excise duty, etc., come within the meaning of operational debt and whether the Central Government, the State Government or the legal authority having statutory claim, come within the meaning of operational creditors. It held that operational debt in normal course means a debt arising during the operation of a CD. Only when the CD is operational and remains a going concern, the statutory liability, such as payment of income tax, value added tax etc., will arise. As the income tax, value added tax and other statutory dues arising out of the existing law, arises when the CD is operational, such statutory dues have direct nexus with operation of the CD. Therefore, all statutory dues, including income tax, value added tax, etc. come within the meaning of operational debt. Consequently, Income-tax Department of the Central Government and the Sales Tax Department(s) of the State Governments and local authority, who are entitled to dues arising out of the existing laws, are operational creditors.<sup>4</sup> A resolution plan, which settles dues of the creditors, should be binding on Government. There were instances where Government followed up for the balance dues after approval of resolution plan which created uncertainty and discouraging potential resolution applicants. The Insolvency and Bankruptcy Code (Amendment) Act, 2019 makes resolution plan binding on Central Government, any State Government or any local authority to whom the CD owes debt under any law.

### CONCLUSION

The CIRP of Dooray served as the laboratory for evolution of best practices and as the school for every IP and other elements of the ecosystem. It was one of the most fiercely litigated CIRP which settled several issues and paved the doorway for many CIRPs in future. It engendered amendments in the Code in 2017 preventing undeserving persons from taking over CD through a CIRP, which in a sense is another dimension of *Swachh* India. It engendered amendments in

<sup>3</sup> *Edelweiss Asset Reconstruction Company Ltd. Vs. Synergies Dooray Automotive Ltd. & Ors.* [CA (AT) Nos. 169 to 173-2018].

<sup>4</sup> *Pr. Director General of Income Tax & Anr. Vs. M/s Synergies Dooray Automotive Ltd. & Ors.* [CA (AT) (Insolvency) No. 205/2017 and connected matters]

the Code in 2019 clarifying the scope of resolution plan and making resolution plan binding on Government. A successful experiment of an economic legislation with far-reaching ramifications, it reinforced rule of law and the notion that institutions do matter.

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## Part III

### The Ecosystem



## *Walking the Regulatory Tightrope*

K. R. Saji Kumar

*'Regulators, under unprecedented pressure, face a range of demands, often contradictory in nature: be less intrusive – but more effective; be kinder and gentler – but don't let the ..... get away with anything; focus your efforts – but be consistent; process things quicker – and be more careful next time; deal with important issues – but do not stray outside your statutory authority; be more responsive to the regulated community – but do not get captured by industry.'*

Prof. Malcolm K. Sparrow<sup>1</sup> (Harvard University)

### REGULATION AND REGULATORS

Regulation is quite pervasive in our contemporary society. It is a key socio-economic tool for both policy development (regulatory design) and policy implementation (regulatory delivery mechanism).<sup>2</sup> A 'good quality regulation' should meet five criteria viz., democratic legitimacy, accountability of the regulator, fair, accessible and open procedures, expertise and efficiency.<sup>3</sup> Additionally, good regulation should emphasise on the achievement of the outcomes rather than mere technical compliance.<sup>4</sup>

Regulators function in a polycentric environment, at the interface among public authorities, the private sector and the stakeholders. They can best be labelled as the 'referees' of the markets.<sup>5</sup> As public institutions they help guarantee access to and the quality of key public services and enhance market efficiency. They play a pivotal role in driving fiscal discipline and preserving confidence in the markets. As 'referees', they must strive to balance conflicting interests of diverse stakeholders by utilising principles of good governance, to ensure justice-oriented outcomes. Essentially, a regulator must act objectively, impartially and consistently, without prejudice, fear, apprehension or undue influence.

In the Indian regulatory landscape, systemic economic reforms in the year 1991 led to the setting up of several independent sectoral regulators to check market distortions and safeguard the interests of the beneficiaries. The regulators have partaken in supporting the stakeholders and have assumed themselves the task of 'drivers of development'.<sup>6</sup> A bulk of these reforms focused on the financial sector stability and strengthening the legal and institutional framework for speeding up the process of recovery of debts. However, the

<sup>1</sup> Sparrow, Malcolm K. (2000). *The Regulatory Craft- Controlling Risks, Solving Problems, and Managing Compliance*. Brookings, p. 17.

<sup>2</sup> Organisation for Economic Co-operation and Development (OECD), (2016). *Being an Independent Regulator, The Governance of Regulators Series*.

<sup>3</sup> Baldwin, Robert., Cave, Martin., and Lodge, Martin (2012). *Understanding Regulation: Theory, Strategy and Practice*. 2nd ed, OUP, p. 25.

<sup>4</sup> Black, Julia. (2008). *Constructing and Contesting Legitimacy and Accountability in Polycentric Regulatory Regimes*. *Regulation and Governance* 137.

<sup>5</sup> OECD (2016). *supra* note 2.

<sup>6</sup> Gopal Jain. (August 28, 2019). *Why India needs empowered regulators to partner in economic growth*, *Business Today*.

insolvency landscape was highly fragmented with several overlapping laws being implemented in an unpredictable manner in different fora, without any coordination. Resultantly, India needed a policy shift towards a definite and structured framework of laws and a centralised point of access to information.

#### WINDS OF BEHAVIOURAL TRANSITION

Pertinently, the enactment of the Insolvency and Bankruptcy Code, 2016 (Code), hailed as a key economic reform, changed the legal and economic rescue landscape in India. It is a reform, probably, much deeper than GST,<sup>7</sup> and has already demonstrated early signs of behavioural changes amongst the various market players. As a progressive economic legislation, the Code has shifted the balance of power from the debtor to the creditor. It has instilled a significantly better sense of fiscal discipline and ascribed greater certainty of outcome of the insolvency and bankruptcy processes. The Code has adopted the principle of mercantile law that 'the law should follow the merchant and not vice versa'.<sup>8</sup> The Code and the regulations have been designed and implemented to suit the prevailing business practices, as per this mercantile law principle. The entire regulatory framework under the Code has been instituted to proactively lead the winds of change and dispel information asymmetry. Many major reforms were triggered by the Government in order to facilitate the swifter implementation of the Code. It was recognised that robust institutional frameworks should be put in place to attribute judicial and legislative certitude, as well as orderly conduct of processes under the law. With this thought-process, the Insolvency and Bankruptcy Board of India (IBBI) was conceived and crafted by the Code and was established on October 1, 2016. As the Indian insolvency regulator, it is tasked to formulate enabling ecosystem and regulatory framework, *inter alia*, for implementation of corporate processes which commenced on December 1, 2016.

#### Positioning

IBBI is touted as the key pillar of the insolvency and bankruptcy institutional infrastructure. Its remnants can be traced to the suggestions made by the Bankruptcy Law Reforms Committee (BLRC)<sup>9</sup> and the Working Group-I.<sup>10</sup> It was envisioned as the supervisor of the institution of insolvency professionals, as well as other regulatory entities, for the overall insolvency and bankruptcy processes in the country.<sup>11</sup> As regards the functions of IBBI, the BLRC recommended four strands of activities *viz.*, malleability in the operations- to be achieved through a formal regulation making process, performing legislative, executive and quasi-judicial functions vis-à-vis the two regulated entities of information utilities and also insolvency professionals and agencies, and maintenance and public release of granular data about the working of all the insolvency and bankruptcy transactions.<sup>12</sup> The objective of IBBI, as outlined by the BLRC, is to utilise all its legislative, executive and quasi-judicial functions to achieve a well-functioning bankruptcy process in India.<sup>13</sup> No doubt, IBBI is a unique regulator as its regulatory functions

<sup>7</sup> The Central Goods and Services Tax Act, 2017

<sup>8</sup> William Murray, 1<sup>st</sup> Earl of Mansfield

<sup>9</sup> The Report of the Bankruptcy Law Reforms Committee (BLRC)- Volume I: Rationale and Design. November 2015.

<sup>10</sup> Report of the Working Group- I- Building the Insolvency and Bankruptcy Board of India (Design of the Board). Ministry of Corporate Affairs, Government of India.

<sup>11</sup> *Supra* note 9 at p. 38 (Para 4.1.5).

<sup>12</sup> *Supra* note 9 at p. 35

<sup>13</sup> *Supra* note 9 para 4.1.3

are distinctive in nature. It is mandated, *inter alia*, to make regulations for registering, monitoring and guiding individual professionals and professional entities. IBBI performs its functions subject to the general directions of the Central Government. However, the Government does not intervene in the day-to-day affairs of IBBI. It sends three of its officers at the level of Joint Secretary representing the Ministries of Finance, Corporate Affairs and Law and Justice, as *ex-officio* members, besides having a nominated member of the Reserve Bank of India.

### Specific Role

The functions of IBBI are stipulated in section 196 of the Code. Like a financial sector regulator, it has, broadly, three sets of functions, such as:

- *Legislative*: Making regulations for market intermediaries (service providers) and processes;
- *Executive*: Registering and regulating service providers for the insolvency process and taking measures for professional development and expertise for the market players through education, examination, training and continuous professional education; and
- *Quasi-judicial*: Adjudication of service providers for ensuring their orderly growth, development and functioning.

Besides the above, IBBI also prosecutes persons who contravene the provisions of the Code and thus assumes enforcement functions. It, therefore, acts as a regulator that writes down the norms by way of regulations for the insolvency and bankruptcy process but does not *per se* partake in the process. The processes under the Code are private affairs of corporates and individuals. IBBI does not get into any financial or strategic business decisions of either the persons in distress or the ones whose financial exposure is in distress. However, it facilitates smooth conduct and culmination of the processes for the stakeholders by making regulations, within the secondary legislative powers offered by the Code. By registering the professionals and monitoring their performances during the processes, IBBI exercises executive functions. It carries out investigation and inspection of the insolvency professionals and professional entities for alleged violations of the law, thereby discharging adjudicatory functions. While disciplining the professionals who contravene the regulations during the process, IBBI assumes quasi-judicial functions as well. Thus, the role of IBBI is by and large administrative, regulatory, enforcement-oriented and quasi-judicial in nature. This makes IBBI distinct from many other regulators.

### Exercise of Regulatory Functions

As discussed, IBBI performs functions generally for regulating the conduct of professionals and professional entities, and facilitating the processes. Section 196(1) (aa) of the Code is similar to the functions of the Securities and Exchange Board of India (SEBI) under section 11(1) of the Securities and Exchange Board of India Act, 1992. However, SEBI's powers are wide enough to protect the interests of investors in securities market and also to promote and develop the market by resorting to any measure that SEBI may think fit. IBBI does not have such outspread functions but are limited to promoting the development and regulation of working and practice

of professionals and professional agencies, information utilities and other institutions, in furtherance of the purposes of the Code. IBBI cannot take any measure to achieve the above said purposes. This restrains it from an absolute development of the insolvency and bankruptcy regime, and taking all measures for the betterment and advancement of the insolvency and bankruptcy realm in the country, much beyond the limited development and promotion of professions and professional entities. Besides the usual regulatory functions, IBBI also publishes information, data, research studies and other information. This function of IBBI is oriented towards forging alliance with the academia. Since it has been entrusted with writing regulations for the conduct of processes, knowledge building is necessary to position it as a repository of information to strengthen the regulatory goals. In order to reach out to the masses, IBBI maintains website for maximum dissemination of information. Aggregation and maintenance of records relating to insolvency and bankruptcy cases and their publication for information is one of its other important functions. It is interesting that IBBI has disseminated more than seven thousand orders on its website in the less than two years' of their evolution, to ensure that the stakeholders are not deprived of the day-to-day judicial developments.

#### REGULATORY GOALS BY REGULATIONS

Pursuing regulatory goals involves an interplay between various policy choices. While implementing the policies, a pertinent question arises as to whether the concerned legislation should regulate the area directly or should it delegate some part of the regulatory endeavour to a specialised statutory body or a body corporate. By and large, with enhanced Governmental remit, delegated/subordinate legislation has become a favoured route of Governments *en route* socio-economic policy implementation. The Code, by section 240, vests with IBBI the responsibility to make regulations for effectively 'carrying out' the provisions of the Code (enabling Act/legislation). It is one strand of the regulatory authority conferred on IBBI for pursuing the general and specific public policy goals enunciated in the Code. It helps in fleshing out the operational terms and procedures of the insolvency and bankruptcy regime instituted by the Code. These regulations, however, must satisfy the test of consistency with the Code and the rules made thereunder and shall be laid, as soon as possible, before each House of Parliament to ensure Parliamentary control over delegated legislation. While sub-section (1) of section 240 provides for making regulations consistent with the Code and the rules, sub-section (2) postulates the specific circumstances of regulatory mandate. In exercise of this specific provision, so conferred, IBBI has made regulations, *inter alia*, regulating the Information Utilities<sup>14</sup>, liquidation process<sup>15</sup>, corporate insolvency resolution process<sup>16</sup>, insolvency professionals<sup>17</sup>, etc.

#### Democratic Regulation Making

Increasingly, with the turn towards deliberative democracy, IBBI has developed a transparent and consultative process to regulation making. It seeks to bridge the gulf between the regulator, the regulated and other stakeholders. As a responsible and receptive regulator, it

<sup>14</sup> The IBBI (Information Utilities) Regulations, 2017.

<sup>15</sup> The IBBI (Liquidation Process) Regulations, 2016.

<sup>16</sup> The IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016.

<sup>17</sup> The IBBI (Insolvency Professionals) Regulations, 2016.

invites comments from the public on draft regulations notified under the Code. Besides regulatory impact assessment / analysis, public consultation and participation is one of the key regulatory gears employed by Government or its instrumentalities to enhance transparency, efficacy and effectiveness of regulation.<sup>18</sup> The Code neither mandates consultation with the Central Government nor seeks Government approval before regulations are made by IBBI. Section 196(1)(s), provides for 'making regulations for issuing regulations' giving opportunity to the regulated by the regulator to present their views and suggestions before a particular regulation is actually made and implemented by IBBI. This public participation mechanism is a rarity in the Indian regulatory landscape. Expert views of Advisory Committees and Working Groups are also sought before a policy framework on regulations is made. Roundtables and similar stakeholder consultations are also undertaken before policy decision for making regulations are formulated. The ideas and views from all these are crystallised and draft regulations are published on the website of IBBI to elicit public opinion. IBBI considers the views of the stakeholders and then a final regulatory decision is taken by the Governing Board before regulations are published in the Official Gazette. IBBI also voluntarily offers an all year long online public consultation process on regulation making. Suggestions of the general public are obtained in an online format, including suggestion to make amendments to the Code and the Regulations, which are considered at the end of every financial year for review. Time is the essence of the Code and this is reflected in various provisions. Section 196(1)(t), thus provides for making regulations and guidelines on matters relating to insolvency and bankruptcy, including mechanism for time bound disposal of the assets of the Corporate debtor or debtor keeping in mind the true spirit of the Code.

### **Inspection and/or Investigation**

The Code requires IBBI<sup>19</sup> to carry out inspection and/or investigation of the professionals and professional entities. Generally, an inspection or investigation is undertaken by a regulatory authority on a complaint by any aggrieved person or where there is reasonable ground to believe that the regulated entity has contravened any provisions of law, primary or secondary. The Code provides inspection *or* investigation to be conducted by any person or persons within a time period as directed by it. However, it is interesting to note that the person carrying out 'inspection' *or* 'investigation' is regarded in the Code as 'investigating authority' and not 'inspection authority'. It, thus mandates inspection *or* investigation to be conducted by a person or persons by 'investigating authority' only. Both inspection and investigation are different in pith and substance in terms of the procedure and process adopted. Inspection is sifting through the documents and scrutiny of existing material or record; however, investigation entails formal deep delving into facts and figures, involving proper exploration and understanding of the violations committed by the regulated entity. The Code has not clearly made a distinction between inspection and/or investigation, and a strict contradistinction between these two procedures, therefore, appears to be necessary. Detailed procedure for conducting inspection *or* investigation by the investigating authority is contained in section 218 but it only envisages conclusion of 'investigation' but silent about 'inspection' in sub-section (5) thereof.

<sup>18</sup> OECD. Background Document on Public Consultation., [https://www.mcgill.ca/law-studies/files/law-studies/sao\\_handbook2017\\_2018.pdf](https://www.mcgill.ca/law-studies/files/law-studies/sao_handbook2017_2018.pdf)

<sup>19</sup> Sections 217-220 of the Code

Interestingly, sub-section (6) of section 218 mandates a detailed report of 'inspection or investigation' to be submitted to IBBI by the 'investigating authority'. In view of the above, inspection and investigation provisions of the Code warrant rationalisation.

### **Expedited Regulatory Intervention**

It is expected that IBBI takes immediate market intervention in matters of contraventions without waiting for detailed report submitted by the investigating authority on completion of inspection or investigation. It is interesting that the Code<sup>20</sup> provides for issuing show cause notice after completion of 'inspection or investigation' and yet again carrying out 'inspection'. This appears to be a repetitive, time consuming and unconscionable exercise. IBBI appoints disciplinary committee<sup>21</sup> to consider reports of the investigating authority and to further deal with matters covered under the report and dispose of the same. There appears to be no logic in issuing show-cause notice after completion of the inspection or investigation. IBBI cannot wait for an inspection or investigation report before proceeding against a regulated entity which contravenes the law that warrants immediate intervention. The disciplinary action by the committee should not be defeated for want of a report from the inspecting or investigating authority. IBBI must be able to immediately intervene in any market manipulation and thwart an attempt to derail the course of a process or cause damage to a process. IBBI must be able to temporarily suspend or cancel registration of a regulated entity pending inspection or investigation and without any report thereon. It is essential for an important regulator such as IBBI to intervene and contain a market malpractice and to call for information relating to any contravention of process and also to detect and prevent violations. It must also be able to give directions to the market participants, including intermediaries, for any contraventions of law and process. Preventive action is also important for effective market regulation. IBBI must ideally possess authority to issue cease and desist orders, if it finds that there is any violation or likely violation of provisions of law as course correction alone would not always be helpful in efficacious market regulation.

### **Disciplinary Action**

Besides carrying out inspection and investigation of the professionals and professional entities, the Code also mandates monitoring their performance as to legal compliance and may call for information and records. Mechanism is also put in place for redressal of grievances against them and to pass orders relating to complaints against regulated entities. Law requires professionals,<sup>22</sup> to comply with professional behaviour and conduct. No authority except the disciplinary committee appointed by IBBI is authorised to initiate, hear and dispose of disciplinary proceedings against professionals and professional entities. There have been trends of Adjudicating Authority (AA) taking over this disciplinary burden of IBBI, which are reflected in some of their decisions. In a matter,<sup>23</sup> the AA observed that the show cause notice issued by IBBI deserved to be recalled. Further, the AA directed all disciplinary proceedings initiated by the IBBI against the insolvency professional be quashed and the matter was treated

<sup>20</sup> Section 219 of the Code

<sup>21</sup> Section 220 of the Code

<sup>22</sup> Section 220; regulations 11 and 7(2)(h) r/w the Code of Conduct in the First Schedule to the IBBI (Insolvency Professionals) Regulations, 2016

<sup>23</sup> *Punjab National Bank v. Rana Global Ltd.* [(IB)-196(ND)2018]

as closed. The National Company Law Appellate Tribunal (NCLAT), however, set aside the order of the AA<sup>24</sup> which quashed the disciplinary proceedings initiated against the professional by IBBI and observed that once a disciplinary proceeding is initiated by IBBI on the basis of evidence on record, it is for IBBI to close the proceeding or pass appropriate orders in accordance with law. It further held that the AA is not vested with powers to discipline professionals under the Code.

### **Section 236 of the Code and Section 213 of the Companies Act, 2013**

In a matter<sup>25</sup>, the NCLAT, nullified the effect of section 236(2) of the Code that provides for filing complaints by IBBI before the Special Courts for taking cognizance of offences committed by market participants and punishable under sections 68 to 77 and section 235A of the Code. The NCLAT directed the committee of creditors to move an application under section 213 read with section 447 of the Companies Act, 2013 before the AA, for it to decide as to whether a reference to IBBI or the Central Government was required for taking any action under section 74(3), which provides for punishment for contravention of resolution plan. Section 213 of the said Act, relating to investigation into the affairs of a company, is for providing opportunity to the concerned parties before an investigation by an inspector is undertaken, into the affairs of the company. The logic behind giving opportunity to the parties concerned is that the tribunal must be satisfied that it is justifiable to investigate into the affairs of the company, as it is an extraordinary affair. The tribunal needs to ensure as to whether the business of the company is conducted to defraud the creditors, equity holders and others or the business itself is fraudulent or unlawful, which would be brought to light only after investigation. Similar opportunity to the accused, who has contravened provisions of the Code, is against the scheme of the Code and there is no concept of 'inspectors' and 'investigation' under it. A private complaint is filed before a Special Court by IBBI or the Central Government to facilitate 'taking cognizance of offence' and no investigation is necessary before setting criminal law into motion as per section 236(2) of the Code. Mixing up criminal prosecution under the Code and the Companies Act creates confusion. Probably, the role of the IBBI as a regulator to approach the criminal court has not been fully understood in this matter and this poses a big block in building discipline in the insolvency and bankruptcy regime.

### **Judicial Interplay and Regulations**

Rendition of the Code in the light of judicial interplay has been echoed in so many pronouncements touching the Code and the regulations made thereunder. In the matter of *ArcellorMittal India Private Limited v. Satish Kumar Gupta & Ors.*<sup>26</sup> the Supreme Court observed that the model timeline under regulation 40A of the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (CIRP Regulations) is of utmost importance and that all the authorities concerned with the process of resolution should follow this timeline as closely as possible. In *Francis John Kattukaran v. The Federal Bank Ltd. & Anr.*,<sup>27</sup> the NCLAT held that regulation 30A of the CIRP Regulations, which refers to the process of withdrawal of

<sup>24</sup> *Punjab National Bank v. Rana Global Ltd.* [(IB)-196(ND)2018 CA 781 of 2018]

<sup>25</sup> *Committee of Creditors of Amtek Auto Ltd. through Corporation Bank v. Mr. Dinkar T. Venkatasubramanian & Ors.* [Company Appeal (AT) (Insolvency) No. 219 of 2019]

<sup>26</sup> (2019) 2 SCC 1

<sup>27</sup> Company Appeal (AT) (Insolvency) No. 242 of 2018

application, do not have an overriding power over the substantive provisions of the Code and that the regulation cannot override section 12A of the Code, which provides for withdrawal by the applicant, and not the resolution professional. In *K. Sashidhar v. Indian Overseas Bank*,<sup>28</sup> the apex court declared that the regulations 25 and 39 of the CIRP Regulations should always be read in the light of the substantive provisions contained in section 30(4) of the Code and a harmonious approach should be adopted during the process of interpretation.

In the matter of *Sharad Sanghi and others v. Vandana Garg and Others*,<sup>29</sup> the AA held that a certain regulation is completely directory in nature and it does not have the power to override the power of the committee of creditors.

In *Swiss Ribbons Private Limited & another v. Union of India & others*<sup>30</sup>, the apex court upheld the constitutional validity of the Code on the basis that post amendment, the CIRP Regulations, 2016, give priority to operational creditors under the resolution plan over the financial creditors. This clearly states the importance of a regulation in terms of determining the Constitutional validity of the Code.

In *State Bank of India v. Su Kam Power Systems Ltd*,<sup>31</sup> the AA held that regulation 36A of CIRP Regulations is *ultra vires* section 240(1) of the Code because speed is the essence of CIRP and inviting 'Expression of Interest' would impede the process referred to in section 240(1). This poses a great challenge in building a strong insolvency ecosystem, although the decision of the AA stands stayed by the High Court.

### Institutional Goals

Every law brings about some behavioural change, so has the Code. The effect of behavioural change triggered by a law depends on its impact on the stakeholders (the regulated), the market mechanisms and also the regulatory endeavours undertaken by the authority (the regulator). A regulator must justify its action(s). IBBI has already established its position in the market as a responsive statutory body that attends and addresses the institutional and plethora of other issues in functional way. It has striven to design and define its path by capturing the available market wisdom and expertise and also understanding the needs of the stakeholders. It has streamlined compliance and increased efficiency for the regulated entities along with promoting growth, supporting competition and innovation.

### CONCLUSION

Credibility of a regulator, as an institution, rests on consistency of thought and action coupled with scientific vision. Regulators lay down their path within the applicable law and decide the distance they want to travel. It is the endeavour of every regulator to 'go by' the law and not to 'go to' the law, as the latter leads to diminution of the very institution of the regulator. Effective regulation by the regulator is accomplished not by mere legal compliance but identifying its regulatory path. Autonomy of the regulator is visible through the prism of democratic legitimacy and/or regulatory accountability to the consumers and to the society in general.

<sup>28</sup> 2019 (3) SCALE 6.

<sup>29</sup> Company Appeal (AT) (Insolvency) No. 461 of 2018 [(Arising out of Order in MA Nos. 491/2018, 341/2018, 515/2018, 410/2018, 91/2018, IA Nos. 35/2018 & 30/2018 in CP (IB) 1137 (MB) 2017), Company Appeal (AT) (Insolvency) No. 464 of 2018, Company Appeal (AT) (Insolvency) No. 548 of 2018.

<sup>30</sup> (2019) 4 SCC 17.

<sup>31</sup> C.P. No. (IB) – 540 (PB)/ 2017.

Regulators need to understand their business well and that it is done easily, timely and effectively. The profits and gains of doing regulatory business is assessed, may be from lesser market interventions and not probably from over-regulation.

Regulatory travel is formidable, and every regulator is destined to balance a tightrope walking. IBBI's journey is not an exception. It has been treading a fair, accessible and broad approach to regulation. The regulatory discourse initiated by IBBI in the insolvency ecosystem is intertwined with fostering 'rule of law' and meta regulation. As stated by our first full-time Finance Minister in her maiden budget speech recently, *Karya purusha karena lakshyam sampadyate*, which means, with determined human efforts,<sup>32</sup> the task will surely be completed. It is envisioned that IBBI will be able to accomplish its diverse tasks going by the spirit of this *Chanakya Niti*.

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<sup>32</sup> *Chanakya Niti* (Sanskrit).



# 17

## *Insolvency Professionals and the Code of Conduct*

Mukulita Vijayawargiya

*“Where your talent and the needs of the world cross, there lies your purpose.”*

Aristotle

In today's world, the success or failure of any activity depends upon the kind of professionals involved. The professionals are persons having domain knowledge and experience. In the era of super speciality, their role has become more significant. There are as many professions as the numbers of activities or services. No individual, institution or industry works without professionals. Professionals, by and large, are associated with trade and business of every sector. They are responsible for a higher rating of any institution or industry or establishment. In other words, professionals lay down the benchmark for their quality, efficiency and good governance. In business, failures are due to managing the business in an unprofessional manner or not engaging the right professionals or intentionally not following the advice of the professional. Obviously, this results into the state of insolvency.

Since ancient times, though professionals are revered, the credibility of any individual has been measured across all civilisations in terms of the state of solvency. It has been seen that an undischarged insolvent is disqualified to occupy public offices under various laws. Thus, society and the system of governance do not take the state of insolvency in a good taste. Further, the state of insolvency is not limited to individuals but extends to the universe of corporate persons having limited liability. The business plans of corporates, as per the usual market practice, are incomplete without debt component. Large number of corporate debtors are defaulters and account for huge non-performing assets thereby adversely affecting the economic growth of the country. The findings of the World Bank in its Report (2014), especially with regard to time taken in recovery of debts and rate of recovery, have been matters of grave concern for the ease of doing business. To address these issues and other related issues, the Insolvency and Bankruptcy Code, 2016 (the Code) has been enacted which contemplates special class of Insolvency Professionals (IPs) from various streams of professions.

### LEGAL FRAMEWORK

The legal framework for insolvency and bankruptcy prior to the enactment of the Code was inadequate and ineffective. There have been undue delays in resolution of issues despite special laws being in place for the recovery actions by creditors, for example, in case of corporates, the Recovery of Debts Due to Banks and Financial Institution Act, 1993, the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interests Act, 2002, the Sick Industrial Companies (Special Provisions) Act, 1985 and the winding up

provisions under the Companies Act, 2013, and also the non-statutory corporate debt restructuring mechanism, such as Strategic Debt Restructuring (SDR), Corporate Debt Restructuring (CDR) and Joint Lenders Forum, while in case of individuals, the Presidential Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920 had been enacted.

A new legislation was required to deal effectively with insolvency and bankruptcy and as also for development of credit markets in the country and improving ease of doing business to facilitate investments. The Bankruptcy Law Reforms Committee (BLRC) was constituted under Chairmanship of Dr. T. K. Vishwanathan with a mandate to suggest comprehensive reforms covering all aspects of insolvency and bankruptcy of both corporates and individuals. Based on its recommendations, the Code was enacted on May 28, 2016, to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time-bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders. It came into force on December 1, 2016. It has paved the way for much needed effective reforms while focussing on creditor driven insolvency resolution.

The Code envisages a sound insolvency regime with a paradigm shift in jurisprudence of procedure for insolvency resolution under the Code, *i.e.*, from a debtor-in-control regime to creditor-in-control regime, for timely revival of the business of the debtor companies and limited liability partnerships as well as for individuals and unlimited liability partnership. The Code also envisages a shift from profit maximisation to value maximisation of the firms. In this context, it is relevant to refer the observations of former Governor of the Reserve Bank of India, Mr. Raghuram G. Rajan :

‘The shift to firm value maximisation is not just good for the society (in that a value enhancing investment takes place regardless of how the fruits are shared), it is good for employees (since their wages go up) and even it is good for shareholders.’<sup>1</sup>

He further observed:

‘The firm value maximising management will continue to take hard decisions, a necessity, if the firm is to stay competitive and survive.....Tough decisions will continue to enhance productive efficiency, a key contribution of private corporations.’<sup>2</sup>

The Code lays down effective ecosystem for implementation of the provisions of the Code which consists of four pillars, *viz.*, the Adjudicating Authorities (the National Company Law Tribunals and Debts Recovery Tribunals), IPs and Information Utilities (IUs), Insolvency Professional Agencies (IPAs) and the Insolvency and Bankruptcy Board of India (IBBI) to exercise regulatory oversight over IP agencies, IPs and IU.

The Code provides for a time bound institutionalised process for resolution of insolvency to be completed within 180 days after admission of the application.<sup>3</sup> In case of corporate insolvency resolution process (CIRP), the period is extendable by another 90 days and maximum period to be 330 days<sup>4</sup> (inclusive of the litigation time) as also provisions for fast-track resolution of corporate insolvency within 90 days extendable by 45 days.<sup>5</sup> The financial

<sup>1</sup> Raghuram G. Rajan, (2017). *The Third Pillar*. p.376.

<sup>2</sup> *Id.* at p. 377.

<sup>3</sup> Sections 12 and 101 of the Code

<sup>4</sup> Proviso to section 12.

<sup>5</sup> Section 56.

creditor or operational creditor or corporate debtor (CD) can trigger the process for resolution of corporate insolvency even after first default by the corporate debtor. The Insolvency resolution professional is appointed by the Adjudicating Authority (AA) to conduct the entire process, manage the operations of the CD<sup>6</sup> as also to facilitate the committee of creditors (CoC) in taking prudent decisions for resolution of insolvency. At every stage, flexibility in the process, such as withdrawal of the CIRP application<sup>7</sup> by the applicant or resolution to liquidate by CoC<sup>8</sup> at any time after the initiation of the CIRP gives an added opportunity to revisit their decisions. In case of individuals, the Code envisages two distinct processes, namely, Fresh Start and insolvency resolution process. The failure of the resolution process of the CD resulting in liquidation facilitates ease of exit and failure of the resolution process of individual debtor leads to bankruptcy. Further, declaration of moratorium from the date of admission of the application till the completion of the insolvency resolution process (the calm period) facilitates the resolution professional, the CoC and other stakeholders to effectively resolve the insolvency of the CD or of the individual. In the case of individual insolvency proceedings, there is also a provision for interim- moratorium. The waterfall mechanism under sections 53 and 178 of the Code clearly spells out significantly the paradigm shift in the order of priority in distribution of liquidation proceeds in case of liquidation and priority of payment of debts in case of bankruptcy, however, insolvency process cost or liquidation process cost to be the first priority.

#### THE ROLE OF INSOLVENCY PROFESSIONALS

An important component of the ecosystem is the IP who has been entrusted with a wide range of functions so as to effectively strive to maximise the value of assets of debtor during the resolution process. As the processes underlined in the Code, viz., CIRP or withdrawal of the CIRP or liquidation process is largely executed through IPs. He is the backbone of all such processes and success thereof hinges on the conduct and competence of the IP. He is the fulcrum of the process and link between the AA and CoC as also other stakeholders. As on August 31, 2019, there are 2734 IPs registered with the IBBI.

Under the scheme of the Code, an IP is a professional enrolled under section 206 of the Code with an IPA as its professional member and registered with the Board as an IP under section 207 after qualifying Limited Insolvency Examination. The Code provides for a two-tier regulatory regime for the professionals, the IBBI and the IPA which is regulated by the IBBI. The IPAs are mandated to promote the professional development<sup>9</sup> and first-tier regulation of IPs and as also to promote good professional and ethical conduct among them. The IPA grants membership to persons who qualify Limited Insolvency Examination and complete pre-registration educational course, lays down standards of professional conduct for its members, is empowered to issue certificate of authorisation for assignments<sup>10</sup> (such certificate to be effective after December 2019) and may suspend or cancel the membership of IPs on certain grounds as provided in the bye-laws. The IPs giving consent for the assignments and against

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<sup>6</sup> Section 23.

<sup>7</sup> Section 12A.

<sup>8</sup> Section 33(2).

<sup>9</sup> Section 200.

<sup>10</sup> IBBI (Insolvency Professional Agencies) Regulations, 2016.

whom no disciplinary proceedings are pending are on the panel of IPs recommended by IBBI which saves judicial time.

### **Pre-Registration Conduct**

The regulations, in addition to the requirement of qualifying Limited Insolvency Examination and requisite experience of the relevant profession in terms of regulation 5 of the Insolvency and Bankruptcy Board of India (Insolvency Professionals) Regulations, 2016 and completion of pre-registration educational course for the purpose of registration with the Board, also provide that the applicant needs to be a fit and proper person and no disciplinary proceedings are pending against him for the purpose of registration with the Board. This ensures that a person with clean hands can enter this profession to manage the operation of the business of CD and conduct the insolvency resolution process.

In the matter of rejection of application for registration by the Board in XXX case on the ground that the applicant is not a fit and proper person as criminal proceedings were pending against him, the Court of the Special Judge, Central Bureau of Investigation, Greater Mumbai observed:

'What is material is that what others feel about the applicant who has been charge sheeted for offences such as criminal conspiracy, cheating .....  
Does such a person inspire confidence of the stakeholders who can entrust him with property of lakhs of crores for management under corporate insolvency resolution process? Pendency of serious criminal proceedings against the applicant adversely impacts his reputation and makes him not a person fit and proper to become an IP.'

The IP may be appointed by the AA as an interim resolution professional, the resolution professional or liquidator or bankruptcy trustee. The BLRC in its final report, emphasised the role of an IP as follows:

'The Insolvency Professionals form a crucial pillar upon which rests the effective, timely functioning as well as credibility of the entire edifice of the insolvency and bankruptcy resolution process. ... In administering the resolution outcomes, the role of the IP encompasses a wide range of functions, which include adhering to procedure of the law, as well as accounting and finance related functions. The latter include the identification of the assets and liabilities of the defaulting debtor, its management during the insolvency proceedings if it is an enterprise, preparation of the resolution proposal, implementation of the solution for individual resolution, the construction, negotiation and mediation of deals as well as distribution of the realisation proceeds under bankruptcy resolution. In performing these tasks, an IP acts as an agent of the adjudicator. In a way the adjudicator depends on the specialized skills and expertise of the IPs to carry out these tasks in an efficient and professional manner.....This creates Role of Resolution Professionals in CIRP the positive externality of better utilisation of judicial time.'

It further states:

'The IP makes sure that assets are not stolen from the company and initiates a careful check of the transactions of the company for the last two years, to look for illegal diversion of assets. Such diversion of assets would induce criminal charges...  
These IPs will be delegated the task of monitoring and managing matters of business by the Adjudicator, so that both creditors and the debtor can take comfort that economic value is not eroded by actions taken by the other.'

The UNCITRAL Legislative Guide on Insolvency Law spells out the role of an 'insolvency representative' as follows:

'[T]he insolvency representative plays a central role in the effective and efficient implementation of an insolvency law, with certain powers over debtors and their assets and a duty to protect those assets and their value, as well as the interests of creditors and employees, and to ensure that the law is applied effectively and impartially. Accordingly, it is essential that the insolvency representative be appropriately qualified and possess the knowledge, experience and personal qualities that will ensure not only the effective and efficient conduct of the proceedings and but also that there is confidence in the insolvency regime.'

The International Monetary Fund described the role of a liquidator and the administrator in effective implementation of the law as follows:

'As court-appointed officials, they have an obligation to ensure that the law is applied effectively and impartially. Moreover, since they normally have the most information regarding the circumstances of the debtor, they are in the best position to make informed decisions.'

The Code casts various duties upon the IP or resolution professional, viz., to make public announcement for inviting claims, receive and collate claims, take immediate custody and control of all the assets of the CD, preserving and protecting the assets of the CD, manage affairs of the CD including the continued business operations of the CD, to appoint authorised representative, if required, to give instructions to financial institutions, constitute CoC within 30 days of his appointment, to convene and conduct the meetings of the CD, raise interim finance, represent and act on behalf of the CD with third parties, prepare an information memorandum, appoint valuers, invite prospective resolution applicants to put forth their resolution plan and to take all such steps as may be required for an on-going concern.<sup>11</sup> However, the professional is required to seek approval of the CoC for certain acts, such as, to raise interim finance beyond certain limit, to change the capital structure of the CD, to create security interest over the assets of the CD, to make any change in the management of the CD and its subsidiary, etc.<sup>12</sup>

The role of an IP becomes very crucial and important in view of the provisions of section 20 of the Code. Its sub-section (1) provides that the interim resolution professional shall make every endeavour to protect and preserve the value of the property of the CD and manage the operations of the CD as a going concern. Further clause (d) of its sub-section (2) empowers the IP to issue instructions to personnel of the CD as may be necessary for keeping it as a going concern. Section 25 of the Code also casts similar duty on the resolution professional. The biggest challenge before the resolution professional or the liquidator is examination of the affairs of the CD and to identify who have contributed to its insolvency as also to examine whether there has been any preferential transactions or undervalued transaction or fraudulent transaction or extortionate transactions and, if so, to take action for avoidance of such transactions in accordance with the provisions of the Code.<sup>13</sup> He shall comply with the provisions of the Code regulations made thereunder as also terms and conditions specified in the bye-laws of the IPAs of which he is a professional member and take reasonable care and

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<sup>11</sup> Section 25

<sup>12</sup> Section 28.

<sup>13</sup> Sections 43-51.

diligence while performing the duties.<sup>14</sup>

In this context, words of wisdom of *karma* in Fourth Chapter of the *Geeta* appears to be relevant for professionals:

**कर्मण्यकर्म यः पश्येदकर्मणि च कर्म यः।  
स बुद्धिमान् मनुष्येषु स युक्तः कृत्स्नकर्मकृत्॥4.18॥**

It means he who sees inaction in action and action in inaction, he among men is intelligent. He is a perfect actor-doer of all *karmas*. This equally applies to IP while performing his duties under the Code and regulations.

#### CODE OF CONDUCT

A Code of conduct is generally derived from Codes of ethics. These ethical norms are benchmark of right actions at a given point of time which the society or the system expects from an individual and are responsible for evolution of the mankind and strengthening the legal system. All the religious scriptures prescribe a code of conduct for the followers. Ancient society in India was governed by the principles of Dharma which may mean, though not exactly, righteousness and subjected the king and the subject alike to the rule of law to ensure well-being of all, not only of human beings but the entire environment. These principles are found in teachings of *Bhagavad Geeta*, Old Testament, edicts of Buddha and Ashoka, etc. In addition to the ethical norms propounded by saints and sages in various religious scriptures, eminent scholars and statesmen also spelt out ethical norms in their principles and practices, e.g., Mahatma Gandhi gave new dimension to the national struggle based on truth, and non-violence and expressed in relation to *Ahimsa* as:

**'vaishnav janto te kahiye jo peer parai jane re'**

Jeremy Bentham, the great reformer, based the premise of principle of utility on the ethics of 'greatest happiness of the greatest number'.

The Indian Constitution also provides code of conduct for its citizens under Article 51A as 'Fundamental Duties' which forms the foundation of human dignity and national character. Further, the principles of natural justice are in the nature of code of conduct for every judicial and quasi-judicial authority. In *Tulsiram Patel v. Union of India*<sup>15</sup>, the Supreme Court held that the term natural justice means certain rules of conduct supposed so just that they are binding upon all mankind and observed:

'The principles of natural justice constitute the basic elements of fair hearing, having their roots in the innate sense of man for fair play and justice which is not the preserve of any particular race or country but is shared in common by all men.'

At present there is a code of conduct for every professional, be it Advocates, Chartered Accountants, Company Secretaries, IP, valuers, engineers, doctors, *vaidya*, government officers/ employees, etc. A professional is known by the practices he professes and code of conduct he adheres to.

<sup>14</sup> Section 208

<sup>15</sup> AIR 1985 SC 1416.

## **Post Registration Conduct**

As far as the IPs are concerned, the code of conduct has been codified in writing and enforced with penalties in various countries. The code of ethics aims to help IPs or practitioners meet their professional obligations. In the United Kingdom (UK), the Code of Ethics for insolvency practitioners' details how the code should be applied in specific circumstances. It lays down five fundamental principles which guide how IPs should act in the course of their work: (i) the IPs should be straightforward and honest in all professional relationships(Integrity); IPs should not allow any bias or conflict of interest to cloud their decisions(Objectivity); IPs have a duty to maintain professional knowledge and skill based on the latest developments in practice, legislation and techniques (Professional competence and due care); IPs should respect the confidentiality of the information acquired as a result of professional and business relationships and not disclose such information to third parties (Confidentiality) and IPs should comply with relevant laws and regulations and conduct themselves with courtesy and consideration when performing their work (Professional behaviour).

The IBBI has notified the Insolvency and Bankruptcy Board of India (IPs) Regulations,2016 (Regulations). Regulation 7(2) of these Regulations provide for five primary commandments of conduct after registration with the Board. It provides that the registration of an IP is subject to the conditions that the IP shall (a) at all times abide by the Code, rules, regulations, and guidelines thereunder and the bye-laws of the IP agency with which he is enrolled; (b) at all times continue to satisfy the requirements under Regulation 4; (c) undergo continuing professional education, as may be required by the Board; (d) not outsource any of his duties and responsibilities under the Code, except those specifically permitted by the Board and abide by the Code of Conduct specified in the First Schedule to Regulations.

The First Schedule to the said Regulations provides detailed Code of Conduct for IPs which is briefly summarised as under:

### **Integrity and objectivity**

- An IP must maintain integrity and act with objectivity in his professional dealings without any bias, conflict of interest, coercion, or undue influence of any party and not acquire assets of the debtor.

### **Independence**

- An IP must maintain complete independence in his professional relationships and should conduct the insolvency resolution, liquidation or bankruptcy process, as the case may be, independent of external influences.
- He or his relative must not accept gifts or hospitality nor offer gifts or hospitality nor a financial or any other advantage to a public servant or any other person, which undermines or affects his independence as an IP.
- An IP must not engage in any employment when he holds a valid authorisation for assignment or when he is undertaking an assignment.
- An IP shall not engage or appoint any of his relatives or related parties, for or in connection with any work relating to any of his assignment until a period of one year has elapsed from the date of his cessation from such process.

### **Confidentiality**

- An IP must ensure that confidentiality of the information relating to the insolvency resolution process.

### **Disclosure obligations**

- An IP shall disclose the existence of any pecuniary or personal relationship with any of the stakeholders entitled to distribution under sections 53 or 178 of the Code, and the concerned corporate person/ debtor by making a declaration of the same to the applicant or committee of creditors.
- An IP must not conceal any material information or knowingly make a misleading statement to IBBI, the AA or any stakeholder, as applicable.
- An IP shall disclose the fee payable to him, the fee payable to the IP Entity, and the fee payable to professionals engaged by him to the IPA of which he is a professional member.
- An IP shall disclose all costs towards the insolvency resolution process costs, liquidation costs, or costs of the bankruptcy process, as applicable, must endeavour to ensure that such costs are not unreasonable.

### **Professional behaviour**

- An IP must adhere to the time limits prescribed in the Code and the rules, regulations and guidelines thereunder for insolvency resolution, liquidation or bankruptcy process, as the case may.
- An IP must provide all information and records as may be required by the Board or the IPA with which he is enrolled and must co-operate and be available for inspections and investigations carried out by the Board or such IP agency.
- An IP must ensure that he maintains written contemporaneous records for any decision taken, the reasons for taking the decision, and the information and evidence in support of such decision.
- An IP must not conduct business which in the opinion of the Board is inconsistent with the reputation of the profession or brings disrepute to the profession.
- An IP must provide services for remuneration which is a reasonable reflection of the work necessarily and properly undertaken.

In addition to the above Code of Conduct, the Bye-laws of IPAs made in accordance with the IBBI (Model Bye-Laws and Governing Board of Insolvency Professional Agencies) Regulations, 2016, *inter alia*, provide that in the performance of his functions, a professional member shall discharge his functions with utmost integrity and objectivity; and be independent and impartial with the highest standards of professional competence and professional ethics, and perform duties subject to the timelines under the Code; maintain confidentiality of information obtained in the course of his professional activities unless required to disclose such information by law.

### **Orders**

In view of the key role of the IP during CIRP and liquidation process, any non-cooperation by the personnel of the CD with the IP delays the time bound process. In the matter of Shivam

Water Treaters Pvt. Ltd., CD was not cooperating with the RP and not handing over the possession of the property to her. The NCLAT vide its order dated February 18, 2019 held that RP is discharging her duties as Court Officer and any non-compliance of the Court Officer will be deemed as Contempt of Court. However, any non-compliance of the provisions of the Code or regulations made thereunder or violation of the Code of Conduct on the part of IP affects the process and in some of the cases, disciplinary action has been taken by the IBBI against IPs. The Disciplinary Committee of IBBI, vide its Order dated November 12, 2018, observed as follows:

'An IRP or RP is appointed by the AA. He is an officer of the Court. He is duty bound to (i) conduct CIRP with fairness and diligence, (ii) confirm that the resolution plan does not contravene any of the provisions of the law for the time being in force, (iii) maintain absolute independence in discharge of his statutory duties, and (iv) assist the AA with the correct perspective of the law, including provisions of section 29A of the Code. The AA relies on the work of an IP, as an insolvency proceeding is mostly not adversarial in nature.'

In various cases, the AA has made remarks against IP for his failure to perform duties under the Code. In *Ankit Kumar v. Advance Power infra Tech Limited*,<sup>16</sup> the AA vide its order dated May 6, 2019 observed:

'whether the corporate Debtor has undertaken fraudulent trading within the meaning of section 66 of the Code also not explored by the Resolution Professional in the case in hand. Though he has observed that there are certain preferential transactions carried on by the CD, no application also seems to have been filed u/s 44,45 & 46 of the Code by him.'

Due to these issues, AA did not appoint RP as liquidator in the said case.

Similarly, in *Tirupati Jute industries Limited*,<sup>17</sup> the AA vide its order dated February 13, 2019, observed that RP did not give correct advise when he submitted K. L. Jute's plan for approval of CoC and held that in such a situation it would not be proper to appoint the present RP as the Liquidator.

Further, in *Madhucon Projects Limited*,<sup>18</sup> the AA vide its order dated November 22, 2017, in relation to the exorbitant fee quoted by an IP, observed:

'...the Adjudicating Authority is of the considered view that remuneration quoted by the IRP is quite exorbitant and the same needs to be referred to IBBI. Though there are no prescribed set of Rules and Regulations/Guidelines at present with regard to the fee payable to the IRP/RP, the Adjudicating Authority is of the considered view that the fee quoted by the professionals should be reasonable, commensurate with work to be handled. In view of the above we recommend the matter to IBBI for taking appropriate action/remedial measure against the proposed IRP including disciplinary action if any, as deemed fit.'

In *Hahnemann Housing and Development Private Limited*,<sup>19</sup> the AA vide order dated October 29, 2018 observed that it is quite unfortunate to take note that the RP has not taken any earnest effort to see that the landed properties of the Corporate Debtor are identified and its valuation is fixed by appointing professionals from qualified surveyors or revenue authorities. In *Apna Scientific Supplies Pvt. Ltd.*<sup>20</sup> AA vide order dated March 14, 2019 observed that in spite of three

<sup>16</sup> CA (IB) No.528/KB/2019 in CP (IB) No. 990/KB/2018

<sup>17</sup> CP(IB) No. 508/KB/2018 along with CA (IB) Nos.972/KB/2018, 974/KB/2018, 1013/KB/2018, 08/KB/2019, 24/KB/2019 & 83/KB/2019

<sup>18</sup> CP (IB) SR No. 4322/9/HDB/2017

<sup>19</sup> C.P. (IB) No. 275/KB/2018

<sup>20</sup> MA/154/2019 in CP 811/IB/2018

directions, there is no compliance by the IRP. The IRP is flouting the orders of the Tribunal wilfully, intentionally and avoiding personal appearance.

Various orders of the AA indicate that non compliance of the provisions of the Code and regulations and as also directions given in their orders has led many a time to the replacement of professional during the CIRP or disciplinary action against such professionals.

The institution of IP stands on conduct and capability of the professionals. The capability needs to be enhanced continuously because of evolving legal and regulatory framework as also jurisprudence and evolution of best practices including use of technology. Every function which an IP is required to perform under the Code requires highest level of professional excellence including financial engineering and value maximising management. The objectives of the Code cannot be achieved unless the resolution professional strives for excellence and follows the Code of Conduct in various processes under the Code for establishing fairness in the conduct of the processes in order to inspire confidence among all the stakeholders.

To conclude, in the words of *Gurudev* Rabindranath Tagore:

*'You can't cross the sea merely by standing and staring at the water.'*<sup>21</sup>

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<sup>21</sup>Sir Rabindranath Tagore, The Geetanjali.

## *Role of Resolution Professionals*

Vijaykumar Iyer and Abhishek Sood

**E**nsuring financial stability of an economy hinges on an effective enforcement of creditor rights, duly supported by procedures that afford efficacious, transparent and predictable mechanisms for debt recovery. Insolvency processes establish such comprehensive procedures wherein legal and administrative policies and rules are put into play by different economic agents. The Cork Committee Report<sup>1</sup> advocated that successful administration of any insolvency resolution process hinges chiefly upon the economic actors who conduct it. These actors, widely known as Resolution/ Insolvency Professionals/ Practitioners play diverse roles in the socio-legal milieu and make the revival process operational. In this way, they turn around the fortunes of financially distressed firms and ensure value maximisation for all stakeholders. At this juncture, it is relevant to take note of the role of Resolution Professionals (designated as Insolvency Practitioners in the UK) as underlined by the Centre for Economics and Business Research,<sup>2</sup> viz.:

'The role of the Insolvency Practitioner is to administer an insolvency outcome within the legislation and to ensure a fair, efficient and quick redistribution of assets. In doing this, the regime itself, and the individual practitioners within it, need to strike an appropriate long-term balance between the interests of debtors and creditors [the people who are owed money]. An often overlooked part of the industry is its role in helping businesses and individuals avoid insolvency in the first place, both through providing advice to individuals and businesses as well as through instigating formal 'rescue procedures'.'

In the Indian legal context, Insolvency Professionals (IPs) constitute a new class of professionals accredited under the Insolvency and Bankruptcy Code, 2016 (Code). They are regulated by the Insolvency and Bankruptcy Board of India (IBBI). Sub-section 27 of section 5 of the Code defines a Resolution Professional (RP) as '*an insolvency professional appointed to conduct corporate insolvency resolution process and includes an interim resolution professional.*'

Essentially, the RP is tasked with facilitating the entire resolution process while attempting to address and balance the interests of all stakeholders. In this regard, section 23 of the Code requires that:

'Section 23(1): The resolution professional shall conduct the entire corporate insolvency resolution process and manage the operations of the corporate debtor during the corporate insolvency resolution process period.'

<sup>1</sup> Report of the Review Committee on Insolvency Law and Practice (Cork Committee) (1982). This led to the enactment of the UK Insolvency Act, 1986.

<sup>2</sup> Insolvency Practitioners: An Essential Part of the UK Economy (2019). <https://www.r3.org.uk/media>.

Section 23(2): The resolution professional shall exercise powers and perform duties as are vested or conferred on the interim resolution professional.'

From an appraisal of the provisions of the section, one can safely deduce that an enormous responsibility is placed on the shoulders of a RP. This encompasses much more than what the responsibilities and duties of the RP. The practical challenges and case-to-case variations are however beyond the scope of such legislation and regulations. Such challenges and variations are where significant trials for the RP arise from, and this article will discuss a few practical nuances to the role a RP.

#### SUPPORT FROM DIRECTORS AND ERSTWHILE MANAGEMENT

One of the primary legal duties of the RP is to assume the powers vested in the board of directors and manage the operations of the corporate debtor (CD) as a going concern. However, the intent of the Code is not that the directors cease to remain in office (which is still a common misconception). It is also not envisaged by the Code that the RP individually carries out all the activities being performed by the board of directors and the erstwhile management. The Code provides for suspension of powers of the board of directors and vests such authority in the RP. For any RP to step in and replace the entire board and its experience and wisdom in managing the CD is not practical. The RP assumes overall responsibility for the CD and approves key decisions. The directors continue to discharge their duties and responsibilities, as called upon by the RP, in order to support and assist him in discharging his role and in order to protect the interests of the CD.

Similarly, while the responsibility for the management of affairs of the CD as a going concern vests in the RP, the duties of the management, employees and workmen of the company and their day to day functions are not extinguished.

Thus, the RP has to fulfil his statutory duty to the CD, and the Code, with the support of the directors, key managerial personnel, officers and other employees of the CD, while retaining overall responsibility for key decisions.

When an RP steps in, it takes time for him to develop an understanding of the business of the CD before any meaningful decisions are taken. However, the ongoing nature of operations do not afford him such luxuries and it is crucial for the RP to rapidly surmount the steep learning curve. At this stage, if the directors and employees do not actively support and assist him, the RP can only have a limited impact, and the RP may even become a bottleneck leading to disruption of operations which could lead to an adverse impact on the resolution process. Human compulsions may also come to play for the erstwhile management of the CD in trying to deter the RP from succeeding. The more the RP is dependent on the erstwhile management and is not able to take independent decisions, larger is the threat of the RP getting inadvertently compromised.

#### UTILITY OF ACCURATE DATA IN CIRP

The key duties of the RP with respect to the conduct of the corporate insolvency resolution process (CIRP) include verification of claims, preparation of the Information Memorandum (IM), conduct of the valuation, facilitate of diligence by potential resolution applicants.

For verification of claims, the RP would require updated books of account, along with

support from the finance and operations teams of the CD for resolution of queries that he may have. In absence of such updated books of account and support, the RP would be forced to verify the claims basis only on the submissions by the claimant. This may not be an accurate or complete representation of facts, which the RP will have no means to crosscheck.

The preparation of the IM, conduct of valuation by registered valuers, and diligence by potential resolution applicants are data-based activities. The quality of data determines the quality of the diligence, which, in turn, has a direct impact on the outcome of the resolution process. In absence of relevant data, the RP will not be able to capture the accurate financials, accurate statement of assets and liabilities in the IM – which would be a key input for any audience of the IM. The registered valuer is required to determine liquidation value and fair market value of the CD. Both these values would depend upon data regarding the assets and the operations of the CD. The collation of this data would require active support from the employees of the CD. The resolution applicants usually have a multitude of queries regarding the operations of the CD. The long serving directors and employees of the company would be better placed to answer such queries. In case they are not forthcoming with their support, the ability of the RP to enable the resolution applicants to submit the best possible resolution plan will be adversely affected.

Each of these activities has a significant dependency on data provision, requiring active assistance by the officers and employees of the CD. Accuracy and inclusiveness of data in a corporate insolvency resolution process is a big deal.

#### BALANCING CONFLICTING INTERESTS

It has been observed that the support from the erstwhile promoters, directors, officers and employees may not be forthcoming in several situations. In cases where the operational cash flows are not sufficient to meet operating expenses such as raw materials, pending repairs and employee salaries, the RP is forced to prioritise expenditure. In such a scenario, it is not possible to meet all requirements of the CD. The inability to pay employee salaries becomes a sore discussion point between the RP and the employees of the CD. In this regard, a common refrain heard is 'why do we work when we ourselves are not paid?'

Again, there is normally a high degree of wariness of the erstwhile management of the CD to be transparent or forthcoming with information, insight and support. They may have a skeleton or two to hide or are not sure how any such information would be used against them. Protecting one's self-interest does, at such times, take supremacy for the officers, over the interests of the company. The CD is in stress and desperate times lead people to take desperate measures.

Often, as the CD might have been under stress for some time prior to commencement of CIRP, and salaries of employees would have been delayed, employees may have already left or be looking out for other opportunities. In such a scenario, the dedication level of employees is adversely affected and the support that the RP receives is minimal.

In some cases, the employees, especially at the higher levels of the hierarchy may have a certain sense of loyalty for the erstwhile promoter(s). This could be attributable to their long and close association with them. Due to such loyalty they may also be less enthusiastic and forthcoming in their support to the RP.

In each of these cases, the RP faces significant challenges in fulfilling his duties under the Code. In many of the above cases, due to the powers vested in the RP, there is no active opposition. However, the support that should be provided to a court appointed officer<sup>3</sup> is not forthcoming and it hampers his activities and fulfilment of his duties. In India, it is not unusual for stakeholders to render all assistance short of actual help.

#### ENFORCEMENT OF MORATORIUM

As per section 14 of the Code, a moratorium is declared by the Adjudicating Authority (AA), on the insolvency commencement date, prohibiting any new suit, or continuation of existing suit, against the CD. This provision would enable cessation of ongoing matters 'against' the CD. Yet it allows the RP to pursue matters initiated by the CD, as a successful resolution in these may benefit the CD.

A CD with ongoing operations having a wide scope, inevitably, has multiple litigations. Further, it has been observed that despite the moratorium, new proceedings and suits are initiated against the CD in various fora. One challenge the RP faces is that there is no automatic imposition of the moratorium. Representations are required to be made to individual regulatory authorities and to courts for imposition of moratorium in each matter.

While the enforcement of the moratorium is an administrative issue, it requires effort and cost on part of the RP that could be potentially avoided. Having to make representations also opens potentially continuing pursuit of such litigations. In several cases, the court having jurisdiction may take a view that the moratorium does not apply to the matter in hand.

One is optimistic that as the awareness of the Code becomes more pervasive, such litigation or actions by the regulatory authorities or the courts would reduce.

#### MANAGING STATUTORY COMPLIANCES

As per section 17(2)(e) of the Code, the RP is responsible for complying with the requirements under any law for the time being in force on behalf of the CD. The RP is responsible for all compliances, and requires significant on-ground support from the existing directors and employees in meeting such compliances.

There are certain compliances where there remains some ambiguity on account of commencement of insolvency and appointment of the RP. One such instance is of the ambiguity regarding 'factory occupier' under the Factories Act, 1948 wherein the occupier is defined, amongst other things, as any of the directors of the CD. There is lack of clarity regarding the position of the occupier, especially given the suspension of the powers of the board of directors (being misread as suspension of directors) and imposition of such duties on the RP. Such a scenario leads to unwarranted personal exposure, and is an additional imposition on the RP, who has oversight of and limited involvement in the day to day activities at a factory. RP faced with such a situation is then required to actively engage with the relevant authority to ensure that the CD continues to comply. Support from the concerned directors and key managerial personnel at the plant becomes critical.

There are certain matters which require past compliances to be completed. Due to pending past compliances, the RP is also not able to fulfil the ongoing compliances which are

<sup>3</sup> *Asset Reconstruction Company (India) Pvt. Ltd. v. Shivam Water Treaters Pvt. Ltd.*, (CP (IB)-1882/MB/2018)

due during the CIRP. An example is the ACTIVE-(INC-22A) requirement of Ministry of Corporate Affairs (MCA), which requires all past compliances with Ministry to be fulfilled prior to filing of ACTIVE. In such a case, where the past compliances are not completed, the RP is hindered from fulfilling his duty and meeting all compliances of the CD due within the CIRP period due to factors beyond his control.

In addition to ongoing compliances, the RP has to deal with multiple government and statutory authorities such as various tax authorities, environmental boards, specific industry regulators, etc. In most cases, the RP, in addition to informing such authorities of the commencement of insolvency, also has to guide them regarding the implications of the commencement of insolvency (especially on the de-prioritisation of government dues) and the claim filing process. There have been cases that despite such information and education, the authorities have not filed claims with the RP in a proper form or within the requisite timelines, resulting in potential losses to the exchequer. The RP is again required to extend effort in 'managing' such authorities as they have significant influence that they can choose to exert and potentially cause disruptions in operations.

It has been our experience that if one is transparent and is willing to have an open dialogue, the government and regulatory authorities in this country will walk more than half-way to support. The competence of our officers across the bureaucracy and more particularly, their empathy, has been compelling.

#### OVERCOMING CHALLENGES

While the above are practical challenges any RP may face, he has to find a way to overcome such challenges as he is not, *prima facie*, protected from failure to discharge his duty due to such challenges.

To meet his primary responsibilities under the Code, and to overcome the issues faced, the RP requires the support from all stakeholders such as directors, employees, creditors, etc. especially to get a holistic view of the CD and all available information and insights. Such stakeholders can also play a key role in highlighting risk factors and peculiarities associated with the operations and functioning of the CD, enabling the RP to plan for, and implement strategies to overcome such potential risks. However, being the officer in charge, the RP is more often than not, held responsible for failing to achieve certain objectives instead of being provided support by such stakeholders.

It is a simple matter for any stakeholder to raise a finger against the purported ineptitude of the RP without even being cognisant of the challenges being faced by him. To overcome this threat, the RP must cease to have delusions of grandeur or any misconceived belief of having a monopoly of knowledge. There is a lot he or she may learn if the RP is willing to collaborate, particularly with the committee of creditors (CoC). This approach of consultation, in addition to placing on record the challenges being faced by him, would also enable the RP to gain guidance from the members and other participants who would have had a much longer relationship with the CD and may be aware of certain challenges which may have also been faced in the past. The presence of directors in the meetings will help understand their perspective on such challenges. As the Indian '*karmic*' working philosophy states – '*for every man-made problem there is a man-made solution, provided you are willing to find it!*'

The Code, through section 19, enables the RP to seek assistance from any person associated with the CD. In case such assistance is not received, the provision authorises the RP to make an application to the AA seeking directions to such person from whom assistance is required. While this is a tool available to the RP, it has several practical challenges associated with it. Firstly, this is a legal process and would require valuable time from the AA. Considering the excessive load on the judiciary there may be a delay before the appropriate directions are passed. Given the strict timelines envisaged in the recent amendment to the Code, for completion of the CIRP, the benefit of such a time-consuming legal procedure may be limited. Secondly, the RP may be reluctant to seek directions against such personnel as he is required to work with them daily. A coerced support is not as valuable and expedient as a voluntarily-given support. Also, the RP may be receiving limited support from the personnel.

He may have a concern that making a section 19 filing for specific support could even adversely impact whatever little support he is receiving currently.

To garner support from the requisite personnel, the RP has to utilise a fine mix of personal inter-relationship skills. Particularly, the attribute of sensitivity, while engaging with the personnel, and also pro-actively seek support from all participants at the meetings of the CoC. In this context, some lines by Jeffrey Pfeffer<sup>4</sup> seem relevant:

'...being sensitive to others does not mean that one is necessarily going to act in their interests, in a friendly fashion, or on their behalf. Sensitivity simply means understanding who they are, their position on the issues, and how best to communicate with and influence them.'

As a last resort, in case the RP is still not able to gather the requisite support, he/she must not hesitate to file an application under section 19 of the Code and seek the necessary directions from the Court.

## CHALLENGES POST-COMPLETION OF CIRP

### **Ongoing Litigation – the Twilight Zone**

We have discussed some practical challenges that a RP faces during CIRP. Given the evolving nature of the Code and the nascent maturity level of the insolvency ecosystem, the challenges faced by a RP do not cease with his demitting office with respect to a particular CD.

Even after the completion of CIRP process and handover of the CD to the successful resolution applicant, there are various stakeholders with respect to the CD who make certain applications at various fora for grievances. The RP is inevitably a defendant in such applications. The applications may vary and may seek redressal on issues such as allegations against the CIRP process; claims not admitted by the RP; statutory dues for the CIRP period but claimed post completion of CIRP, etc.

The RP is an officer of the court, who comes into existence for a specific purpose, and on completion of his defined duties and responsibilities, ceases to exist. However, due to the post-CIRP litigation, and him being made a defendant in such matters, the RP is required to continue to act.

It may also be noted that the Code provides specific forums and limitations of time for filing any grievances. However, it has been seen that RPs are being made parties to litigations in

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<sup>4</sup> Jeffrey Pfeffer (1993). *Managing With Power: Politics and Influence in Organizations*. Harvard Business Review Press.

forums beyond those specified in the Code. Such suits are being filed beyond the limitation periods specified under the Code. The RP has to respond to, and defend against such litigations despite being a creation of, and being governed by the Code itself.

Involvement of RP in post-CIRP litigation opens him up to personal liability for any adverse ruling. It involves not only effort but also a cost on the part of the RP – which is not compensated or reimbursed. The legal expenses may be covered in case the RP was able to avail an appropriate insurance product. However, his own efforts and costs may not be covered by insurance policy as well.

The RP should ensure that the resolution plan clearly addresses all claims, disputes and litigation, particularly of statutory authorities to limit the level of such post-CIRP litigation. He may choose to remain in active dialogue with the successful resolution applicant to follow through on such litigation.

### CONCLUSION

To summarise, an RP has an overarching responsibility for the CD and the insolvency process. The Code also defines specific duties and responsibilities. Having said that one should recognise that there are several practical challenges that he may face, which may or may not be explicitly envisaged under the Code. An RP has to overcome all these challenges in order to effectively discharge his duties during the CIRP, using the tools available to him under the Code. There are no clear readymade solutions to practical challenges and a RP is required to use his discretion on most occasions.

The guidance provided by Chester Bowles, an American diplomat and ambassador, is quite apt in this case– *'When you approach a problem, strip yourself of preconceived opinions and prejudice, assemble and learn the facts of the situation, make the decision which seems to you to be the most honest, and then stick to it.'*

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## *Accountability of Professionals*

P. R. Ramesh

**T**he Oxford Dictionary of English defines a profession as 'a paid occupation, especially one that involves prolonged training and a formal qualification'. It traces the origin of the word from Latin words '*professio(n)*' and '*profitieri*' which mean 'declare publicly'. Thus, the word profession is derived from the notion of an 'occupation' that one 'professes' to be skilled in.

### ***Emergence of Professions and Professionals***

Some professions have a long history and have been around for centuries, such as medicine and accountancy. In today's day and age, the need for professional services in the commercial world has arisen with the emergence of joint stock companies wherein the ownership of the enterprise is separate from its management. This bifurcation or dichotomy has created the need for independent, qualified and competent service providers who can provide the assurance sought by the owners of the enterprise and other stakeholders. With the ownership of enterprises moving away from family ownership to a wider public holding, either directly or through mutual funds or similar other entities, and new models of businesses and enterprises emerging, the requirement of independent, expert professionals has significantly increased.

As businesses grow and diversify, the legislative landscape alters itself to meet the new market requirements and a number of new laws are framed for this purpose. The regulatory bodies are one of the integral components of the legislative landscape that regulate professions and professionals. These professionals play the role of regulator's 'eyes and ears' into the workings of the market and thus shoulder immense responsibility and are accountable not only to the immediate user of their services but also to a wider stakeholder group, including regulators and the society as a whole.

Owing to the heterogenous nature of professions and professionals and their functions different capacities, it is important to understand their basic attributes, roles and prerequisites before proceeding to discuss their accountability in the commercial eco-system.

### ATTRIBUTES OF PROFESSIONS AND PROFESSIONALS

The quality of any profession and its membership is influenced by the criteria for qualification and continuance as a professional. Only 'fit and proper' persons should be admitted as members of any profession. A profession is only as good as its members.

Attributes of a 'fit and proper' person varies depending on the profession, the environment in which the profession operates, the skill sets required, the conduct expected and, above all, the values a professional must possess. A professional's character and

reputation stands on a higher pedestal and is the most important attribute. While reputation is built over time, it can be destroyed overnight by a single slip in the discharge of professional duties, inappropriate conduct or fraudulent acts. A professional's reputation once dented, not only impairs his ability to render professional services but tarnishes the image of the entire profession. A professional should not only be a paragon of honesty like *Yudhishthira* from the Mahabharata, but also should be seen to be honest.

Every profession, therefore, should have tight entry criteria which allow only 'fit and proper' persons to become its members. It should also have procedures in place to regularly screen its membership to determine whether the members continue to meet the 'fit and proper' criteria.

A professional is required to be technically proficient and updated in his technical knowledge. This requires continuous learning and every profession should have a Continuous Professional Education (CPE) system which requires mandatory compliance by its members. Theoretical technical knowledge apart, the requirements for a person to be admitted as a member of a profession should include a minimum period of practical experience. This would ensure that a professional possesses both knowledge and skill required for discharge of his duties.

The number of assignments a professional takes up should be within his capacity so as to enable him to effectively deliver his services. The quality of his services delivered would be affected if he accepts too many assignments that are beyond his capacity to complete. Every profession should institute capacity building measures to ensure that the profession is equipped to meet the expectation of its users. Whilst building capacity, measures must also be taken to ensure proliferation of healthy competition within a profession to provide wider choices to its users. Competition stimulates and sustains quality as users of professional services will have the opportunity to seek the best service provider rather be compromised in accepting from a limited choice.

In what is popularly referred to as the Fourth Industrial Revolution, we are currently witnessing rapid and significant developments in technology. With the confluence of the physical, digital and biological worlds, a dramatic transformation in the business and professional landscape is anticipated. We are likely to witness the 'demise' of several professional services and professions and at the same time witness the birth of new professions. This effect of the Fourth Industrial Revolution is inescapable and it is imperative that all professions review the trends and prepare themselves for the imminent disruption.

Technology will be the single largest disruptor. The developments in the speed of processing, storage, connectivity and sensors have been exponential. Besides these there have been very significant developments in the internet of things, big data, data analytics, artificial Intelligence, nano technology, etc., which will continue to disrupt professions. A professional should be technologically 'literate' and avoid being 'technology myopic'. He should not underestimate the capacity of technology to disrupt his profession.

A professional is also expected to employ 'state-of-the-art' tools in delivering his services. He is accountable for discharging his services effectively and efficiently. This would include the use of the latest and best knowledge management systems to keep himself abreast of the current developments, analytical tools to handle and interpret large volumes of data, tools and devices that facilitate real-time access to him by his users, etc.

In summary, every professional should be endowed with the requisite 'Mindset, Skillset and Toolset'. He should possess a high-quality service mindset with attributes of empathy and understanding of his users' needs, contemporary skills required by his profession and a repertoire of tools to efficiently and effectively deliver his services.

The need for professional services often arises due to the requirements of statutes. As a result, certain professions arise exclusively to fulfil the requirements of a particular statute. Such professions exist because of the statute and sometimes inadvertently create entry barriers, preventing other professions from entering their space. Thus, they retain exclusivity not only in being the only profession allowed to provide such services but also the profession which provides a service required by a specific statute. Such professions however run the risk of their demise in the event of a withdrawal of the requirements of the statute. While there is an argument that an exclusive profession is appropriate for development of bespoke technical skills, it does limit user choice and could result in quality erosion.

Increasingly we are witnessing bundling of services and blurring of lines between the roles of different professions. With the developments in technology, it is almost impossible to deliver any service without the involvement of a technology specialist. Similarly, most assignments will involve advisory or representation services or interpretations of laws which may conflict with the services of the legal profession. It is now time for multi-disciplinary partnerships to be encouraged so that users are benefitted from the whole suite of services on a comprehensive basis.

With the blurring of lines between the roles and services provided by different professions, it is also imperative that professions jettison exclusivity and enter into partnerships or alliances to avoid extinction or conflicts. This would logically result in the demise of self-regulation and may require the setting up of an independent regulatory body to enforce discipline and deal with service quality issues.

#### ACCOUNTABILITY OF PROFESSIONALS

Ever since the advent of the Insolvency and Bankruptcy Code, 2016(Code) and associated regulations, there are several new categories of professionals that have arisen, and several old categories that have had to reinvent themselves to meet the demands of the Code and its impact on the business ecosystem in India. The professionals created and reinvented pursuant to the Code include insolvency professionals (IPs) acting as interim resolution professionals, resolution professionals (RPs) and liquidators, valuers required for fair and liquidation valuation, legal counsels specialising in insolvency resolution related matters, forensic auditors assisting IPs in determining avoidable transactions as specified in the Code, firms assisting IPs in discharge of their duties, and also Merger & Acquisition firms advising and assisting the committee of creditors (CoC) and resolution applicants in traversing the resolution process.

Given the large number of cases where application for insolvency has been filed and admitted thereafter, there has been a huge growth in the demand for such professionals in the last three years. Considering this exponential growth in demand for professionals, the Insolvency and Bankruptcy Board of India (IBBI) has also launched the Graduate Insolvency Programme, a programme that would create a cadre of IPs to support the insolvency resolution ecosystem.

It is interesting to note that all of the professionals described above, are a part of the insolvency resolution ecosystem, and are working towards the stated objective of the Code i.e. the resolution of a defaulting corporate debtor (CD) in a time bound manner for maximisation of value of its assets. These professionals are appointed in various capacities by different parties to serve the overall objective of the Code.

Firstly and primarily, the RP is the master of ceremonies of the entire resolution process and is perceived to wield a great amount of power and influence over the entire process. He is a court appointed officer under the Code and the Code entrusts several powers, rights and duties upon him. As defined under the Code, the RP is responsible for managing the affairs of the CD and running the insolvency process in a fair and transparent manner. As the custodian of the CD, the RP is responsible and accountable to each and every stakeholder involved in or impacted by the resolution process, viz. the employees, financial creditors (FCs) and operational creditors (OCs), homeowners, statutory authorities having a claim and/or regulatory oversight over the CD, resolution applicants, etc.

At the same time, the fee of the RP for managing the resolution or liquidation process is approved by financial creditors who are the members of the CoC, and it is the CoC that has to approve each of the key steps in the resolution process. As a result, an RP must maintain a balance between his responsibility towards the CoC and towards each of the other stakeholders.

With great power comes great responsibility and greater accountability. The RP must visibly demonstrate his impartiality and lack of bias by (i) being transparent in all his interactions and decisions, (ii) by being collaborative and consultative with all participants of the CoC and (iii) ensuring that all decisions are arrived at by active consensus and are not bulldozed by a dominant participant or by the RP himself. All actions of the office of the RP must speak for themselves as being honest, without fear and favour and keeping the best interests of all concerned.

Every professional has two primary responsibilities. The first pertains to their client and the second to the ecosystem that has entrusted the profession with a certain degree of responsibility and provides the professionals an opportunity to practise and earn a livelihood. Every profession has a written and/or unwritten code of conduct that specifies certain expectations from all its professionals. The underlying theme of any such code of conduct is that the professional should exhibit such behaviour and adhere to such standards that are expected of him. For any professional involved in the insolvency resolution ecosystem, the expectation thus laid down by their profession itself, would include upholding the objectives of the Code and working towards the larger good of the insolvency resolution ecosystem.

Moreover, every individual that earns his bread from this ecosystem, should feel personally responsible for cultivating and improving the ecosystem further to keep the ball rolling. Any professional rendering a service should consider himself as an ambassador of the ecosystem as a whole, and perform his duties towards his respective clients, being mindful of his larger responsibility towards the ecosystem. At no point should his individual interests or the interests of his clients, or any stakeholder involved be placed above the letter and spirit of the standards and laws governing his profession. Each professional is responsible and accountable to each stakeholder who may be affected or impacted by his actions.

Another important aspect for a professional, which deserves a separate discussion, is the issue relating to 'conflict of interest'. Every professional must, to the best of his abilities, avoid any and all conflicts of interest. Even the barest hint of conflict may taint his reputation as a professional and, by extension, that of his profession. A professional must not only be independent, impartial and free of any conflict, he must also demonstrably appear to be so. This was aptly captured in the Order of the Disciplinary Committee of IBBI, dated April 17, 2019, in the matter of Mr. Sanjay Kumar Ruia, IP where the Committee opined that:

'When relationship triumphs over merits in professional matters, there is no place for independence, integrity and impartiality. A professional must be not only be impartial, but also appear to be impartial..... Any conduct, whether explicitly prohibited in the law or not, is unfair if it impinges on independence, integrity and impartiality of an IP or inconsistent with the reputation of the profession.'

Every professional must be held accountable to the highest standards of independence with respect to the matter at hand. It is the professional's responsibility and duty to not only actively and consciously meet such standards, but to also ensure that no aspersion can be cast on him or his profession.

Finally, the most important attribute of a professional for which he is accountable is integrity in character and conduct. This is non-negotiable. He should judge whether his actions satisfy his own conscience before considering whether it meets the expectations of others and the society at large. His conduct should be the same whether his actions are being observed or not.

#### CONCLUSION

To conclude, the actions of a professional has an impact on multiple aspects including his own profession, various stakeholders and the ecosystem as a whole. He is accountable to the ecosystem and its various constituent stakeholders. The working of a professional must go hand-in-hand with integrity. This is essential for building and preserving the reputation of the whole cadre of professionals.

The final test for an individual is to be his own judge and be governed by the principles of ethics and accountability.

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## *Need for Uniform Valuation Standards*

Navrang Saini

*'Timely resolution is very important. I'd request you to ensure that the resolutions are done in time, not just for the regulatory requirement but also because it will result in better valuation going forward.'*

N. S. Vishwanathan<sup>1</sup>

**I**n a global world, rigorous, understandable and universal financial information significantly influences the proper functioning of markets and economic growth conditions. The question whether markets are efficient and if not, where the inefficiencies are located, is central for the assessment of the performance of the economy. The onset of corporate distress is one such situation which enables the identification of market inefficiencies by the regulator. In this regard, it is often crucial to ascertain the value of a distressed company in attempting business valuations, whether carried out for adjudicatory purposes or otherwise. The process of 'valuing' the company and its business units help in the identification of sources of economic value creation and destruction within the company. Those interested in the company's undertaking require this information to determine what should be done with the company's business, and how the value in the company's estate should be distributed amongst them.<sup>2</sup>

In this context, an understanding of the mechanisms of corporate valuation is an indispensable requirement. The valuation approaches and methodologies aim to establish an economic value of assets and liabilities or of the entire entity or selected businesses, as appropriate, as required by the Regulation. The firm's estimated value regulates the value of the assets to be distributed among insolvency claimants and drives projected pay-outs and recoveries.

Valuation is a vital component of much financial information that is relied on by investors or otherwise used to support decisions in the financial markets. This includes financial reporting, managing the solvency of financial institutions, supporting lending or other investment decisions and the pricing of units in collective investment schemes. It is critical to resolution execution. A robust valuation contributes to the effectiveness of resolution actions, including the legitimacy and soundness of the decision, and the achievement of the resolution objectives. To be robust, a valuation must rely on the timely provision of high-quality data and information to the valuer. To ensure this, there is a need to enhance institutions' preparedness in the course of the resolution planning phase.

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<sup>1</sup> Deputy Governor, Reserve Bank of India

<sup>2</sup> Crystal, M. & Mokal, R. (2006). The Valuation of Distressed Companies - A Conceptual Framework, Part II. *International Corporate Rescue*. 3.

Valuations form a key part of publicly traded companies' audited accounts, which should provide transparency and comparability in relation to the fair value of assets and liabilities, and therefore, can impact companies' share prices. A consistent approach to performing quality valuations is of interest to anyone with a pension or investment in real property or publicly traded shares, and more broadly society who wish to see financial market stability, because of the link to a stable economy in different tax jurisdictions, as well as in connection with the determination of global transfer pricing arrangements.

Valuations also have a significant impact on the transfer of intellectual property rights between related parties in different tax jurisdictions, as well as in connection with the determination of global transfer pricing arrangements.

#### NEED FOR STANDARDS FOR VALUATION

Given the high positive correlation between an accurate valuation and the effectiveness of the resolution action(s), including safeguarding of public money, the valuation methods should identify the data and information needs that in principle ensure the performance of a definitive valuation. Besides being a complex process and exercise, valuations are required for various purposes and periods making it more challenging. Therefore, the need for standards in valuation is based on accepted and robust principles and methods were put in place in different countries to serve the various sectors of the economy, especially, financial, banking and taxation.

Standards provide a benchmark to the professionals to ensure uniformity in approach and quality of valuation output. They encourage 'best practices' and fairness in valuation services. They endorse credibility, relevancy and transparency of valuation information. Furthermore, they augment quality, consistency, comparability and uniformity of valuation practice. To enhance reliance on the valuation amongst stakeholder, they boost market knowledge and understanding and expand corporate governance. In this way, they improve public confidence in valuation and improve market efficiency.

Pertinently, a standard helps in the identification of or development of globally accepted principles and definitions. They also play a significant role in the promulgation of considerations for undertaking valuation assignments and reporting of valuations. Additionally, their import can be felt in specific matters that require consideration and methods commonly used for valuing different types of assets or liabilities.

It is noteworthy that advanced economies could develop standards for valuation due to their inherent advantages like a transparent and stringent regulatory mechanism. However, for other developing and underdeveloped economies, due to their inherent weaknesses, opaque markets and incoherent regulatory mechanisms, standardisation has been big challenge. The presence of standards in the developed world provided courts and adjudicating mechanisms a robust system to adjudicate and settle valuation disputes. The absence of standards led to inconsistency in adjudication of disputes. Also the transformation of markets from the traditional less active ones to fast track high volume transaction markets has led to need for higher level of competence among valuation professionals and expertise in the judiciary which is found wanting and such a situation has led to inconsistencies in valuation, especially in the developing economies. This has led to significant system problems

necessitating an immediate need for putting in place standards and regulatory statutes.

In the twentieth century, global trade in the form of cross border business and finance had been consistently growing due to economic growth across the world. Standardisation of transactions and valuation of assets were increasingly felt in cross border transactions. This created stakeholders in businesses and finances including valuers, investors, government and regulatory bodies. There was a need for a convergence on various aspects of businesses and finances, especially the value and principles of computing values and reporting them at appropriate financial reports of the firms for stability of the financial system. This was the first step towards standardisation.

The consensus between international forums in the valuation field, since 2004, has focussed on developing valuation standards that would clarify the measuring of market (fair) value for tangible and intangible assets. The Toronto Agreement<sup>3</sup> asks for valuation professional bodies to work together with the legislative and regulatory bodies in order to clinch the simplification and convergence of financial reporting standards.<sup>4</sup> These valuation professional bodies have shown their support for the action undertaken by the International Valuation Standards Council (IVSC) and the International Accounting Standards Board (IASB) in this respect.

There is a clear public interest need for globally consistent valuation standards for a multitude of purposes, not just for financial reporting, but also to support secured lending decisions, for tax reporting, litigation support and transaction support etc. However, globally, there are significant inconsistencies in valuation standards. Furthermore, some countries have established valuation professional organisations (VPOs), which have a sophisticated approach to standards, and some other countries have either no VPOs or VPOs with very little or no valuation standards in place.

#### ECONOMIC DISASTERS CAUSED BY POOR VALUATION STANDARDS

An inflated valuation may cause project cost to rise making it difficult to supply goods and commodities in the face of global competition even within the country's own territorial jurisdiction. Further, a poor valuation may cause a steep rise in the number of non-performing assets (NPAs) of banks and financial institutions. The poor standards of secured lending, valuations had led to serious economic disasters in several countries in the past. The most recent of such disasters was caused by the poor valuation standards in sub-prime lending by banks in the United States (US) that led to a total global meltdown in 2008. The banks in the US advanced loans for sub-prime mortgages indiscriminately without carefully examining the repayment capacity of the borrowers.

In the US, the residential real estate market had never witnessed a downturn since 1989. This convinced the banks about the certainty of recovering their advanced amounts in case of default by the borrowers because they anticipated that the growth in the price of the mortgaged property will be sufficient to recover the loan amount. But the residential market was soon flooded due to a glut of real estate development. Unfortunately, the real estate valuers and other stakeholders of the mortgaged properties were unable to foresee this. As borrowers defaulted, the banks started to sell off the mortgaged properties through foreclosures. But the sale of the foreclosed properties failed to achieve the expected price and so the banks were

<sup>3</sup> Sayce, S. & Connellan, O., (2005). Convergence of valuation standards, *Property Management*, 20 (4), Business Source Premiere Database.

<sup>4</sup> Adela, Deaconu., Silvia, Cristina Nistor., Filip, Crina., & Cuzdriorean, Dan. (2010). Measuring the Convergence Degree between Accounting and Valuation Standards: Case Study on Intangible Assets, *International Journal of Business Research*, 10 (2).

unable to recover their advances and pay off the depositors' money. The bank failures sent a chain of reactions across the country and the globe as everyone was eager to withdraw funds from all investments. The share markets across the worlds crashed because of globalisation and the entire world was in the midst of an economic disaster.

Similar chain of events had also been witnessed elsewhere earlier. In 1997, the Bank of Thailand collapsed under its property loans due to poor valuation standards in a similar fashion and that again caused the crashing of share markets of the south-east Asian region including the countries like South Korea, Indonesia, Malaysia and others. Again, due to globalisation, the impact of this also affected the US and Russia.

A look, further backward down the history, would indicate that similar collapse of property market occurred in 1973 when commercial rent freeze was introduced by the UK government to check inflation. The real estate valuers were unable to foresee the eventual effect that it would bring on the property market and the British economy as a whole. The prices of the developed commercial properties were unable to take off and the developers could not lease their developed properties at even break-even prices. The developers were, therefore, unable to repay their loans from the banks and a number of banks collapsed as a result putting the economy in turmoil.

#### CLASSIFICATION OF VALUATION STANDARDS

The objective of valuation standards is to standardise the various principles, practices followed by registered valuers or valuation professionals in valuation of assets and liabilities. They can be classified into:

- Principles-based or rules-based standards;
- International or local standards.

Principles-based standards present general, broad norms of conduct. They emphasise expected outcomes. Firms have to reverse engineer what they need to do to meet these expectations and document to the regulator and the court how their actions achieve this. A rules-based standard uses detailed, prescriptive norms of conduct. Rules-based systems emphasise what firms must do to comply. The regulator must forward engineer the implications of compliance for the intended regulatory outcomes.

International standards are followed worldwide. Local standards are limited to the country specific. The following two standards have a worldwide following:

- International Valuation Standards (IVS) issued by the IVSC; and
- The Royal Institution of Chartered Surveyors (RICS) Red Book.

Both IVS and the RICS Red Book command great respect among the users of valuation.<sup>5</sup>

#### INTERNATIONAL VALUATION STANDARDS

IVS are issued by IVSC, which is 'the independent global standard setter for valuation practice and the valuation profession.'<sup>6</sup> It is a non-government organisation having 141 members and

<sup>5</sup> RICS Research, The Role of International and Local Valuation Standards in Influencing Valuation Practice in Emerging Practice in Emerging and Established Markets, March 2014.

<sup>6</sup> <https://www.ivsc.org>

sponsors.<sup>7</sup> The current set of IVS 2017 has two parts: the *General Standards*: IVS 101 to IVS 105 (principles applicable to all asset classes)<sup>8</sup> and the *Asset Standards*: IVS 200 to IVS 500 (principles applicable to specific asset classes).<sup>9</sup> The coverage of asset classes in IVS has been expanding over the years. Additional standards are required in a number of asset classes of interest to India including standing crops, plantations, livestock, precious metal, precious stones, antiques, and mines, minerals and quarries.

### Adoption of IVS by countries

Many countries have been adopting IVS as national standards, for example, Romania, South Africa, Turkey, Abu Dhabi, Bahrain, Dubai and Philippines. IVS has been adopted as national standards with amendments to meet requirements of national legislation by Australia and New Zealand. Professional organisations have adopted part or all IVS for their members in many countries including China and Hong Kong. IVS has been used in IFRS Model Financial Statements published by two of the Big Four accounting firms, Deloitte and EY.<sup>10</sup> The European Banking Authority (EBA) references IVS in a new valuation handbook for central banks and prudential regulators across the EU.<sup>11</sup>

In December 2018, global real estate firm Newmark Knight Frank became the first such corporate member of the IVSC, signalling a commitment to international standards and valuation professionalism.<sup>12</sup>

### THE RICS RED BOOK

RICS is an independent professional body established in 1868 and it has a UK Royal Charter. According to its website, ‘The Charter means that important changes to our constitution – its bye-laws–have to be ratified by the UK Government, through the Privy Council, even after they’ve been approved by a majority of our members voting at a general meeting.’<sup>13</sup>

RICS Red Book adopts and applies IVS. RICS supports and contributes to the development of IVS. It is a sponsor of the IVSC. IVS is appended to the RICS Red Book as part of the agreement between the IVSC and RICS to align their standards. RICS promotes and enforces the highest professional qualifications and standards in the valuation, development and management of land, real estate, construction and infrastructure.<sup>14</sup>

RICS has technical standards as well as rules of conduct for members and rules for the conduct of business firms.<sup>15</sup> RICS certifies valuer credentials and sets valuation standards. Being a self-regulatory body, it regulates the conduct of its members.

<sup>7</sup> IVSC, Annual Report, 2018-19 p. 8.

<sup>8</sup> IVS 101 Scope of Work, IVS 102 Investigations and Compliance, IVS 103 Reporting, IVS 104 Bases of Value, IVS 105 Valuation Approaches and Methods

<sup>9</sup> IVS 200 Business and Business Interests, IVS 210 Intangible Assets, IVS 300 Plant and Equipment, IVS 400 Real Property Interests, IVS 410 Development Property, IVS 500 Financial Instruments; New set of IVS will be effective from January 31, 2020.

<sup>10</sup> Deloitte, International Financial Reporting Standards (IFRS) Model Financial Statements (2018), <https://www.iasplus.com/en/publications/global/models-checklists/2018/ifrs-mfs-2018>; Ernst & Young, Good Group (International) Limited, Illustrative consolidated financial statements for the year ended December 31, 2017, [https://www.ey.com/Publication/vwLUAssets/ey-ifrs-ctools-good-group-2017/\\$File/ey-ifrs-ctools-good-group-2017.pdf](https://www.ey.com/Publication/vwLUAssets/ey-ifrs-ctools-good-group-2017/$File/ey-ifrs-ctools-good-group-2017.pdf)

<sup>11</sup> *Supra* note 7 at p. 7

<sup>12</sup> *Id.* at p. 21

<sup>13</sup> Official website of the RICS; The Privy Council is the mechanism through which interdepartmental agreement is reached on those items of Government business which, for historical or other reasons, fall to Ministers as Privy Counsellors rather than as Departmental Ministers. <https://privycouncil.independent.gov.uk>

<sup>14</sup> RICS Valuation – Global Standards 2017: India National Supplement, (July 2019). <https://www.rics.org>

<sup>15</sup> IVSC Consultation Paper, *Structure and Scope of the International Valuation Standards* Response of the RICS, October 1, 2014.

RICS Valuation–Global Standards, commonly known as the Red Book, were first published in 1976. The current version is the one published in 2017.

The RICS Red Book also includes *Valuation Practice Guidance–Applications (VPGA)*. These are advisory. Among the topics covered are valuation for specific purposes and valuation of certain specific asset types. Departures are allowed by RICS from its global standards to meet local statutory or regulatory requirements. These are called ‘National Association Valuation Standards’. In the event of conflict between these standards, the National Association Valuation Standards take precedence and may not be interpreted as imposing a lesser standard than the global standards.

In view of the flexibility described above, national association valuation standards have been published in Brazil, Canada, Cyprus, France, Germany, Greece, Hong Kong, Poland, Portugal, Russian Federation, and Sweden.

In July, 2019, RICS issued RICS Valuation–Global Standards 2017: India national supplement 2019. These are effective from July 2019.<sup>16</sup> This national supplement sets out supporting guidance for members on the application of RICS Valuation–Global Standards, 2017 (Red Book Global Edition) to valuations undertaken subject to Indian jurisdiction. It places fresh emphasis on the fact that the content is supplemental to that in Red Book Global Edition, and not in substitution for it. This removes the need for an overall Introduction reproducing that in Red Book Global Edition. Specific standards that apply in India – VPGAs:

- Ind VPGA 1 Valuations for financial statements;
- Ind VPGA 2 Valuations for secured lending;
- Ind VPGA 3 Valuations for taxation purposes;
- Ind VPGA 4 Valuations for determining the compensation to be paid for the compulsory acquisition of land by the government;
- Ind VPGA 5 Valuations of properties under the Insolvency and Bankruptcy Code, 2016 (Code);
- Ind VPGA 6 Valuations for Real Estate Investment Trusts (REITs).

#### STATUS OF VALUATION STANDARDS IN SELECT COUNTRIES

Over the years, more countries have been moving towards IVS or are planning to do. China is good example of a major country choosing to work with the IVS instead of developing its own standards. US has decided to work with the IVSC for converging local standards with IVS.

The Table below details the valuation standards followed in different jurisdictions across the world:

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<sup>16</sup> *Supra* note 14

S. No.	Country	Standard followed by Appraisers	Remarks
1.	US	Uniform Standards of Professional Appraisal Practice (USPAP), IVS and the AICPA Statement of Standards for Valuation Services No. 1. <sup>17</sup>	USPAP are not created as International Standards. The Appraisal Foundation (TAF) does not require compliance with USPAP.
2.	UK	Besides the Red Book, the UK National Supplement is followed	UK National Supplement contains standards and guidance applications.
3.	Canada	Canadian Uniform Standards of Professional Appraisal Practice (CUSPAP)	CUSPAP endorse IVS as an authority promoting worldwide acceptance of standards for property valuation and are compliant with IVS. <sup>18</sup>
4.	Australia & New Zealand	Australia & New Zealand Valuation Standards set by the Australian Property Institute (API) and the Property Institute of New Zealand (PINZ).	Australian Property Institute (API) requires mandatory training in IVS. <sup>19</sup>
5.	Singapore	Valuation Standards issued by Singapore Institute of Surveyors and Valuers (SISV)	SISV is a member of IVSC and the World Association of Valuation Organisations (WAVO), headquartered in Singapore. <sup>20</sup>
6.	Hong Kong	HKIS Valuation Standards 2017 issued by the Hong Kong Institute of Surveyors (HKIS)	HKIS Valuation Standards 2017 were issued following two global valuation standards that became effective on 1 July 2017 IVS 2017 and the RICS Red Book 2017 <sup>21</sup>
7.	China	China Valuation Standards (CVS)	Issued by the Board of Valuers, Appraisers, Estate Agents and Property Managers (BVAEAP), a government body. The new Malaysian Valuation Standards comes with seventeen standards and two introductory chapters.
8.	Malaysia	Malaysian Valuation Standards	Issued by the Board of Valuers, Appraisers, Estate Agents and Property Managers (BVAEAP), a government body. The new Malaysian Valuation Standards comes with seventeen standards and two introductory chapters.
9.	Philippines	Philippines Valuation Standards	Issued by the Philippine Government. Philippines becomes the latest APEC country to adopt IVS in new valuation laws. <sup>22</sup>

### VALUATION STANDARDS: INDIAN SCENARIO

The importance of valuation and its recognition in the financial world in situations of buyout, mergers or insolvency is increasing in the Indian economy. In addition to the statutory requirements, valuations are required for a number of other purposes such as for obtaining bank loans, financial reporting, mergers and acquisitions, compulsory acquisitions, REITs, property tax assessment, and registration fee and stamp duty determination, family

<sup>17</sup> Technical Advisory Service for Attorneys (TASA), Every Attorney Should Know About Appraisal Report Critique, <https://www.tasanet.com/Knowledge-Center/Articles/ArtMID/477/ArticleID/1251476/Every-Attorney-Should-Know-About-Appraisal-Report-Critique>

<sup>18</sup> Official website of the Appraisal Institute of Canada, <https://www.aicanada.ca/>

<sup>19</sup> Australian Property Institute (API), Valuation and Property Standards, <https://www.api.org.au/valuation-and-property-standards>

<sup>20</sup> Official website of the World Association of Valuation Organisations (WAVO), [www.wavoglobal.org](http://www.wavoglobal.org); According to WAVO's website, "WAVO members are located from around the world from South-East Asia (Singapore), to Asia (Hong Kong, Korea and China), Australasia (Australia and New Zealand) to Europe (Romania, Germany, Portugal) and in America (United States and Mexico).

<sup>21</sup> Hongkong Institute of Surveyors (HKIS), (2017). HKIS Valuation Standards, 2017, [https://www.hkis.org.hk/ufiles/HKIS-VS2017\\_rev2.pdf](https://www.hkis.org.hk/ufiles/HKIS-VS2017_rev2.pdf)

<sup>22</sup> *Supra* note 11

settlements, contractual disputes, and intellectual property disputes. It is also required under various Securities and Exchange Board of India (SEBI) regulations including those for REITs, mutual funds and takeovers. Moreover, IRDAI has requirements for valuation of securities held by insurers for net asset value (NAV) calculation. Valuation is also required under various provisions of the Income Tax Act, 1961 and Wealth Tax Act, 1957.<sup>23</sup> The Reserve Bank of India (RBI) too has valuation requirements for issue and transfer of shares where non-residents are involved. However, in the absence of any statutory mandate and local valuation standard issued by any regulatory authority, the valuers generally have been following the IVS General Standards with or without minor modifications or the RICS Red Book.

Under the Companies Act, 1956, there was no provision for conduct of valuation by complying with the prescribed / notified standards. Valuers use to give their opinion without following any particular standards. The Institute of Chartered Accountant of India (ICAI) has issued ICAI valuation standards in August 2018 and the Centre for Valuation Studies, Research and Training Association (CVSRTA) has issued draft valuation standards. However, there is no track record of their application and they do not cover all asset classes.

With the enactment of the Code, the importance of valuation has become noticeable. Fair value and liquidation value requirements are prescribed under the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016. Section 59 of the Code requires valuation for voluntary liquidation. Valuation is required for financial reporting purposes under the Companies (Indian Accounting Standards) Rules, 2015.

Besides the Code, the registration of valuers under section 247 of the Companies Act, 2013 is flagged as an important milestone for the valuation profession. Section 247 provides for valuation by registered valuers where a valuation is required under the provisions of the Act. With the Government realising the need for regulating the valuation professionals and valuation professional organisations, this is increasingly cited as the first step towards a comprehensive regulatory mechanism for such professionals. Only with the notification of this provision that most of the valuation fraternity realised the existence of IVS and the reform in the valuation profession suddenly started taking shape. In no time, it became 'a reform for the regulator as well as regulated'. Prior to the notification, there was no provision for doing valuation as per valuation standards. Valuers of big firms only used to follow IVS or the RICS Red Book or a mix of both.

It bears emphasis that in pursuance of Rule 19 of the Companies (Registered Valuers and Valuation) Rules, 2017, the Central Government has, on April 23, 2018, set up a 'Committee to advise on Valuation Matters'. This Committee has been tasked with making recommendations on the formulation and laying down of valuation standards and policies for compliance by companies and registered valuers. The Committee has submitted its first report to the Central Government in the month of February, 2019 and is expected to come up with a further report on valuation standards in due course.

The Ministry of Corporate Affairs (MCA) has issued the Companies (Registered Valuers and Valuation) Rules, 2017 (the Rules) on October 18, 2017. The relevant provisions in this

<sup>23</sup> Valuation under the Income Tax Act, which is being conducted as per the Income Tax Valuation Rules. (their application is limited solely to valuation for tax purposes), CPWD's *Guidelines for Valuation of Immovable Properties* published in 2009 and the Indian Banks Association's publication *Handbook on Policy, Standards and Procedures for Real Estate Valuation by Banks and HFLs in India* published in 2009. (these publications are more in the nature of rules and application guidance and less in the nature of standards and principles)

regard are those as contained in rule 2 (i) (Definition),<sup>24</sup> rule 8 (Conduct of Valuation),<sup>25</sup> rule 18 (Valuation Standards)<sup>26</sup> and rule 19 (Committee to advise on Valuation Matters).<sup>27</sup> These Rules apply for valuation in respect of any property, stocks, shares, debentures, securities or goodwill or any other assets or net worth of a company or its liabilities under the provision of the Act or these rules. The Central Government has designated the Insolvency and Bankruptcy Board of India (IBBI) as an Authority under the Rules. IBBI, upon designation as an Authority, demonstrated the highest commitment for establishment and regulation of the unregulated profession so far. Very swiftly, it started registration of registered valuers organisations (RVOs) and commenced the online examination on March 31, 2018 and then the registration of valuers.

### REGULATORY GOALS AND CHALLENGES

Acceptance of any new regulatory mechanism is difficult in the society as challenges are always there. The Central Government (Regulator) and IBBI (Authority) faced many hurdles. To overcome these, minor amendments in the Rules were made. It was clarified by an amendment that conduct of valuation under any other law than the Companies Act, 2013 or the Rules by any person shall not be affected by virtue of coming into effect of the Rules. Valuer Organisations existing prior to enactment of section 247 (Societies/Associations) came forward proactively and others by follow up have put steps together with the Regulator.

The Regulator (Central Government) has shown keen interest in fulfilling its duty. It announced the formation of an Institute for Valuers on the lines of other three Professions (i.e. CA, CS, CWA) in the first National Seminar of Valuers, organised by IBBI on June 8, 2019. Further, the Government announced the constitution of a Committee of experts to examine the need for an institutional framework for regulation and development of valuation professionals by an order dated August 30, 2019.

IBBI as an 'Authority'<sup>28</sup> has been pro-active in organising various conferences, seminars and webinars for creating awareness about the profession. Some of the RVOs have shown great interest in knowledge building and sharing. Participation of large number of valuers in various programmes across the country shows that the Authority has been successful in creating awareness and has left an impact about the acceptance of a regulated mechanism. For example, participation of approximately 150 valuers from across the country in a two-days programme conducted by an RVO in association with the IBBI exclusively on valuation standards on August 31, 2019 and September 1, 2019 at New Delhi shows the eagerness of the valuers to adopt the new valuation standards, as and when notified by the Central Government in near future. There has been unprecedented cooperation and partnership between the

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<sup>24</sup>Valuation standards' means the standards on valuation referred to in rule 18;

<sup>25</sup> A registered valuer shall, while conducting a valuation, comply with the valuation standards as notified or modified under rule 18: Provided that until the valuation standards are notified or modified by the Central Government, a valuer shall make valuations as per:

(a) internationally accepted valuation standards;

(b) valuation standards adopted by any RVO.

<sup>26</sup> The Central Government shall notify and may modify (from time to time) the valuation standards on the recommendations of the Committee set up under rule 19.

<sup>27</sup> The Central Government may constitute a Committee to be known as 'Committee to advise on valuation matters' to make recommendations on formulation and laying down of valuation standards and policies for compliance by companies and registered valuers.

<sup>28</sup> Under section 2 (1) (b) 'authority' means an authority specified by the Central Government under section 458 of the Companies Act, 2013 to perform the functions under these rules

Authority and stakeholders with the motive to take a leap towards the development of this profession.

It is also relevant to mention here that 'valuation' has been attributed a higher weightage by the Adjudicating Authority. For example, in *Binani Cements Ltd.*,<sup>29</sup> the National Company Law Tribunal (NCLT), Kolkata Bench raised questions on the authenticity of the valuation of stressed assets, done by the resolution professional.

#### CONCLUSION

Valuation standards have a significant role to play in helping to regulate professional practice at national, regional and global levels, promote professional ethics, integrity, impartiality and trust in valuer activities. Many Governments and professional bodies are responding to international pressure to regulate the valuation profession by reviewing the regulatory environment, valuer training and compliance with standards. At a global level, the IVSC has become the recognised body that produce the IVS. However, despite the existence of these Standards there is considerable variation in how local standard engage and comply with the accepted principles laid out in the IVS. This is further compounded by diverging bases of value and methodologies that are being adopted for valuation across the world. The different interpretation of concepts such as market value, differing valuation approaches adopted as well as the lack of qualified valuers continue to represent major challenges across both mature and emerging markets.

Valuation as a field is gaining importance and is considered as one of the most critical areas in finance and is increasingly utilised in buying/ selling, insolvency resolution, merger and acquisitions. It is an inexact science requiring both objectivity and subjectivity. Hence, professional judgment of the valuer is critical in valuations. It plays an important role in the insolvency resolution regime where fair and liquidation value must be ascertained by the Resolution Professional through the Registered Valuers.

One of the key reasons of regulating this domain was to bring consistency and uniformity. Different valuers have been taking different assumptions which may lead to drastic differences in value conclusion. In many cases, valuation also lacks uniformity and generally accepted global valuation practices. The standards provide a benchmark to the professionals to ensure uniformity in approach and quality of valuation output.

Recognising the need to have consistent, uniform and transparent valuation policies and harmonise the diverse practices in use in India, uniform valuation standards having international recognition are required. Simultaneously, the valuation standards should be consistent with the Indian legislative, regulatory or other authoritative requirement. However, credible valuation standards setting is not something that can be achieved unilaterally, it requires extensive collaboration between standard setters; a willingness to compromise and a shared aspiration to enhance and empower the profession in the public interest.

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<sup>29</sup>CP (IB) No. 359/KB/2017

## *Litigation: A Tool or Weapon*

Swarupama Chaturvedi

*‘...happy to note that in the working of the Code, the flow of financial resource to the commercial sector in India has increased exponentially as a result of financial debts being repaid.’*

Justice R. F. Nariman<sup>1</sup>

**H**on' ble Supreme Court of India hailed the working of the Insolvency and Bankruptcy Code, 2016 (Code) in these words affirming its positive impact on the Indian economy. The Code has streamlined the process of resolution of insolvencies in the country. The Code envisages that once the insolvency process has commenced, it should be established as irreversible as quickly as possible and be concluded in a time bound manner. Time is considered to be the essence of the Code. However, it has been observed that during the journey of three years since the Code was enacted, there have been situations where meeting the laid down timelines has been a challenge.

With a new law in vogue, stakeholders have frequently knocked the doors of the judiciary seeking clarifications and decisions on various aspects of the Code. While these litigations have brought about clarity in interpretations of various provisions of the Code, it has also resulted in some delays in approval of resolution plans. Extension of timeline in the corporate insolvency resolution process (CIRP), under the Code, due to exclusion of time spent in litigation and consideration of the timeline provided in the Code as a directory provision, has also resulted in delays in admission. The pronouncement by the Apex Court<sup>2</sup> that the timelines provided in sections 7, 9 and 10 of the Code, for deciding a matter within 14 days as well as the time to remove a defect within 7 days, are directory and not mandatory, brought about a big shift in adherence of timelines provided in the Code.

Since litigation is touted to be one of the reasons that delays the resolution process, this article attempts to analyse the emerging jurisprudence around the provisions of CIRP under the Code and the Regulations framed under it. It explores whether resorting to litigation is indeed helpful for the development of the law or is it just a route to buy time and delay the resolution process.

### THE JOURNEY ON UNEXPLORED ROADS

With the implementation of the Code, there is now an easier exit option available to entrepreneurs, enabling them to take more risks. Also, it has been seen that investors are more willing to invest as there is less uncertainty about loan repayments. As observed by the apex

<sup>1</sup> Justice R.F. Nariman, in the matter of *Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.*, (2019) 4 SCC 17 (hereinafter 'Swiss Ribbons')

<sup>2</sup> *Surendra Trading Company v. Juggilal Kamalpat Jute Mills Company Limited and Others*, (Civil Appeal No. 8400 of 2017)

court, there has been a paradigm shift in the way corporate debtors (CDs) are managed during the insolvency resolution process since the Code was enacted. Creditors now assume control of the CD from the previous management and bring about a positive change. Resolution plans, which are in the interest of the CD and other stakeholders like creditors, workers and shareholders, are effected by the 'new' management.

The Code has led to the resolution and liquidation of various CDs, helping in realisation of claims of creditors. A number of cases have been resolved through settlement between parties as promoters fear losing the ownership of their firm upon initiation of insolvency resolution process under the Code<sup>3</sup>. In the matter of *Swiss Ribbons*<sup>4</sup> it was observed that total flow of resources to the commercial sector in India, both bank and non-bank, and domestic and foreign (relatable to the non-food sector) has gone up from a total of Rs. 14,530.47 crore in 2016-2017, to Rs. 18,469.25 crore in 2017-2018, and to Rs. 18,798.20 crore in the first six months of 2018-2019.<sup>5</sup> These figures show that the Code has proved to be a successful enactment.

In the same matter, the apex court has also upheld the constitutionality of the provisions of the Code and also settled the law on various issues related to the Code. The case has established the jurisprudence, which is helping the Adjudicatory Authority (AA) to decide issues on routine basis and thereby reducing the litigation under the Code in general.

### **Experience of Roadblocks**

As is the case with any newly enacted legislation, which is in its nascent stage of development, the Code is bound to face situations, which might not have been foreseen at the time of its enactment. This has resulted in mainly four types of situations can be identified:

- a situation not covered by any of the existing laws;
- a situation, where there is a provision in law but some clarification is needed;
- a situation which was not ready for any intervention by law leading to a lack of acceptability; and
- a situation regarding the exclusion of a class or classes of people from the applicability of the law.

Settlement of disputes after admission of the application for insolvency is a classic example of the first type of situation mentioned above. Various definitions like debt, claim etc. come in the second category, where judicial intervention offered the necessary clarifications. Third category comprised mostly of debtors, who sought intervention of the judiciary to understand the objectives of the enactment of the Code and to understand if their interest is equally important as the interest of the creditor. Fourth type of situation can be well explained with the example of home buyers. The demand of home buyers<sup>6</sup> to be treated like a financial creditor (FC) is a reflection of the expectations that the general public has with the Code, which is to balance the interest of all the stakeholders.

<sup>3</sup> It was further observed by apex court in *Swiss Ribbons*, that approximately 3300 cases have been disposed of by the AA based on out-of-court settlements between corporate debtors and creditors which themselves involved claims amounting to over Rs. 1,20,390 crore. 80 cases have since been resolved by resolution plans being accepted. Of these eighty cases, the liquidation value of 63 such cases is Rs. 29,788.07 crore.

<sup>4</sup> *Supra* note 1.

<sup>5</sup> *Supra* note 1, observed that the amount realized from the resolution process is in the region of Rs. 60,000 crore, which is over 202% of the liquidation value. As a result of this, the Reserve Bank of India has come out with figures which reflect these results. Thus, credit that has been given by banks and financial institutions to the commercial sector (other than food) has jumped up from Rs. 4952.24 crore in 2016-2017, to Rs. 9161.09 crore in 2017-18, and to Rs. 13195.20 crore for the first six months of 2018-2019. Equally, credit flow from non-banks has gone up from INR 6819.93 crore in 2016-2017, to Rs. 4718 crore for the first six months of 2018-2019.

<sup>6</sup> Home buyers of Jaypee Group before Supreme Court, in *Chitra Sharma v. Union of India*, (W.P. (C) No. 744 of 2017 and other connected matters).

## JUDICIARY: THE SAVIOUR

In the above backdrop, the Code's implementation also saw situations where legal help was sought by different parties and this is where the appellate Courts came into action. National Company Law Appellate Tribunal (NCLAT) and the apex court have worked towards developing the jurisprudence of this Code and have been constantly guiding AAs. It is also important to note that despite having a huge number of appeals, the disposal rate is swift. It must be acknowledged that the judiciary has been the savior for not only all stakeholders but also for the Code and every institution which is a part of the functioning of the Code. Some of the issues settled by the apex court are discussed below to show how some emergent situations, experienced during the journey of the Code, were tackled and solved.

### Interpretation of the Objectives of the Code

In the matter of *M/s Innoventive Industries Ltd. v. ICICI Bank & Anr.*,<sup>7</sup> the apex court gave a detailed judgement, which clarified most of the aspects of the Code. In this case, it was observed that since this was the first application moved under the Code, it was necessary to deliver a detailed judgment that would serve as a piece of guidance to all Courts and Tribunals and they would take cognisance of a paradigm shift in the law. It said that the entrenched managements are no longer allowed to continue if they cannot pay their debts. It was further observed that one of the important objectives of the Code is to bring the insolvency law in India under a single unified umbrella with the object of speeding up of the insolvency process.<sup>8</sup>

This judgement was a loud and clear message that this law was the need of the hour and it was there to stay for the betterment of the economic health of the nation.

### Settlement after Admission

In the matter of *Lokhandwala Kataria Construction Pvt. Ltd v. Nisus Finance and Investment Managers LLP*,<sup>9</sup> the issue was whether in view of Rule 8 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016, the NCLAT could utilise the inherent power recognised by rule 11 of the National Company Law Tribunal (NCLT) Rules, 2016 to allow a compromise between the parties involved in a case, after admission of the matter. The question arose because in the impugned order, NCLAT has held that the inherent power could not be so utilised. On appeal, the apex court agreed with the stand taken by the NCLAT on the aforesaid question of law and utilised its powers under Article 142 of the Constitution and put a quietus to the matter by allowing settlement between the parties.

After this case, there were many cases that were filed before the apex court for grant of similar relief. This became a contentious issue as the apex court was invoking Article 142 multiple number of times, much more than it had ever in the past. Since the same issue was coming up before the apex court in numerous cases, it observed in the matter of *Uttara Foods and Feeds Pvt Ltd v. Pharmachem*,<sup>10</sup> that instead of such orders coming to the apex court (as only

<sup>7</sup> (2018) 1 SCC 407 (hereinafter 'Innoventive')

<sup>8</sup> The Hon'ble Court discussed in Innoventive case that the time taken in insolvency in other countries and then observed that as per the data available with the World Bank in 2016, insolvency resolution in India took 4.3 years on an average, which was much higher when compared with the United Kingdom (1 year), US (1.5 years) and South Africa (2 years). The World Bank's Ease of Doing Business Index, 2015, ranked India as country number 135 out of 190 countries on the ease of resolving insolvency based on various indicia.

<sup>9</sup> Civil appeal No. 9279 of 2017.

<sup>10</sup> Civil Appeal No. 18520 of 2017.

the apex court can utilise its powers under Article 142 of the Constitution of India), the relevant Rules be amended by the competent authority so as to include such inherent powers. It further observed that this would obviate unnecessary appeals being filed before this Court in matters where such an agreement had been reached. The apex court also directed that a copy of the order of the judgement of *Uttara Foods* be sent to the Ministry of Law and Justice immediately. The amendment has resolved the issue and now there is a provision to permit such a settlement.

### **Rights of Operational Creditors**

In the matter of *Mobilox Innovations Pvt Ltd. v. Kirusa Software Private Ltd*,<sup>11</sup> the apex court dealt with the issue of existence of dispute and settled the law on this issue. It has considered questions such as initiation of insolvency resolution process by operational creditors (OCs) and as to what would constitute a 'dispute', entitling the debtor company to have the AA reject the application.

The apex court observed that there can be situations where a debtor company may have a dispute with an OC, which may not have escalated to a court or arbitral tribunal. Issues like this were resolved in one judgement, imparting clarity on the issue and setting a precedent to follow in similar situations, which ultimately reduced the burden of litigation on future CIRPs.

### **Copy of the Resolution Plan to Ex-Directors**

In *Vijay Kumar Jain v. Standard Chartered Bank & Ors.*<sup>12</sup>, the apex court allowed ex-directors to get a copy of the resolution plans from the resolution professional. It was considered that some of the suspended directors may have offered personal guarantee for the CD and the approved resolution plan under section 31(1) of the Code would be binding on the suspended board of directors, therefore, they had right to access resolution plans. This judgement gave a sense of satisfaction to ex-directors who otherwise had started to feel completely ousted in the process.

### **The Issue of Related Party**

While rejecting the challenge of the petitioners on the constitutional validity of section 29A of the Code in case of *Swiss Ribbons*,<sup>13</sup> the apex court clarified that the definition of relative/related person will mean persons who are connected with the business activity of a resolution applicant. In the absence of being able to prove that such a person is connected with the business activity of the ineligible resolution applicant, such a person cannot possibly be disqualified under section 29A of the Code. It further pointed out that it is a settled law that a statute is not retrospective merely because it affects existing rights nor is it retrospective merely because a part of the requisites for its action is drawn from a time antecedent to its passing. Further, the apex court also held that according to the legislative policy, a person who is unable to service its own debt beyond the grace period, is unfit to be eligible to become a resolution applicant.

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<sup>11</sup> Civil Appeal No. 9405 of 2017.

<sup>12</sup> Civil Appeal No. 8430 of 2018.

<sup>13</sup> *Supra* note 1.

### **The Issue of Home buyers**

A group of home buyers of Jaypee approached the apex court for the first time in the matter of *Chitra Sharma v. Union of India*<sup>14</sup> along with many connected matters, several intervention and applications for being impleaded in the matter, for inclusion in the class of FCs. It directed for an arrangement wherein home buyers could convey their intention to receive their money back or continue with the possession of their flat.

While the aforesaid petitions were under consideration before the apex court, the Government amended the Code to include home buyers in the list of FCs. The Government has been following the functioning of the Code closely and proactively dealing with issues in its implementation. With the aforesaid amendment, the issue of the status of home buyers got resolved. However, stakeholders are continuing to approach the Courts for any issue related to the Code. This is how the Code's jurisprudence is evolving and developing faster than any other law.

#### LEARNING FROM EXPERIENCE

The apex court has upheld the constitutionality of the Code in its entirety while observing that the flow of financial resources to the commercial sector in India has increased exponentially as a result of financial debts being repaid. While this is a positive acknowledgement by the apex court, there were also concerns shown by different stakeholders. As the Government is closely following the functioning of this Code, observations have been taken positively by the government and there have been amendments to resolve those concerns. Many amendments have been made to the Code, and to the subordinate legislation made thereunder, based upon Committee Reports which are looking into the working of the Code.

One such concern flagged is the adherence of timelines provided in the Code. To understand the gravity of this issue one has to analyse the days taken by some of the CIRPs, which have been delayed by over 450 days due to litigations. Jaypee, Essar Steel, Bhushan Power and Steel, Lanco Infra, and Alok Industries are few such examples. Time is the essence of the Code as outcomes are calculated in terms of time, value and money. Considering the essence and spirit of this law, it was necessary to prioritise adherence to the set timeline. While avoiding litigation can be one of the aspects, it must be noted that litigation (notwithstanding its major role) is not the sole reason for the delay in the CIRP.

Keeping in view the importance of time in the debtor-creditor relationship and CIRP, there is greater emphasis on the need for time-bound disposal at application stage. Therefore, the deadline for completion of CIRP, within an overall limit of 330 days, was introduced by a recent amendment to the Code, which will include time for any extension granted and the time taken in legal proceedings in relation to the process. This Amendment Act also makes a provision for pending matters which are over 330 days. The Amendment has stipulated that such pending matters be resolved within 90 days.

### **Litigation: An Instrument to develop Jurisprudence**

While litigation has indeed delayed the process, it has also played a major role in the implementation and effective functioning of the Code. When the Code got enacted, there were

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<sup>14</sup> *Supra* note 6

queries from every corner, but solution of every issue was received from the judicial pronouncements. It is unfair to now say that many days were lost to the litigation process and how exclusion of those days has delayed the process. It is imperative balanced to note that days taken by the courts in the interpretation of the Code would save the time of all future CIRPs on similar issues and queries. It is also necessary to analyse the time taken by the courts to decide a civil appeal as opposed to insolvency appeals. Such an analysis would reveal that the courts do show concern to the timeline provided in the Code.

#### CONCLUSION

The Code has brought high hope and aspirations due to the influence it has had on the economy of the country. It is an important law which has had a strong impact on business and the economy.<sup>15</sup> Since this law helps all stakeholders, delays in admission of applications and extended timelines for resolution process are a matter of concern. Everyone, including the AA and regulatory authorities, have shown their commitment to implement the Code despite working under constraints and limitations.

Some steps can be taken to reduce litigation. Sending insolvency resolution professionals for a mandatory short refresher course before they give consent for the term can be the first step. It is also necessary that the AAs are aware about judgements passed by various courts and for that they need to have a research team that can update the courts about various interpretations of the Code. This will help in avoiding conflicting views leading to further litigation. It is also suggested that the power to give exclusion of days from CIRP should be limited to the discretionary power provided under Article 142 of the Constitution. Going further, when AA gets sufficient infrastructure, more number of Information Utilities become functional and insolvency professionals gain sufficient experience, it is expected that CIRP processes would be able to adhere the timelines prescribed under the Code.

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<sup>15</sup>Swarupama Chaturvedi (2017). Triggering the Corporate Insolvency Resolution Process by the Operational Creditor Under Insolvency and Bankruptcy Code 2016. *Amity International Journal of Juridical Sciences*, Vol-3.

## *Cost-Benefit Analysis of Insolvency Regulations*

Sumant Batra

The past two decades have witnessed both an unparalleled rise in new regulations as well as significant deregulatory reform around the world generating a hot debate on the impact of regulatory activity on the economy.<sup>1</sup> Few would deny that regulations have added substantially to the costs of doing business. This has increased the demand by market players for greater cost-benefit analysis (CBA) of regulations prompting the policy makers, regulators and scholars to undertake deep studies on this subject. The issue takes on even greater importance as firms find it increasingly difficult to compete in the global marketplace prone to economic slowdowns and other risks.

The CBA is now recognised as one the most elucidate tools to explain the trade-offs for a given policy or regulation although it has also received some criticism on efficiency grounds as being unnecessarily costly and time-consuming. But it can be safely stated that there is a general agreement that CBA as a mechanism provides a structured way to assess what costs and benefits a policy is expected to generate. It attempts to describe and quantify its likely impact on industry, consumers, markets and the concerned policy maker and regulator. Social scientists have attempted to measure the impacts of regulatory changes using a variety of estimation techniques in the CBA toolkit. Researchers have calculated very different estimates of regulatory costs. Economists and scholars also agree that the impact of regulation on the overall economy is challenging and difficult to measure with full certainty based on any available mechanism. The general perception is that in case of economic regulation, the benefits are negligible in most cases, while in social regulation, the potential to confer benefits is significant. Because social regulation can address specific 'market failures', it may provide net benefits to society. While potentially beneficial, such social regulation also has costs. Another challenge in estimating the costs and benefits of regulation requires a working definition of regulation itself. Scholars have grappled with this problem for some time with only limited success.<sup>2</sup> One difficulty in performing CBA is trying to accurately determine the human behavioural response to the implementation of a regulation. Predicting human choices involves modelling consumer behaviour in the market, statistical interpretations of available data, and some degree of uncertainty.

Quantification of outcomes also poses challenges in determining causation and measuring magnitudes of effects. After an estimate has been made of the quantity and

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<sup>1</sup> Hahn, Robert W. (1990). Regulation: Past, Present and Future. *Harvard Journal of Law and Public Policy*. 13, pp. 167- 228.

<sup>2</sup> Financial Conduct Authority (2018). How we analyse the Costs and Benefits of our Policies. <https://www.fca.org.uk/publication/corporate/how-analyse-costs-benefits-policies.pdf>

magnitude of outcomes, those effects must be monetised because measuring the varied effects of a regulation requires a common unit of measurement. This becomes problematic when attempting to assign a dollar value to outcomes that do not have market prices. Regulatory benefits may often be more difficult to monetise than major costs. Costs are often economic costs, which may be more easily monetised, such as an industry's reduction in economic activity or the added expense of complying with regulation. Benefits may be harder to quantify because of the difficulty in determining causation and because the outcomes are harder to price.

In financial sector regulation, some of the most compelling arguments for the application of CBA have come from regulators themselves. The United Kingdom Financial Services Authority (UK FSA) argued more than a decade ago that CBA provides benefits not just to regulated parties, but to the regulators themselves.<sup>3</sup> The UK FSA notes that although CBA requires time and effort, the information gained from a good quality CBA can provide significant pay-backs by improving the quality of regulation and by increasing the confidence of the industry and the public in the regulatory process. Quality CBA also helps ensure that the regulator fulfils its obligation to explain why its proposed rules are compatible with its other general duties, including duties to facilitate innovation in regulated activities, minimise the adverse effects on competition, and facilitate competition between regulated persons.<sup>4</sup>

The United States Securities and Exchange Commission (US SEC) records in its Guidelines that 'high-quality economic analysis is an essential part of SEC rulemaking.' Such analysis offers several benefits, including that the decisions to propose and adopt rules are informed by the best available evidence about a rule's likely consequences, and that economic analysis allows the SEC 'to meaningfully compare the proposed action with reasonable alternatives, including the alternative of not adopting a rule.' A rule's potential benefits and costs should be considered in making a reasoned determination that adopting a rule is in the public interest.<sup>5</sup> The SEC thus, recognises CBA as an important check on potentially harmful regulation; regulation may have unintended negative consequences, and effective CBA provides a means of protecting against such consequences.

In a recent study on CBA, Financial Conduct Authority of United Kingdom (FCA) has explained how it goes about analysing and estimating the costs and benefits of its policies. The study outlines the steps taken by FCA and the key challenges it faces. The study sets out how CBA is used to inform decisions; the level of detail and accuracy aimed for, gathering the evidence; and how uncertainty is dealt with. It comprehensively discusses what is typically covered in the CBA. On costs, it presents new standardised approach to estimating compliance costs, designed to increase consistency of compliance cost estimates and reduce the information-gathering burden on firms. On benefits, it illustrates the types of benefits that FCA aims for when it intervenes in financial markets, the challenges in quantifying these, and the continuing efforts made in this area.

#### COST-BENEFIT ANALYSIS IN INSOLVENCY REGULATION

In the area of insolvency regulation, economists and scholars estimating the costs and benefits

<sup>3</sup> Alfon, Isaac, & Andrews, Peter (1999). Cost-Benefit Analysis in Financial Regulation How to Do it and How it adds Value. Financial Services Authority Central Policy.

<sup>4</sup>Id.

<sup>5</sup> SEC Guidance Memorandum, (2012)

of regulation encounter formidable problems. The most important of which is identifying a reasonable benchmark with which to compare the current system. Unfortunately, such a counterfactual does not exist globally.

In India, estimating the costs and benefits of regulation assumes even greater significance. The Insolvency and Bankruptcy Code, 2016 (Code) is mainly a regulation-based law with substantive provisions of the law being heavily dependent on the regulations for their implementation. It is the procedural glue that holds the substantive provisions together. The choice of regulations, therefore, plays a crucial role on the costs they may impose on the market and their benefits. Dealing with a web of economics-based laws makes assessing CBA even more complex in India. The addition of immensely diverse social, cultural and human factors makes it more challenging. The challenges are compounded by the fact that the Code contains many new principles and concepts alien to the Indian market on which neither any best practices nor recorded precedents exist. For example, the Code introduces a shift from the debtor-in-possession regime to the creditor-in-control regime. Many new institutions were established under the Code. The Insolvency and Bankruptcy Board of India (IBBI) was set up and tasked with framing regulations for the corporate insolvency regulation process and liquidation process for corporate persons, and fresh start, insolvency and bankruptcy of class of individuals. Besides this, the IBBI is mandated to regulate insolvency professionals, insolvency professional agencies, valuers and others. The IBBI has a crucial role to translate general statutory imperatives into workable regulations.

Insolvency regulation is a dynamic exercise. Modification of regulations becomes necessary as a response or reaction to the developments in the market, changes in law or demand from the market. Initial regulations under the Code were framed on the basis of the policy framework introduced. Based on the learnings from ground, amendments made in the Code and the judicial pronouncements, IBBI tweaked the regulations over a dozen times in less than three years. One of the significant concerns with the increased pace of regulation making stems from the difference between getting rules done and getting them done right. While IBBI held a degree of consultation with stakeholders in the process of making changes in the regulations, the general sentiment of the market was that the impact of regulations was neither deeply thought through nor the consultation with stakeholders, adequate and meaningful. Moreover, there was no method to these changes. Most changes were in the form of reactions and responses to the market developments. There were also some concerns on lack of objectivity in regulation making and providing justification behind such changes.

In 2018, IBBI framed regulations to govern the mechanism for issuing regulations (Regulations Framing Mechanism).<sup>6</sup> Regulation 5 of the Regulations Framing Mechanism provides that IBBI shall cause an economic analysis of the proposed regulations to be made. The economic analysis shall cover the expected costs to be incurred by, and the benefits that will accrue to, the society, economy, stakeholders, and IBBI, both directly and indirectly on account of the proposed regulation; and how the proposed regulations further strengthen the objectives of the Code. There is no doubt that a structured approach to CBA by way of Regulations Framing Mechanism will help IBBI systematise this process and provide an

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<sup>6</sup> The IBBI (Mechanism for Issuing Regulations) Regulations, 2018.

analytical template for the consideration of any new regulation. At the same time, it is crucial that the approach and process adopted by IBBI for undertaking CBA gives not only adequate consideration to a variety of significant economic questions but follows an inclusive, objective and transparent process that earns respect and confidence of stakeholder.

### Approach

It is no exaggeration to say that IBBI is handling many times the normal rule-making volume of other regulators. It is dealing with the problem of rushed proposals that are pushed out in a bid to meet strict deadlines. However, the pace of rule-making required should not be an excuse for imprudent rule-making. While it is well-recognised that insolvency regulation making is a dynamic exercise and the regulator has to be ever alert and ready to step in to address the issues arising from market developments, a long-term policy view is equally essential while formulating or modifying regulations. It is also important that regulations address causes and not just symptoms. Applying economic analysis to financial regulation is the only way of getting to the bottom of these issues. CBA should be used by IBBI as a practical and rigorous means of identifying, targeting and checking the impacts of regulatory measures on the underlying causes of the ills with which it needs to deal with. These causes have to be market failures that justify regulatory intervention.<sup>7</sup> IBBI can seek useful guidance from this approach. Regulatory efforts that follow a 'boom-bubble-bust-regulate cycle of financial market regulation',<sup>8</sup> and which Larry Ribstein characterised as 'bubble laws' create special risks. As Ribstein explains:

'boom encourages unwarranted trust in markets, leading to the speculative frenzy of a bubble and then to the inevitable bust. The bust, in turn, leads first to the disclosure of fraud and then to the mirror image of the bubble—a kind of speculative frenzy in regulation. A political context combining long-standing interest group pressures with panic and populism virtually ensures against a careful balancing of the costs and benefits of regulation. Regulators are more likely to react to past market mistakes than to prevent future mistakes. Even worse, post-bust regulators are likely to ignore the benefits of market flexibility and, therefore, to impede the risk-taking and innovation that will bring the next boom.'

In its comprehensive study on analysis of the costs and benefits of its policies, the FCA has listed key steps to identify and estimate likely impacts (Refer Table).<sup>9</sup> In addition, it is crucial that IBBI focuses on economic as well as administrative budgetary costs. A regulator's budget reveals little about its effect on the economy. Indeed, the relatively small budgets of some regulatory agencies belie their large impact on the economy.

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<sup>7</sup> *Supra* note 3.

<sup>8</sup> Ribstein, Larry E. (2003). Bubble Laws, *Houston Law Review*, 40, pp. 77-79; This cycle has been noted by other scholars as well. See, e.g., Grundfest, Joseph A. (2002). Punctuated Equilibria in the Evolution of United States Securities Regulation, *Stanford Journal of Law and Business Finance*, 8, p. 1; Partnoy, Frank. (2000). Why Markets Crash and What Law Can Do About It, *University of Pittsburgh Law Review*, 61, p. 741.

<sup>9</sup> *Supra* note 2

Table: Key steps to identify and estimate likely impacts

Key steps to assess impact	Description	Other points
Counterfactual or baseline scenario	What would have happened in absence of the intervention	If the baseline is the present state of the market, we look at whether the market is rapidly expanding or declining (to avoid under/over estimating impacts).
Identification of direct impacts	Direct costs and benefits to market participants and to FCA	Costs of complying with new regulatory requirements (or savings from removal of requirements). Costs to FCA of managing new/ extended reporting systems, supervising and enforcing new rules. Benefits to consumers (financial loss prevented, or other improvement in consumers' well-being).
Identification of indirect impacts	Impacts that are not an aim of the policy or a direct result from complying with the rules.	If the baseline is the present state of the market, we look at whether the market is rapidly expanding or declining (to avoid under/over estimating impacts).
Quantification of impacts	Quantification of any incremental costs and benefits, when possible. As well as estimates of direct and indirect impacts, this may include transfers between different types of agents.	There are financial components (e.g. variations in prices multiplied by number of transactions, variations in financial losses from unsuitable products) and non-financial components (e.g. welfare gains, psychological benefits, time saved, welfare effects of innovation).
Monetisation of impacts	Quantified impacts are converted into monetary impacts, where reasonably practicable	For some of the non-financial components there are well-established measures, e.g. using salaries to infer the opportunity cost of working time. Other non-financial effects are more difficult to measure, as they require an attempt to estimate changes in consumers' welfare (welfare analysis). We cannot always monetise all aspects of welfare, but we can get to some of them (for e.g. well-being) quantitatively.

EX-ANTE AND EX-POST COST-BENEFIT ANALYSIS

In the early stages of policy work, the process of undertaking a CBA helps think through the likely impact of a proposal; identifying alternative options for achieving the desired outcome; make sure the consultation exercise is meaningful by being explicit about intended and unintended impacts; determine whether the costs are proportionate in light of the expected benefits and whether there are any groups of society that will be disproportionately affected; and assess whether market processes (competition, innovation) will be affected for better or worse.<sup>10</sup> However, given that it is generally applied in the pre-investment stage of projects, its results are dependent on a range of assumptions regarding demand, cost, social prices as well as other parameters which are difficult to ascertain objectively *ex-ante*. *Ex-post* evaluation are useful for improving appraisal methodologies and refining the parameters and assumptions used in subsequent *ex-ante* evaluations. *Ex-post* analyses consists of reviewing the costs, implementation timeframes and compliance with the regulations, and in-depth analysis of the attainment of the benefits and expected costs after the project has been in operation for a reasonable period of time. IBBI undertook framing of regulations in the year 2016 without the fear of the unknown. The quality of regulations was reasonable considering there was little

<sup>10</sup> Ibid.

experience of a creditor-in-control regime. The aim was to improve the quality alongside the implementation of the Code. Amendments have been introduced by IBBI from time to time. Most changes were promoted by the experience of implementation of the Code as a response or reaction. There was no CBA undertaken as the need to amend was mostly, pressing. This approach, however, is expected to reduce in future and amendments are more likely to be the result of a thorough analysis. CBA will provide a template designed to ensure that, despite the accelerated pace, IBBI will not cut corners but will engage in more rational decision-making, will produce better regulations, and will promote good governance. The *ex-post* CBA should be carried out by an expert group of which no member of IBBI's Governing Board should be a part.

### **Gathering data**

Smart regulation requires taking the time to understand the problem that needs to be addressed, including not only the proximate cause of the problem but also the often complex and hidden factors underlying that problem. Therefore, data available to inform estimates, as well as the proportionality of gathering more data, has a bearing on the level of detail in a CBA. In its study, the FCA noted that it makes use of the best available internal information, including the judgement and experience of FCA supervisors and sector experts, information from previous CBA and consultations. There may be data available that is sufficient for its purposes, for example data cited in our previous publications, field trials or evaluations of previous policies; regulatory data, previous data requests, the surveys and the external information sources. When the above is not sufficient to produce reasonable estimates, evidence from informal consultation with stakeholders (such as industry representatives), stakeholder working groups and, where necessary and practical, with bespoke data requests to firms is used to supplement. Some remedies may be ruled out at an early stage on the basis of in-house evidence and knowledge.<sup>11</sup> Unfortunately, adequate evidence is not available in this early life of the Code to make an effective CBA. But, IBBI should make optimum use of the best available internal information. It is necessary that IBBI gathers maximum evidence to ascertain whether there is a problem that needs to be addressed and, if so, whether it is merely a perceptual one or whether evidence exists that a regulation is not working as intended. A targeted consultation should be undertaken requesting evidence rather than views. Evidence should be collected through a mix of direct requests for written evidence and telephone and face-to-face interviews with key informants. A set of generic questions may be posted on the website for the review, to which a number of members of the public would respond, usually providing details of cases they had been involved in where they considered that the fees charged had been high. These responses would be from debtors, unsecured creditors and directors of companies that had experienced corporate insolvency.

In-depth analysis of the data is the key to achieving an effective CBA. All the available evidence should be subject to rigorous scrutiny, including requesting additional written evidence to substantiate any key points that had been raised in oral or written evidence. Evaluations can sometimes be manipulated, either consciously or unconsciously (optimistic bias), to yield unrealistic results. Consequently, there is a risk that public institutions may use

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<sup>11</sup>Ibid.

this tool inappropriately, viewing it merely as a bureaucratic obstacle that has to be overcome prior to implementing a project that they want to promote or have already approved.<sup>12</sup> The review should be to assess what further changes (if any) are required to address the problems (perceived and real) that have been identified. It should not be confined to issues of legislation and regulation, but also consider other possible changes such as the guidance and advice that is available to creditors and others who are affected by insolvencies. Analysis of the data by the IBBI should be at two levels – internal and external (research/publications, business surveys, etc.) The Regulations Framing Mechanism provides that IBBI shall upload on its website seeking comments from:

- the public draft of proposed regulations;
- the specific provision of the Code under which IBBI proposes regulations;
- a statement of the problem that the proposed regulation seeks to address;
- an economic analysis of the proposed regulations;
- a statement carrying norms advocated by international standard setting agencies and the international best practices, if any, relevant to the proposed regulation;
- the manner of implementation of the proposed regulations; and
- the manner, process and timelines for receiving comments from the public.

IBBI shall consider the public comments received and upload the same on its website along with a general statement of its response on the comments. While the process appears to be fair on the rule book, its real test will lie in it being following not just in letter but also in spirit. When the available data is not sufficient to produce reasonable estimates, IBBI should supplement this with evidence from informal consultation with stakeholders (such as industry representatives), stakeholder working groups and, where necessary and practical, with bespoke data requests to firms. When information is not readily available, nor forthcoming, IBBI should use its own judgement and experience.

#### OBJECTIVITY AND TRANSPARENCY

CBA has long been extolled as the best method for stripping regulatory decisions of bias and anchoring them with objective, real-world economic consequences. The presumption that regulators have acted neutrally is linked to CBA. But this also means quantitative analyses have to be neutral? Yet, proper CBA will always require some degree of judgement and cannot pretend to be just a mechanical application of a set of norms, standards and methodologies. Analysts will always have some discretion over the details of a project's appraisal. Thus, there will still be room for discrepancy between project proponents, project analysts and supervisors of the latter with respect to the appraisal of a particular project. IBBI should set high standards of objectivity in its analysis of evidence. It should not only be objective but appear to be objective. This will help in enhancing market confidence in the objectivity and independence of IBBI in the matter of regulation making. CBA is also about transparency and making sure powers are used appropriately. Transparency is the other critical benefit to the process, and one that seems particularly important in light of the nearly irresistible urge to game the analysis that is presented by the cost-benefit approach. Publishing a CBA before proposing or

<sup>12</sup> Gómez-Lobo, A. (2012). Institutional Safeguards for Cost Benefit Analysis: Lessons from the Chilean National Investment System. *Journal of Benefit-Cost Analysis* 3.

amending regulations should be an important part of IBBI's accountability framework.

### **Engagement with experts**

The CBA as practiced in the modern administrative state enhances the ability of regulatory experts to leverage their expertise while limiting the dangers of reliance on such experts by promoting and enhancing opportunities for public debate and their legal and operational scrutiny. Some critics however, object to over-reliance on experts arguing that its increased use vests control in experts who subtly manipulate the evaluation so that it conforms to the procedures of the market-place. It is necessary to remember that the regulations framed by IBBI are subject to judicial review.<sup>13</sup> Although, the National Company Law Appellate Tribunal (NCLAT) and the Adjudicating Authority do not have the jurisdiction to undertake judicial review of regulations, they can and will scorn at an arbitrary or capricious regulation or an abuse of discretion, or any regulation which is not in accordance with law. The cost of changing regulation, which may potentially fall in any of the above categories is high and off sets the benefits aimed at which such regulation is framed. Meaningful engagement with experts will help in minimising this risk and cost. IBBI statutory advisory committees comprising of experts should be convened more frequently to benefit from the expertise located therein.

### CONCLUSION

CBA is as much an art as a science due to imperfect methodology and insufficient data. Assessing what people are willing to pay for a stable market is difficult. Significant uncertainties affect most cost estimates. These uncertainties arise in predicting how government will implement specific policies and how industry will respond. Although the benefits of regulation may equal or exceed its costs, the potential exists for far greater efficiency improvements since it is unlikely that marginal benefits equal marginal costs. Notwithstanding the challenges, CBA will help IBBI in providing assurance to the market that it will not adopt economically harmful regulations. Importantly, CBA would also serve a democratic function by making the discussion of new regulations more open to truly informed community comment. Stakeholders will know that their comments will be examined by sensible and knowledgeable experts through a credible and transparent process. A rigorous, objective and transparent CBA will help IBBI reduce the risk by considering not only what direct costs and benefits may be associated with compliance with a particular regulation, but also to more broadly consider how IBBI as a regulator fits in with the regulatory apparatus as a whole.

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<sup>13</sup> Zinke, Robert C. (1987). Cost-Benefit Analysis and Administrative Legitimation. *Policy Studies Journal*. 6, pp. 63-88. (citing David Dickson et al. (1981). The Cost-Benefit Swindle Puts Dollar Signs on Human Health, *In These Times*).

## Part IV

### The Impact



## *The Code for Economic Growth*

G. N. Bajpai

**I**n the streets of the financial market at Mumbai, there has been a standing epistolary for a long time. It states ‘Starting a business enterprise in India is like a *'chakravayuh'*; one can get in with Abhimanyu's abilities of *Sam, Dam, Dand, Bhed*, navigating all the *Maharathis* at various check posts, but cannot get out.’

Every business enterprise, big or small, has either of the two propensities, success or failure. In the case of success, the entrepreneurs and all other stakeholders, including providers of financial capital enjoy the benefits of success, albeit in varying degree. However, if the business fails, all the stakeholders suffer, more so the owners of financial capital. The system must, therefore, provide at least an easy exit in the event of failure so that the pain is minimised and the salvage value is optimised and quickly put to better use. Unfortunately, until the Insolvency and Bankruptcy Code, 2016 (Code) was introduced in 2016, the exit journey of failed businesses was arduous, long and messy, and travelled through the ultimate process of painful winding up in most cases. In fact, many of the business enterprises remained in a kind of animated suspension, like vegetated bodies on life support until the 'brain' is dead.

Any commercial activity, and in particular, a formal enterprise necessitates engagement of all the three factors of production *viz.* land, labour and capital. The owners of land, labour and capital look for opportunities to deploy their surpluses with a view to earn adequate returns with safety and liquidity. Entrepreneurs, people with ideas, competence and risk taking ability, look for resources to convert their imagination, invention and innovation into useful products and services, and commercialise them to create wealth for the economic good of all the stakeholders. Markets provide a platform where owners and users shake hands and engage to deploy available resources gainfully with full freedom and abundant opportunity, and efficaciously share the wealth created; while contracting to share the risks involved in the process.

### EFFICIENT MARKETS AND THE REGULATORY PARADIGM

Liberalised markets lead to more efficient use of capital and other resources. The important pillars of efficient markets, *inter alia*, are ease of 'entry' and 'exit'. The ease is necessary not only for establishing, running and/or for closing down an enterprise, but also for quick engagement and disengagement of resources so that idleness or sub-optimal use of resources is minimised, if not eliminated altogether. Globalisation has provided wheels to financial resources, in particular to shop across geographies in search of lucre with lower risks and easier passage. It is

in this perspective that globally, managers of economies have been at pains to improving the ease of entry and exit along with laying down a pragmatic framework of ground rules and effective enforcement mechanisms to guide the behaviour of participants in the market.

The intended outcome of an efficient market is optimal wealth creation out of the resources employed, which goes to help the nations to eradicate economic deprivation and bring about prosperity. Empirical researches suggest that growth of Gross Domestic Product (GDP) of an economy, a barometer of wealth creation, is higher in countries with more efficient markets. And that most of the economically prosperous countries have liberalised and efficient markets.

Among the three factors of production the most important is capital. This is so because financial resources help an enterprise to buy/hire land and labour and conduct operations. Hence, the availability and cost of capital become an important factor for the commencement, growth and sustainability of businesses. In efficient and vibrant capital markets, the availability of financial resources is easier and higher, and the cost lower. The greater success of larger number of enterprises makes it expedient to build efficient financial markets. Architecting efficiencies and enhancement of its robustness require an appropriate legislative and regulatory framework and efficacious processes including ease of 'entry' and 'exit' of engagement of the financial capital.

Unfortunately, India did not have a clear, concise and composite exit policy until the Code was introduced in 2016. Exit policy has been one of the signature structural reforms of the NDA Government during its tenure of 2014-19. Bankruptcy academics firmly believe that a bankruptcy policy is an important element of any set of institutions designed to speed up economy recovery.<sup>1</sup> Modi Government's 1.0 inherited a declining economy. Its recovery in addition to paving the road for high growth trajectory was uppermost in the mind of the Political Executive.

It might be worthwhile to note here the findings of research of Mariana Succoro,<sup>2</sup> University of Colombia, Italy. She, *inter alia*, outlines that empirical evidence suggests:

- the investment share of GDP is higher in the countries characterised by highly efficient bankruptcy system; the more efficient the insolvency procedures in terms of time, cost and recovery rate is; and
- the investment share of gross domestic product is positively associated with the degree of sophistication of bankruptcy law.

In fact, a number of other empirical researches have also revealed that the growth of gross GDP is positively associated with an efficient bankruptcy system.

Needless to say that without adequate investments the wheels of an economy cannot run. The higher the rate of investment, greater is the growth of GDP. The author believes that there is a kind of 4:1 relationship between investment and GDP growth; an investment of 40 per cent of GDP can lead to 10 per cent GDP growth.

Amongst the important features of the Indian exit policy or the Code is the departure of the erstwhile and arrival of new management to husband the resources for taking the

<sup>1</sup> Jackson, Thomas H. and Skeel Jr, David A. (2013). Bankruptcy and Economic Recovery. University of Pennsylvania, Law School.

<sup>2</sup> Succoro, Mariana. Bankruptcy Systems and Economic Performance Across countries: Some Empirical Evidence. Department of Economics and Statistics, University of Colombia, Italy.

enterprise to the route of success. This change in ownership and control has shifted the balance of power from debtors to creditors. Until recently India was a debtor-friendly economy, where creditors were at the receiving end. The shift has brought a salutary effect on the psyche of borrowers whose behaviour seem to be changing fast. The transformation is plugging the erosion of wealth, helping better utilisation of resources and enhances wealth creation. For example in some of the well-known high profile cases, which have been resolved through National Company Law Tribunal (NCLT) under the Code like Bhushan Steel, Electrosteel, Binani Cement etc, the ownership and control have changed following the acquisition by the new entrepreneurs/companies. The resources employed are being better utilised to create greater wealth and all the stakeholders, in particular lenders, are better off. Lenders have received (100 per cent in case of Binani Cement) a significant part of outstanding dues, most of the jobs have been protected and plant and machinery etc. has been put to better use.

In cases the enterprises cannot be revived, the residual resources released out of winding up are put to more efficient use elsewhere. In comparison, in the current scheme of exit through Code, resolutions are faster, realisations greater and wealth protection is higher. In the previous regimes of Board for Industrial and Financial Reconstruction (BIFR), Sick Industrial Companies (Special Provisions) Act, 1985 (SICA), the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI), Corporate Debt Restructuring (CDR), Scheme for Sustainable Structuring of Stressed Assets (S4A), etc. the distressed enterprises perennially remained in the state of revival. 'There were sick enterprises owned by healthy entrepreneurs', goes an old market adage.

#### THE CODE AND ITS BEHAVIOURAL OUTCOMES

It might be useful to assess how the Code is influencing the behaviour of various participants in the chain of economic growth. According to the author, they can be grouped into six broad categories, viz., lenders, operational creditors, borrowers, entrepreneurs, workforce and the economy at large.

##### **Lenders**

Any lender, whether an individual or entity looks at the proposition of lending from the three cannons of investment namely safety, liquidity and return and creates an optimal mix tailored to its priorities. The lenders' decision is based on the assessment of risks, particularly with reference to the environment around the borrower. Actually, the risks are assessed in each of the three buckets and the interest rates are priced accordingly. The safety/return of monies lent alongwith interest is one of the most important criteria.

According to game theory, borrowers' best option is not to repay. India can provide some shining examples of borrowers' game theory. The creditors' option in such a scenario is not to lend. However, beyond game theory, the lenders are conscious that businesses and even individuals do fail. If there is a bankruptcy system, the lenders can broadly assess the cost, speed and the possible amount of recovery in the event of financial or even economic distress. This weaves the tapestry of the confidence of lenders beauty of, which is directly proportional to the level of efficiency of the system. Higher the confidence, greater is the willingness to lend.

The current environment of hesitation to lend validates the surmise. Further, the risk premium that lenders build into pricing comes down. Currently, risk premium in India is much higher compared to economies with the efficient bankruptcy system. Once the Code comes in full play the cost of lending should go down and the pace of lending will increase.

### **Operational Creditors**

During the currency of the business of an enterprise, the suppliers of goods and services extend credit. In case of financial distress, these creditors also suffer. The financial distress of enterprises receiving resources results in seriously impacting the financial health of the entities extending credit. In fact, there are umpteen number of cases, particularly amongst Small and Medium Enterprises (SMEs), which have folded up as a consequence of non-recovery of receivables. In the absence of the Code, these lenders had no worthwhile recourse and had to write off the outstanding in most cases.

The Code has provisions which enables SMEs to take an enterprise to NCLT for overdues of one lakh rupees and above. Anecdotal evidence suggests that recovery rate of outstandings of SMEs have significantly improved just by issue of notices.

Even though, operational creditors grudge in every resolution reached so far about the low payment, their sharing has to be viewed in the context of seniority of the obligations of the distressed entity. Further, in the past operational creditors could hardly recover any amount and it used to be a total write off. In any case, now there is clarity about the risk of default and its fallout which should encourage them to de-risk by improving the contractual processes etc. Reduction of the economic pain of operational creditors also helps the economy on an aggregate basis.

### **Borrowers**

The availability of credit encourages borrowing. The borrowings go to stimulate the economy through production and/or purchase of goods and services, property as also taking the risk for establishing businesses. However, distress adversely influences their future credit, reputation and self-image. Efficient bankruptcy system enables the borrowers to get out of the stranglehold with ease and certainty. The assessment of consequences enables the borrower to take risk mitigating measures. In fact, a borrower can escape being sunk in the whirlpool of debt and steer out reasonably well to a new start. 'A generous consumer bankruptcy system provides insurance against financial risks faced by household'.<sup>3</sup>

### **Entrepreneurs**

An effective bankruptcy system is an important pillar of the entrepreneurial economy and India is more of an entrepreneurial economy. The innovations flower in an environment of success, which enthralls the flow of capital for new initiatives, ventures and ideas with potential prospects of high returns. However, high returns also envisage high risk taking, which may lead to losses.

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<sup>3</sup> Grass, Tal, Klunder, Raymond, Liu, Feng, Notowidigdo, Mathew, J., Wang, Jialan (2018). The Economic consequences of Bankruptcy Reform. <https://economics.mit.edu/files/16255>

The flow of financial resources helps in unleashing animal spirits and growth of the economy. In the absence of an efficient bankruptcy system, failure of business sticks to the entrepreneur as a stigma and sometimes leads to social ostracisation, which often culminates into the death of entrepreneurship. An efficient bankruptcy system helps the entrepreneur in case of failure to go through the resolution or winding up process in a predetermined time frame and move on in life. More and more entrepreneurs are encouraged to set up enterprises with greater confidence in countries where failure is acceptable.

The Hon'ble Prime Minister in his earnestness to promote the faster economic development of India has given a call, 'Stand up India', with a view to promote the rise of millions of new enterprises. In a metamorphosed environment of the day where the sustainability of success cannot be guessed, fusion of multiple life-changing ideas are causing upheavals and speed of failure descends like a tornado, the efficiency of the bankruptcy system can provide a protective umbrella to entrepreneurship and prepare them to overcome the fear of failure.

### **Workforce**

Indian bankruptcy code provides for the revival of the enterprise as the primary option. Revival with the change of ownership and control, in particular helps in saving most of the jobs and in some cases all the jobs in the enterprises under stress; Bhushan Steel and Binani Cement are cases in example. Even in those cases where revival does not become possible, winding up goes through in a predetermined time frame and thus spares human resources along with residual financial and physical resources to be gainfully employed elsewhere. The entire process reduces the eventuality of the misery of the human resources engaged in failed enterprises. The lower the misery, the lesser is the impact on the economic health of employees and on aggregate demand of the economy. In fact, it reduces the dependence of unemployed on society and spares resources, which would have otherwise been distributed amongst them. Thus the efficiency of bankruptcy code helps faster recovery and continued growth.

### **Economy at large**

There are two obvious advantages of an efficient bankruptcy system to the economy of a country. First, it makes the financial market, in particular the debt market more efficient. Its scope enlarges to the trading of even junk bonds. The pricing becomes transparent and finer. Second, an efficient bankruptcy system reduces the friction in the movement of resources from suboptimal to higher and best use. This has been validated by Jackson and Skeel (2013).<sup>4</sup>

Apparently, in the Code, the possibility of the promoters and/or managers being dispossessed of assets and the right to manage has sent shivers down their spine. They were used to restructuring (CDR), strategic restructuring (S4A), ever greening, and haircuts. Now they are at the receiving end and have to accept the verdict of NCLT.

This exit policy is likely to eradicate crony capitalism, gold plating, under and over invoicing, serial defaulters and lead to lower leveraging, responsible behaviour and above all better allocation of capital.

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<sup>4</sup> Jackson, Thomas H. and Skeel, David A. Jr (2013), Bankruptcy and Economic Recovery. University of Pennsylvania Law School. *Faculty Scholarship Paper* p. 476.

## CONCLUSION

The Government and the legislators must be credited for bringing about a thoughtful legislation, which substantially closes the escape routes and also lays down a watertight timeframe for disposal of the cases that are referred to NCLT. The lending scene and the business environment is undergoing a traumatic transformation, which will result in better utilisation of resources and thereby higher economic growth.

The Code has been in full play only for about three years. Whereas, some positive impacts on the behaviour of various actors in the game are visible, adequacy of legal structure, the efficacy of court proceedings, the efficiency of enforcement mechanism and speed and effectiveness of the entire range of intermediary processes are required to be strengthened.

The economic agents in the Indian financial markets are trying to game the system at every stage. The aggregate game theory (of Indian Market) looks much deeper and wider. The impact thereof can be visualised in overshooting of time lines, increasing costs and lower recoveries. In quite a few cases frustrations are obvious and seepages of values visible. However, the Government and IBBI are at pains to take quick policy action to prevent the system from being gamed.

Bankruptcy system is known as the plumbing of economics. It enables the economy to flush out inefficient businesses and reallocate capital to more efficient uses. Unfortunately, in India, too many taps have been leaking for too long. Rent seekers have been thwarting the plumbing. Fortunately, the desired exercise is on and the Indian economy is poised to benefit from a modern, sophisticated and comprehensive exit policy. Once the robustness of the system is ensured, the confidence of domestic and global investors will grow further and the flow of funds will substantially increase benefitting the growth of the economy.

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## *The Code for Resolution*

Rajnish Kumar

**T**he Government of India introduced the Insolvency and Bankruptcy Code (Code) in May 2016 as a consolidated legal framework for time-bound resolution of insolvency and reorganisation of corporate persons, partnership firms and individual firms with the objectives of maximisation of value of assets, promoting entrepreneurship, availability of credit and balancing the interests of all stakeholders.

The Code is one of the most crucial reforms initiated in recent years that represents a paradigm shift for insolvency resolution in India. The Code is a game-changer in the sense that it motivates the management and promoters of firms to avoid default as their inefficiencies to operate above the optimum level may lead to shift in control and management of the firm away from existing promoters and managers. Since the enactment of Code, 2162 cases have been admitted into corporate insolvency resolution process (CIRP). A need has been felt to assess the effectiveness of the Code *vis-à-vis* other erstwhile legislations. According to data published by Insolvency and Bankruptcy Board of India (IBBI) up to June, 2019, 870 CIRP cases stand closed, out of which 174 were closed on appeal or review or settled, 101 withdrawn, 475 ended in liquidation and 120 concluded with an approved resolution plans. 1292 CIRP cases are still ongoing out of which more than 33 per cent have exceeded the 270 day timeline. This article, undertakes an impact assessment of effectiveness of the Code as a potent tool for resolution. For such an assessment, its performance *vis-à-vis* other available resolution options can be tested based on parameters such as transparency and protection of creditor rights; improved handling of conflict among stakeholders; changing borrower behaviour; achieving time bound resolution; preservation and maximisation of value of a corporate debtor (CD), recovery *vis-à-vis* other mechanism; drawing distinction between malfeasance and genuine business failure and predictable and clear allocation of losses.

### TRANSPARENCY AND PROTECTION OF CREDITOR RIGHTS

#### **Transparency**

CIRP under the Code is a non-adversarial resolution process where the defaulting CD cedes control to a court appointed Resolution Professional (RP). While the RP is responsible for managing the affairs of the firm as a going concern and preservation of its value, the committee of creditors (CoC) is responsible for supervising actions of RPs, take critical decisions in the interest of CD and its early resolution after assessing feasibility and viability of a resolution plan. While deliberations and decisions of CoC are made available to all members of CoC and to some extent other creditors, generally all major actions under the insolvency process such as

its initiation, appointment of RP, invitation for resolution plan through expression of interests and approval of resolution plans etc. are available in public domain.

Further proof of transparency under the Code is the day to day reporting of developments in most large insolvency cases in national dailies. Even a common man can access insolvency court orders online. The bidding for assets of a CD are through open market bidding and hence any eligible person can bid as resolution applicant. The number of bids received, and haircuts suffered by creditors under resolution are also available in public domain. Hence, on the test of transparency, the Code outclasses all other options for recovery.

### **Protection of Creditor's Rights**

Protection of creditor's rights is a fundamental requirement of credit markets in a market economy and as a rule, the security interest and other real creditor rights created prior to the insolvency proceedings must remain unaffected by the insolvency or liquidation proceedings. The Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDBFI) and the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 (SARFAESI) regimes protect the rights of only financial creditors (FCs). However, the rights of operational creditors (OCs) other than workmen and employees are generally ignored. The effectiveness of these regimes has been compromised due to multiple litigations by aggrieved creditors/CD and consequent delays.

Inter-Creditor Arrangement (ICA) is another resolution mechanism introduced recently to arrange out of court resolution of insolvency but includes only banks and financial institutions as participants while leaving out other FCs and OCs. It is still too early to judge its effectiveness in protection of creditor rights.

The Code, on the other hand, has brought about fundamental change in the priority ranking of creditors rights by placing sovereign debt and statutory dues at a rank lower than FCs. The Code has also expressly delineated the ranking of creditor rights under a liquidation waterfall (section 53). The Code was however silent on priority ranking of creditors for distribution under a resolution plan. The author is of the opinion that this was deliberately left open to allow normal market practises of distribution waterfall as well as to the commercial judgement of CoC so as to provide greater flexibility for bargaining an optimum sharing arrangement acceptable to majority of creditors and hence approval of plan. However, distribution of resolution amount under various resolution plans were challenged by OCs and unsecured FCs. The insolvency courts misinterpreted the silence of Code to infer that it is an issue left to them to decide by exercising judicial discretion. This resulted in a major interference in creditor rights when National Companies Law Appellate Tribunal (NCLAT) in its judgement in *Standard Chartered Bank v. Satish Kr. Gupta, IP Essar Steel*,<sup>1</sup> declared that the Code does not discriminate between secured and unsecured creditors in a resolution and also that OCs be treated equal to FCs in the interest of fair and equitable distribution.

This created a situation whereby denial of secured creditor's real rights in the insolvency process, the court used the very event of insolvency against which security interests were designed as a protection, as a ground for its destruction. Had this interpretation persisted, a major disruption was expected in credit markets. Through a quick amendment to the Code,

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<sup>1</sup> Company Appeal (AT) (Ins.) No. 242 of 2019

the Parliament re-established the sanctity of priority ranking of creditor rights by giving a clarification that waterfall provided in section 53 of the Code shall also apply to ranking of distribution under a resolution plan. While this is a welcome step towards protection of rights of secured creditors *vis-à-vis* unsecured creditor, it still leaves some scope of potential conflict among secured creditors as different types of security rights have to be treated differently. It is envisaged that this will put to rest most disputes arising from unsecured and operational creditors regarding distribution under resolution.

Hence, it may be concluded that while the Code has been very successful in bringing transparency to the resolution process, it achieved only partial success in securing creditor rights.

#### IMPROVED HANDLING OF CONFLICT BETWEEN STAKEHOLDERS

The Code has improved the scope of managing conflict between creditors and debtors and among the various class of creditors due to its very design. Due to the provision of a calm period (moratorium) immediately on commencement, the Code restrains any individual creditor from taking precipitative action. Through collective CoC mechanism for exploring resolution, the Code has assigned a major fiduciary duty to the CoC to cooperate and follow the prescribed resolution process for seeking a time bound resolution which is equitable and fair to all.

As per data published by IBBI, more than 50 per cent of the CIRP cases were initiated by OCs, around 40 per cent by FCs and only 10 per cent by CDs themselves. It has been observed that in most of the cases settled out of Court, before admission of a CIRP under the Code, an out of court settlement had been reached between the CDs and the OCs and FCs which led to the subsequent withdrawal of the cases.

Thus, it can be inferred that the Code has been effective in improving the bargaining power of both OCs and Fcs *vis-à-vis* the debtor and is becoming the preferred mode of resolution for them.

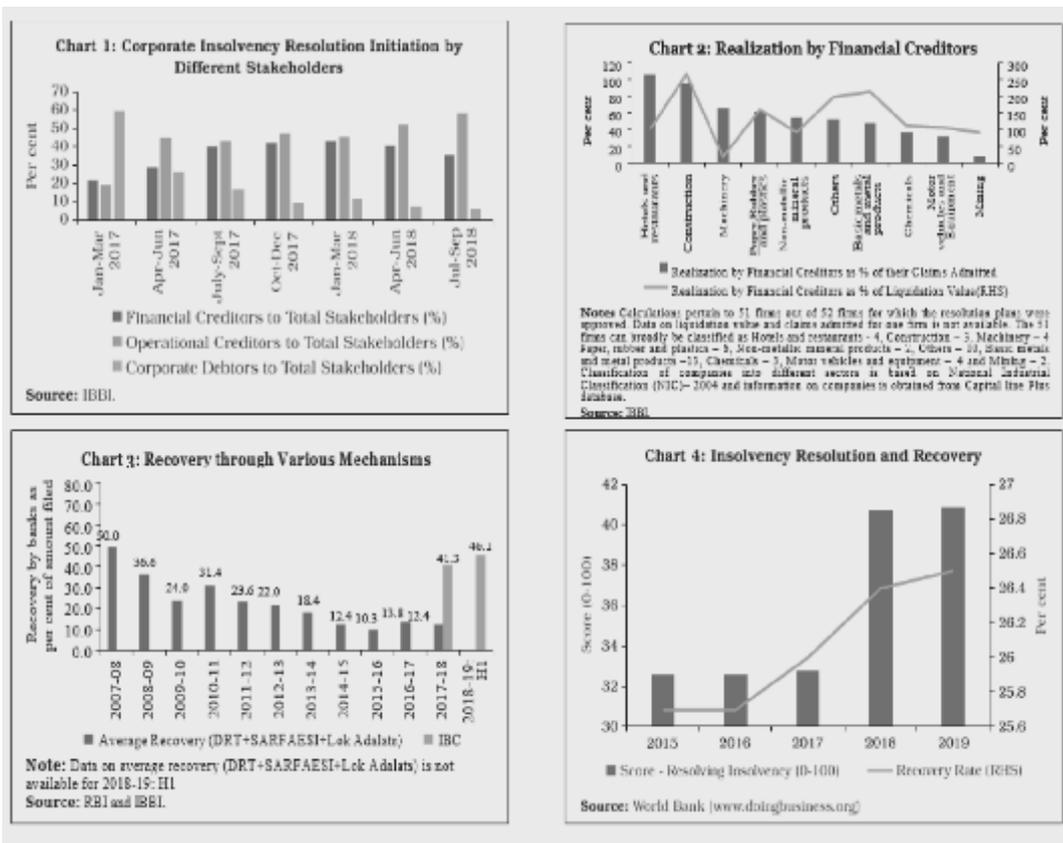
The author observes that while there have been petitions made by OCs before insolvency courts that their interests were overlooked in the resolution plans, the actual data indicates otherwise. As per IBBI data, the recovery rate of OCs in 97 resolved CIRP cases was approximately 42 per cent of their claims. Part of this may be because workmen are treated at par with secured FCs and employees next in distribution priority. However, going by the number of cases resolved amicably before admission of CIRP or cases withdrawn under section 12A of the Code post-admission on account of out of court resolution, it may reasonably be concluded that the Code has been much more effective than other regimes in resolution of conflicts between the stakeholders.

#### CHANGING THE BORROWER BEHAVIOUR

Recovery acts such as RDBFI, SARFAESI and the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) did not deliver encouraging results and had limited impact on borrower behaviour. Due to inordinate delays at Debt Recovery Tribunals (DRTs), the borrowers became rather comfortable in bank initiating DRT proceedings as they did not have to bother about bank loan till proceedings continued. SARFAESI was successful to some extent in influencing customer behaviour but proved effective only in smaller debts. Due to its

provisions of unlimited moratorium, Board for Financial Reconstruction (BIFR) under SICA was used as a legal shelter by defaulting borrowers to stall recovery proceedings while they continued to maintain control over assets. Hence, the best available options for banks before the advent of the Code were either to enter into a compromise with borrower or sell the asset to an Asset Reconstruction Company (ARC) at high discount on deferred payment terms. Even in compromise proposal, the borrowers had upper hand in negotiations due to time involved in recovery under other alternatives.

Post introduction of the Code, a perceptible change in borrower behaviour has been observed. Now many borrowers are approaching the banks with reasonable settlement offers. Some of them come forward due to fear of losing control of their business. This is also reflected in the better recovery rates of most of the banks. In the case of State Bank of India (SBI), the recovery during FY2019 was more than double the recovery during FY2018. The contribution of the Code in this recovery was 37 per cent and compromise settlements at approximately 16 per cent. Hence, based on the experience of better recovery during last two years, the Code has proved to be very effective in bringing about a positive change in borrower behaviour.



Source: RBI Report on Trends and Progress of Banking, 2017-18

## ACHIEVING TIME BOUND RESOLUTION

Under the Code, a defaulting firm has 180 days extendable to maximum 270 days from date of admission to resolve its default. Within such time, if the CoC does not agree to a resolution plan or no resolution plan is received, the company goes into compulsory liquidation. This deadline was meant to be sacrosanct given that it is specified in Code and time-bound resolution mentioned as one of the primary objective in the preamble. The Code also stipulated time-bound admission within 14 days from the filing of a CIRP application.

But this objective has often remained unmet. IBBI data shows that 445 pending cases have crossed the 270-day deadline. Of the 12 large accounts referred to insolvency by banks, under directions of the Reserve Bank of India in June 2017, resolutions have been approved in only six cases so far. These are high-value cases, adding up to an outstanding claim of Rs 3.45 lakh crore, and yet they have been dragging. As an example, Essar Steel Ltd. has now been in the insolvency process for close to 700 days and Bhushan Power & Steel Ltd. for over 650. Among the six cases that have been resolved, many have still exceeded the 270 day deadline. There have been numerous cases filed with NCLTs which are yet to be admitted. For example, SBI has 123 cases where CIRP has not been admitted even after three months after filing. Out of these 123 cases, 3 cases have been pending for admission for more than 18 months; and in 25 cases, anywhere between 12-18 months.

Many cases are pending for approval of resolution plans with NCLTs. SBI has around 38 cases where approval of resolution plans is pending for approval and another 55 cases where liquidation orders are awaited. One reason for this delay is that insolvency courts are entertaining multiple interim applications on petty issues and devoting multiple hearings to such matters. However, the insolvency courts appear to be adopting processes similar to Civil Procedure Code, 1908. The Code is designed on the principle that CIRP is not against the CD and there are no defendants or plaintiffs. It is a collective mechanism where financial creditors, through the institution of CoC apply their technical expertise to work out a viable and feasible resolution. CoC is also the forum for resolving inter-creditor conflicts. However, insolvency courts, by giving multiple hearings to arguments, seem to have failed to maintain the spirit of time bound and collective resolution inherent in the Code. Such delays result in many uncertainties and higher risk, specifically for buyers of stressed assets and lead to substantial erosion in the value of assets. During the insolvency, the industry itself can undergo a change and it has corresponding impact on valuation of the CD. The steel industry, for example, is not in as robust condition today as it was one year ago and such delays may lead to the bidder losing interest in resolution or having second thoughts about the value of its investment.

It needs to be appreciated that the Code is a new law and it takes time for jurisprudence to develop. The delay in some large cases can be attributed to various legal questions and principles being settled before courts and tribunals. However, the jurisprudence around Code has developed at a rather fast pace with Hon'ble Supreme Court providing very frequent and valuable clarifications on different aspects of Code. Accordingly, with availability of greater clarity on various provisions of Code, combined with proactive stance of Government and IBBI in quickly tackling issues arising out of ongoing cases, there is confidence among the stakeholders that the CIRP will become more efficient and will close much before the given timelines in future cases.

## PRESERVATION/MAXIMISATION OF VALUE

While the SICA was not able to achieve preservation of value during resolution, the RDDBFI and SARFAESI, by their very nature of being recovery acts, were expected to only maximise recovery and not value of the enterprise. The Code, on the other hand, was drafted with the objective of preservation or maximisation of value of CD during CIRP. In some large cases like Bhushan Steel, Essar Steel etc., there was an improvement in the turnover and EBITDA (Earnings before interest, tax, depreciation and amortisation) during CIRP leading to enhancement of value. But in most of the other cases, the value of assets has deteriorated on account of delays by the NCLTs in admission of CIRP, in approving resolution plans or even in ordering liquidations.

Approximately 80 per cent of CIRP cases have ended in liquidation and recovery through liquidation so far is insignificant with many liquidation cases still under process. With recent amendment to IBBI( Liquidation Process) Regulations, 2016 reducing process time to one year, it is hoped that the liquidation process will yield better value and in shorter time. Cost of CIRP or liquidation process are also considerably higher than other recovery mechanisms. However, if we compare it with erosion of values due to inordinate delays under RDDBFI and SARFAESI, and better recovery rates under the Code, the same can be justified. Overall, the impact of the Code in preservation and maximisation of value may be considered partially effective.

### **Recovery *vis-à-vis* other Mechanisms**

While recovery is not the objective of the Code, it remains one of the relevant factors for the FCs while deliberating a resolution plan. As may be seen from chart 3, the average recovery through the Code during 2017-18 was 41.3 per cent and HY 2018-19 was 46.1 per cent. This is much higher than the average recovery of 12.4 per cent achieved through the DRT process, SARFAESI and Lok Adalats during 2017-18. It is also apparent that recovery through other mechanisms is a case of diminishing returns with recoveries coming down every year. If the average time of resolution under the Code, which is around 300 days *vis-à-vis* 2-3 years under SARFAESI and 7-9 years under DRT process is taken into consideration, as has been mentioned in the section above, it is possible to conclude that the Code has been very effective in achieving better recoveries in shorter time compared to other options

## DRAWING A LINE BETWEEN MALFEASANCE AND GENUINE BUSINESS FAILURE

Under RDDBFI and SARFAESI, the focus is on recovery and there are no provisions for any enquiry into fraud/malfeasance by the promoters leading to insolvency. Hence, it is always difficult to decide whether insolvency was due to some genuine business failure or due to any fraudulent dealings/transactions. However, the Code provides (sections 43, 45, 49, 50) for examination of any such avoidance during the look back period of 1-2 years. Further fraudulent transaction or wrongful trading does not have any limitation of look back period. Thus, the Code provides a well-defined mechanism to bring such unscrupulous promoters who came under the purview of these provisions to enforce recovery for such amounts from their personal assets and also impose criminal penalties. This unique feature of the Code makes it a potent and an effective law. Hence, the Code has been effective in providing a mechanism

where the genuine defaulters get another chance and unscrupulous promoters are kept out of credit markets.

### **Predictable and clear allocation of losses**

A limited company is an organisation wherein the liability of the company is limited by its equity and losses higher than equity value are borne by the creditors. Hence, to maintain confidence in credit markets, any insolvency law must provide clear guidance for allocation of losses. In other recovery options under RDDBFI and SARFAESI, any liability over and above the liquidation value of assets is covered through enforcing collaterals securities and guarantees. However, since the entire value is captured by FCs, maximum losses are allocated to OCs and then FCs by way of haircuts. The Code has provided a clear and predictable waterfall arrangement for allocation of losses. As per the experience of law in two and half years, the Code has been very effective in allocation of losses as per liquidation waterfall. However, allocation of losses in resolution plans was challenged by OCs and NCLAT also upheld their stance. But the Government has put to rest all such doubts by providing clarification on intent of the Code through a third amendment to the Code. Hence, in providing predictable and clear allocation of losses, the Code has been highly effective.

### **CONCLUSION**

It can be concluded that the Code has delivered a potent tool in the hands of creditors for quick and flexible resolution and despite several issues faced in its implementation due to novelty of the law, infrastructural weakness, underdeveloped ecosystem and slowdown in the economy, the Code has performed beyond expectations of the stakeholders. Being a new and dynamic law, it will continue to evolve and litigated, but has proved its worth as an effective mechanism for resolution of insolvent businesses.

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## Observing and Measuring Behavioural Change

Cyril Shroff and Dhananjay Kumar<sup>1</sup>

The Insolvency and Bankruptcy Code, 2016 (Code) was introduced to address chronic delays in resolving insolvent companies in an economy grappling with non-performing assets of the banks. In the last two years and a half, the Code and the related jurisprudence has constantly evolved and treaded uncharted territory of '*resolution*' of Indian companies. As per the recent statistics released by the Insolvency and Bankruptcy Board of India (IBBI), by June 2019, corporate insolvency resolution process (CIRP) has been initiated in relation to 2162 corporate debtors (CDs), 174 have been closed by appeal or reviewed or settled, 475 have ended in liquidation and 120 have ended in approval of a resolution plan.<sup>2</sup>

One of the most significant changes observed on implementation of the Code is the behavioural change in the stakeholders involved in the resolution process. As per the statistics presented by the Finance Minister during the Monsoon parliamentary session, approximately 6,079 cases were disposed of prior to admission, which meant an amount of approximately Rs. 2,84,000 crore being redressed.<sup>3</sup> These figures reflect that promoters and management are increasingly being wary of financial indiscipline. The change in behaviour of stakeholders outside the process prescribed under the Code but on account of the promulgation of the Code is outside the scope of this article.

One of the objectives of the Code is to '*balance the interests of all the stakeholders.*' Further, a resolution plan cannot pass the muster of the Code without dealing with the interest of all the stakeholders.<sup>4</sup> As pointed out by the Chairperson of IBBI, Dr. M. S. Sahoo '*while in the works for many years, the insolvency reforms suddenly took shape with the enactment of the Insolvency and Bankruptcy Code, 2016 on 28<sup>th</sup> May, 2016. In no time, it became a reform by the stakeholders, of the stakeholders and for the stakeholders.*' (emphasis supplied).<sup>5</sup>

Further, the Legislative Guide on Insolvency Law of the United Nations Commission on International Trade Law (UNCITRAL) provides that:

'...when a debtor is unable to pay its debts and other liabilities as they become due, most legal systems provide a legal mechanism to address the collective satisfaction of the outstanding claims from assets (whether tangible or intangible) of the debtor. A range of interests needs to be accommodated by that legal mechanism....Generally, the mechanism must strike a balance not only between the different interests of these stakeholders, but also between these interests and the relevant social, political and

<sup>1</sup>The authors would like to thank their colleagues Ms. Surbhi Pareek and Ms. Tweisha Mishra for their assistance in writing this article.

<sup>2</sup>Quarterly Newsletter of IBBI, April-June (Vol. 11), 2019.

<sup>3</sup>Ms. Nirmala Sitharaman, Rajya Sabha Debates dated July 27, 2019 (RSS-RPM/1A/11.00).

<sup>4</sup>Regulation 38(1A), IBBI (Insolvency Resolution Process of Corporate Persons) Regulations, 2016 and section 30 of the Code

<sup>5</sup>Sahoo, M.S. (2019). A Journey of Endless of Hope, 2<sup>nd</sup> Annual GRR Live, Singapore.

other policy considerations that have an impact on the economic and legal goals of insolvency proceedings.<sup>6</sup>

In light of the above, it becomes essential to analyse the behavioural changes of the various stakeholders involved in the CIRP as such behaviour may significantly impact the resolution of a CD.<sup>7</sup> It is not out of place to mention that, till June, 2019, realisation by financial creditors (FCs) in comparison to liquidation value in respect of the CD was 188 per cent, while realisation by them in comparison to their claims was 43 per cent, an improvement over the previous regime which yielded a recovery of 25 per cent for creditors and entailed a cost of 9 per cent.<sup>8</sup> These numbers would prompt the FCs to take proactive measures to resolve a stressed account. During or in the vicinity of the period of resolution process also, the stakeholders tend to behave in a certain way and the Code is evolving to provide for ways to dealing with the stakeholders during the CIRP as well.

This article deals with behavioural changes that have been witnessed and that may be required in relation to the different stakeholders post the introduction of the Code.

#### INFLUENTIAL STAKEHOLDERS AND BEHAVIOURAL CHANGES DURING INSOLVENCY

Studies reveal that for an organisation in crisis, it becomes essential to understand, amongst others, what kinds of stakeholders are the most influential in the organisational survival.<sup>9</sup> One model identifies the stakeholders in two groups, i.e. (a) primary stakeholder without whose continuing participation a corporation cannot survive as a going concern; and (b) secondary stakeholders, who influence or are influenced by the firm, but who are not essential to its survival.<sup>10</sup> Another model suggests that the classes of stakeholders are identified by their possession of power, legitimacy and urgency.<sup>11</sup> It is well accepted that enhanced participation of different actors, unobtrusive leadership, anticipation, adequate information sharing and open dialogue about an organisation goals may avert a crisis.<sup>12</sup> While the said theory was primarily based on assessment of an organisation on the verge of crisis, it may very well be made applicable in case of an ongoing CIRP wherein an attempt is made to revive the operations of a CD on a going concern basis.

Importing this background, from an insolvency resolution perspective under the Code, the following objectives become relevant: (a) to identify the stakeholders who are vital for success of the CIRP; (b) to assess the behavioural changes in the approach of the different stakeholders; and (c) to reconcile the conflicting interests of various stakeholders in order to accomplish the objectives of the Code. Currently, these variants are being regularly monitored on a case-to-case basis by the Government and the regulator (IBBI) and adequate legislative and policy changes are being introduced to address the related issues. It would also be relevant for

<sup>6</sup> UNCITRAL Legislative Guide on Insolvency Law (August 14, 2019),

<sup>7</sup> This article looks at 'stakeholders' in the same way as in the IBBI (Liquidation Process) Regulations, 2016, i.e. persons who are entitled to receive dividends from the CD.

<sup>8</sup> *Supra* note 2.

<sup>9</sup> Pajunen, Kalle (2006). Stakeholder Influences in Organizational Survival. *Journal of Management Studies*, Wiley Blackwell, Vol. 43(6), pp. 1261-1288.

<sup>10</sup> Clarkson, M.B.E. (1995). A Stakeholder framework for analyzing and evaluating corporate social performance. *Academy of Management Review*, 20, pp. 92-117.

<sup>11</sup> Mitchell, R.K. Agle, B.R. and Wood, D.J. (1997). Toward a theory of stakeholder identification and salience: defining the principle of who and what really counts. *Academy of Management Review*, 22, pp. 853-86.

<sup>12</sup> Rosenblatt, Z. Rogers, K.S. and Nord, W.R. (1993). Toward a political framework for flexible management of decline. *Organization Science*, 4, pp. 76-91.

the insolvency professionals, who are entrusted with running the business of the CD on a going concern basis during the CIRP, to understand and respond to the behavioural changes of various stakeholders during the CIRP period. Further, it would also become relevant for the committee of creditors (CoC) to understand the behavioural pattern of different stakeholders, given that CoC is entrusted with the task of overseeing the insolvency resolution process and is also expected to balance the interest of all the stakeholders while exercising its commercial wisdom for maximisation of value of the CD (including for negotiation and approval of the resolution plan). The study would also be relevant for the resolution applicants for the purpose of proposing a holistic and compliant plan in terms of the Code.

Set-out below is a brief assessment of the behavioural pattern of certain stakeholder who may impact the outcome of the CIRP in relation to a CD.

### PROMOTERS

Under the provisions of the Code, upon commencement of the CIRP, the powers of board of directors of the CD are suspended and are exercised by the insolvency professional (IP) (i.e. the interim resolution professional or the resolution professional, as the case may be). The personnel of the CD, its promoters or any other person associated with the management of the CD are mandatorily required to extend all assistance and cooperation to the insolvency professional as may be required by him in managing the affairs of the CD.<sup>13</sup> However, there have been multiple instances wherein the promoters or the management have refused to cooperate with the IP or have provided asymmetrical information. This behaviour may be a consequential result of the fear of loss of control of the company, stigma, unwelcome vigilance from an outsider, etc. As a result, various IPs sought relief from the National Company Law Tribunal (Adjudicating Authority). The Adjudicating Authorities (AA) have taken stern measures and issued requisite directions to the management and have also imposed costs in certain cases.<sup>14</sup>

Another aspect pertains to the attempts made by the promoters to regain the control of the CD. In stark departure from the erstwhile insolvency and restructuring regime in India, which was effectively led by promoters, the resolution process under the Code requires recalcitrant promoters to clear the eligibility test in order to regain control of the CD. The Supreme Court (SC) in the *Swiss Ribbons*<sup>15</sup> matter, while upholding the constitutional validity of the Code observed as follows:

‘It can thus be seen that the primary focus of the legislation is to ensure revival and continuation of the corporate debtor by protecting the corporate debtor from its own management and from a corporate death by liquidation. The Code is thus a beneficial legislation which puts the corporate debtor back on its feet, not being a mere recovery legislation for creditors. The interests of the corporate debtor have, therefore, been bifurcated and separated from that of its promoters / those who are in management.’ (emphasis supplied)

The Hon'ble President of India in his address to the Joint Session of Parliament on June 20, 2019

<sup>13</sup> Section 19 of the Code. See also *M/s Educomp Infrastructure & School Management Limited v. Vinod Kumar Dandona, & Ors* (CA No.335/2018 in CP (IB) No.10/Chd/Hry/2018).

<sup>14</sup> *Amandeep Singh, Resolution Professional v. Mandeep Singla & Ors.* (CP (IB) No.60/Chd/PB/2017); See also *Anil Kumar vs. Rolex Cycles Private Limited & Ors.* (C.A. Nos. 122-124/2017 in CP (IB) No. 37/CHD/PB/2017).

<sup>15</sup> *Swiss Ribbons v. Union of India*, 2019 SCC Online SC 73.

stated as follows:

'Insolvency and Bankruptcy Code is among the biggest and most impactful economic reforms undertaken in the country. With the coming into force of this Code, banks and other financial institutions have been able to settle directly or indirectly an amount of more than Rs. 3 lakh 50 thousand crore. This Code has also curbed the tendency of wilfully defaulting on loans taken from banks and other financial institutions.' (emphasis supplied)

Repeated attempts by the promoters to regain control of the CDs have been subjected to intensive judicial scrutiny.<sup>16</sup> In other words, the *defaulter's paradise is lost*.<sup>17</sup> On multiple occasions measures have also been taken by the promoters to settle the debt rather than lose control of the business. As on June, 2019, there were 101 withdrawals of the CIRP applications (post introduction of section 12A in June, 2018), of which 76 were owing to settlement with the creditors.

Further, while the SC has allowed the directors to have access to the resolution plans submitted in relation to a CD,<sup>18</sup> the fallout, if any, on account of factors like conflict of interest are yet to be assessed. Having said that, while there is apparent conflict between the promoters / management and the IP (who takes charge of the CD as an outsider professional with negligible knowledge of the operations of the company), it is crucial that the suspended management of the CD extends adequate co-operation and allows smooth flow of information sharing with the IPs and FCs so as to accomplish the objective of resolution of the CD.

#### FINANCIAL CREDITORS

The Code envisages '*collective decision making*' by bringing all the FCs on one table to make a decision for the resolution of the CD.<sup>19</sup> As was observed in the Report submitted by the Bankruptcy Law Reforms Committee:

'The Committee believes that there is only one correct forum for evaluating such possibilities, and making a decision: a creditors committee, where all financial creditors have votes in proportion to the magnitude of debt that they hold. In the past, laws in India have brought arms of the government (legislature, executive or judiciary) into this question. This has been strictly avoided by the Committee. The appropriate disposition of a defaulting firm is a business decision, and only the creditors should make it.'

Under the Code, while an IP runs the resolution process, the CoC has been entrusted with substantial decision making powers. The CoC is also entrusted with the task of protecting the interest of all the stakeholders while evaluating the feasibility and viability of a resolution plan. While the commercial wisdom of the CoC may not be interfered (unless contrary to the provisions of the Code)<sup>20</sup> the degree of accountability of the CoC has only increased. The National Company Law Appellate Tribunal (NCLAT) in *Essar Steel*<sup>21</sup> (hereinafter 'Essar Steel') held that the CoC must approve that resolution plan (which is a compliant plan under the

<sup>16</sup> *ArcelorMittal India Private Limited v. Satish Kumar Gupta & Ors.* (2019) 2 SCC 1; See also *Standard Chartered Bank v. Satish Kumar Gupta & Ors.* (Company Appeal (AT) (Ins.) No. 242 of 2019).

<sup>17</sup> *Vijay Kumar Jain v. Standard Chartered Bank*, 2018 SCC Online SC 3152.

<sup>18</sup> Id.

<sup>19</sup> Bankruptcy Law Reforms Committee (2015). The report of the Bankruptcy Law Reforms Committee, Volume I: Rationale and Design. Tech. rep. Department of Economic Affairs, Ministry of Finance, Government of India, Nov. 2015.

<sup>20</sup> *K. Sashidhar v. Indian Overseas Bank & Ors.*, 2019 SCC Online SC 257.

<sup>21</sup> *Standard Chartered Bank v. Satish Kumar Gupta & Ors.* (Company Appeal (AT) (Ins.) No. 242 of 2019).

provisions of the Code) which maximises the value of the assets of the CD and balance all the stakeholders, irrespective of realisation for creditors under the plan. This has led to a significant behavioural change in the manner CoC conducts itself before and during the resolution process. During the resolution process also, the FCs engage professionals (such as evaluation agent, legal advisors, etc.) to assist them in handling the resolution process. In terms of filings also, while there was initial reluctance from the FCs, as on June, 2019, 40 per cent of the CIRPs were initiated pursuant to the FCs applications.

It would also be important to ascertain *inter se* relationship between the members of the CoC, who are accountable to take care of interests of all the stakeholders as a group, however, at the same time have vested interests in terms of their respective claim amount as a FC. The English law principles limit the power of majorities to bind minorities, unless it is exercised in good faith and in the best interests of the group as a whole.<sup>22</sup> In India, this issue remains untested. As regards the distribution of the monies proposed by a resolution applicant, the NCLAT in *Essar Steel* held that the FCs being claimants at par with other claimants like other FCs and the operational creditors (OCs) having conflict of interest, are not empowered to decide the manner of distribution between the creditors. However, the recently notified Insolvency and Bankruptcy (Amendment) Act, 2019 (2019 Amendment Act) allows the CoC to consider the manner of distribution proposed, which may take into account the order of priority amongst creditors in case of liquidation, including the priority and value of the security interest of a secured creditor. Both the judgments of the NCLAT and the constitutionality of the 2019 Amendment Act are at present pending adjudication of the SC.

In few cases, FCs have also raced to collect their dues subsequent to the order of moratorium, through different modes such as encashment of cheques, debit from the account of the CD, etc. However, courts have denied such actions and held that any such action would be subjected to moratorium under the provisions of the Code.<sup>23</sup>

Another aspect pertains to the increasing inclination of hedge funds and stressed asset funds in investing in stressed assets undergoing insolvency in India. The interests and objectives of banks and such funds may be at different ends of the spectrum during the CIRP.

Outside the Code, the Reserve Bank of India (RBI) has also played a pivotal role in developing an environment of financial discipline in dealing with stressed assets. Amongst others, the circular dated June 7, 2019<sup>24</sup> encourages restructuring and allows lenders to come up with a resolution strategy during the review period. While there is no long stop date by which the resolution plan should be implemented, additional provisioning norms would presumably create a deterrent effect for early detection and resolution of a stressed account.

#### OPERATIONAL CREDITORS

Unlike the FCs, OCs have limited representation during the insolvency resolution process under the provisions of the Code. Despite this, statistics show that as on June, 2019, 50 per cent of the CIRPs were initiated pursuant to application by OCs, followed by 40 per cent by FCs and

<sup>22</sup> *Redwood Master Fund v. TBD Bank Europe Ltd*, [2002] EWHC 2703 (Ch.) and *Assénagon Asset Management SA v. Irish Bank Resolution Corpn Ltd*, [2012] EWHC 2090 (Ch.). 3.

<sup>23</sup> *State Bank of India v. Mr. V. Ramakrishnan* (Company Appeal (AT) (Insolvency) No. 213 of 2017); See also *State Bank of India v. Debashish Nanda*, (Company Appeal (AT) (Insolvency) No. 49 of 2018) and *ICICI Bank Limited v. Interim Resolution Professional for Ruchi Soya Limited* (Company Appeal (AT) (Insolvency) No. 390 of 2018).

<sup>24</sup> Prudential Framework for Resolution of Stressed Assets, RBI Circular No: RBI/2018-19/203 DBR.No.BP.BC.45/21.04.048/2018-19.

remaining 10 per cent by CDs.<sup>25</sup>

Research suggests that an organisation in crisis must ensure the support of critical stakeholders.<sup>26</sup> Continued cooperation of OCs is essential for running the operations of the CD on a going concern basis during the CIRP period. However, there have been instances where the OCs have threatened or opted for termination of the contracts during CIRP, since section 14 of the Code does not prohibit termination of contracts. For instance, in *Chirag Associates Pvt. Ltd. v. Aircel Limited*<sup>27</sup> the CD had not paid rent to the owners of the leased premises. The resolution professional was directed to vacate the premises (as they were not in business use) and the payment of electricity dues and the rent incurred during the CIRP period were to be considered as CIRP costs. Further, in *ABG Shipyard Ltd. v. ICICI Bank Ltd. & Ors.*<sup>28</sup> the workmen and employee of the CD filed an application before the AA for payment of their outstanding salaries, wages and other dues. The AA directed the resolution professional to apportion a portion of the amount received by the company from Coast Guard through Comptroller of Defence towards the dues of workmen and employee.

In relation to the dues of the OCs as on the insolvency commencement date, the Code requires a resolution applicant to provide for the payment of debts of OCs in such manner as may be specified by IBBI which shall not be less than (i) the amount to be paid to such creditors in the event of a liquidation of the CD under section 53; or (ii) the amount that would have been paid to such creditors, if the amount to be distributed under the resolution plan had been distributed in accordance with the order of priority in sub-section (1) of section 53, whichever is higher. In any event, most costs incurred for running the business of the CD as a going concern would be classified as CIRP costs.

Although the SC has held that fair and equitable treatment should be accorded to the OCs<sup>29</sup> and the same has been re-emphasised *vide* the 2019 Amendment Act, the jurisprudence in this regard is still evolving. The reluctance of the resolution applicants in proposing an amount above liquidation value to the OCs who are not involved in the negotiation process has resulted in multiple litigations before different forums. This has also caused the OCs to have a relook at their contractual arrangements with the CDs to build-in adequate safeguards to seek advance payments, adequate security, etc. Further, the fact that there is a threat to the solvency of small and medium enterprises who suffer major haircuts or receive negligible payments towards their operational debt from larger enterprises they support cannot be disregarded.

Various statutory authorities have raised challenges to the classification of their debt as operational debt, extinguishment of their dues under the resolution plan, issues in relation to attachment of property of a CD during the CIRP period, etc. For instance, the SC in the matter of *Monnet Ispat*<sup>30</sup> upheld the decision of the Delhi High Court which ruled that the moratorium under the provisions of the Code will also apply to appeals being made by the Income Tax Department against the orders of Income Tax Appellate Tribunal, in respect of tax liability of a debtor under CIRP. The Department of Telecommunication has recently challenged the

<sup>25</sup> *Supra* note 2.

<sup>26</sup> Arogyaswamy, K., Barker III, V. L. and Yasai-Ardekani, (1995). Firm turnaround process: an integrative two-stage model. *Journal of Management Studies*, 32, pp. 493-525.

<sup>27</sup> MA 492/2018, MA 987/2018 & MA 945/2018 in CP (IB)-298/(MB)/2018.

<sup>28</sup> IA No. 78 of 2018 in CP(IB) No. 53/19/NCLT/AHM/2017).

<sup>29</sup> *Swiss Ribbons*, *supra* note 15.

<sup>30</sup> *Pr. Commissioner of Income Tax v. Monnet Ispat And Energy Ltd.*, Petition No. (C) No(s). 6483/20.

transfer of spectrum and extinguishment of their claims as OCs.<sup>31</sup> To address these issues, section 31 of the Code has been amended *vide* the 2019 Amendment Act which makes the resolution plan binding on, amongst others, the Central Government, any State Government or any local authority to whom a debt in respect of the payment of dues arising under any law for the time being in force, such as authorities to whom statutory dues are owed.

#### RESOLUTION APPLICANT

Whilst a resolution applicant has no vested right in its resolution plan until the same is approved by the AA (or the appellate authorities),<sup>32</sup> it cannot be disregarded that a resolution applicant who can continue to run the CD as a going concern would be preferred for ensuring resolution and maximisation of value of a CD.

While the 270 day statutory timeline for resolution invited interest from various strategic investors globally, there are cases which are pending at various levels of judiciary and have not been resolved for more than 2 years leading to concerns on deterioration in value of the CD and growing concern amongst the investors on account of delays. Responding to this situation, the Government has appointed 29 new members (judicial and technical) to clear the backlog. We also need to use effective case management tools to boost investor confidence.

There have been instances where preferred resolution applicants have raised diligence issues, delayed payments, or just walked away from implementation of a resolution plan. However, timely intervention by regulators by amending the applicable regulations has ensured that the resolution applicants put some skin in the game upon being declared as a successful resolution applicant.<sup>33</sup> Moreover, the removal of the requirement to disclose liquidation value as a part of the information memorandum has put the onus on the resolution applicants to justify the feasibility of their financial proposal as liquidation value can no longer be a benchmark for the resolution amount.

There is a growing awareness amongst the resolution applicants that the Code does not operate in isolation and is not a single window clearance and accordingly, taking control of the companies on a 'clean-slate' basis may not be possible. Recently, the AAs have also not allowed various reliefs and waivers sought by the resolution applicants and directions have been issued to seek reliefs from the relevant authorities in view of the approved resolution plan.<sup>34</sup> These aspects will eventually vary the price discovery and the financial proposal put forth by the resolution applicants.

Recently, NCLAT has also held that the AA has the power to order IBBI/ Ministry of Corporate Affairs to initiate criminal investigations against resolution applicants under section 74(3) of the Code, provided they are given a proper hearing.<sup>35</sup> This would presumably impact the behaviour of non-serious resolution applicants who would not attempt to be a part of the process without adequate financial strength.

<sup>31</sup> Telecom Department rejects Aircel's resolution proposal. The Economic Times, (July 1, 2019)

<sup>32</sup> *Essar Steel*, supra note 10.

<sup>33</sup> Regulation 36B(4A) of Insolvency and Bankruptcy Board of India (Insolvency Resolution Process of Corporate Persons) Regulations, 2016 requires a successful resolution applicant to provide performance security, which shall stand forfeited if the resolution applicant fails to implement or contributes to the failure of implementation of that plan in accordance with the terms of the plan and its implementation schedule.

<sup>34</sup> *Resolution Professional and AION Investment Private Limited and JSW Limited* M.A. 346/2018 in CP (IB) 1139 (MB)/2017 (Order dated July 24, 2019); See also, *Resolution Professional of Essar Steel India Limited* IA No. 431 of 2018 in CP (IB) 39 and 40 of 2017 (Order dated March 8, 2019).

<sup>35</sup> *Committee of Creditors of Amtek Auto Ltd. through Corporation Bank v. Mr. Dinkar T. Venkatasubramanian & Ors.* (Company Appeal (AT) (Insolvency) No. 219 of 2019).

## INSOLVENCY PROFESSIONALS

IPs acting as interim resolution professional or resolution professional, as the case may be, are primary stakeholders. However, their role in the CIRP is central.

An IP, who exercises the powers of the board of directors of the CD during the CIRP period is also required to maintain complete independence while conducting the CIRP. The IPs are also required to operate the CD as a going concern during the entire CIRP period and in doing so, they deal with all the stakeholders (detailed above) during the entire CIRP period till the time the resolution plan is implemented. The SC and the Tribunals have time and again emphasised that the role of an IP is to run the process as a facilitator. For instance, for claim verification of the creditors of a CD, the role of an IP clarified by the SC in *Swiss Ribbons*<sup>36</sup> wherein it was held that an IP is merely required to act as a facilitator for conducting the CIRP and does not have any adjudicatory powers. Similarly, for the purpose of evaluating the resolution plans, the SC in *Essar Steel*<sup>37</sup> held that the role of an IP is limited to providing a *prima facie* opinion regarding the compliance of the resolution plans with the applicable law (including with the section 29A of the Code) and to place the compliant plans before the CoC, who may or may not approve it.

In view of the above, the behavioural change in IPs can be construed to be shifting towards more of a facilitator for the resolution of CDs.

## CONCLUSION

Behavioural responses of the stakeholders have so far worked in tandem with one of the core objects of the Code, i.e. to balance the interest of all the stakeholders. Though the implementation of the Code is still at a nascent stage and effectively evolving on a regular basis, it may be stated for certain that the Code has set in motion an environment of better financial discipline and has shaped the roles that the stakeholders play in revival of a CD. The Code has also changed the behaviour of the key stakeholders, i.e. the creditors, with FCs using it as a last resort and OCs using it as a weapon of choice to recover their dues.

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<sup>36</sup> *Swiss Ribbons*, *supra* note 15.

<sup>37</sup> *Essar Steel*, *supra* note 21.

## *The Code and its Behavioural Impact*

Somasekhar Sundaresan

**W**hen one considers the introduction and evolution of the Insolvency and Bankruptcy Code, 2016 (Code) three years after its introduction, one cannot but notice that although the legislation is meant to be purely one that governs process and procedure in the journey of an insolvent company from potentially terminal sickness to death, like with most matters mortal, it indeed has a fallout for corporate conduct during healthy life.

The Code is not meant to be a legislation that nudges conduct of corporates towards good conduct, away from misconduct. It is meant to be a procedure-based legislation that applies uniformly to all corporates. However, that it has come to affect corporate conduct cannot be missed. This article is a short contemplation on the effect of the Code as an economics legislation, taking just five facets into account.

### EVIDENCE OF PRIOR DISPUTE

In its journey, the first economic conduct that got nudged, even if unintentionally, was that the corporate debtor (CD) must have a proper record of its disputes with operational creditors (OCs). While prior disputes with financial creditors (FCs) is no bar to the initiation of insolvency proceedings (section 7 of the Code), the Adjudicating Authority (AA) overseeing insolvency proceedings is not meant to bless the commencement of insolvency proceedings in the case of an OC (section 9 of the Code). Initially the judicial declaration of the law on the subject was that pre-existing dispute over the amount claimed to be due between the CD and the OC could only be evidenced by litigation pending in a court of law. Eventually, the law got declared, and indeed amended to make it clearer, that pre-existence of a dispute may be borne out from the material on record, and not necessarily only by initiation of actual litigation filed and pending in courts.

Since the existence of a dispute would necessarily be a mixed question of fact and law, the effect on behavioural conduct of companies is that CDs necessarily need to maintain proper record of disputes and differences with OCs. If a dispute is worthy of litigation, a company would actually litigate. If there indeed exists a dispute, but the circumstances do not warrant the filing of actual litigation, adequate evidence of having assessed why pursuit of litigation is not advised despite the existence of a dispute, would now be maintained.

### NOT A COERCIVE TOOL

A somewhat connected behavioural change is the gaming by parties who have rights and obligations under the Code. An OC of a financial loan-free company would stand on a footing totally different from an OC of a company that routinely takes financial assistance. It is foolhardy for an OC to invoke the Code with a view to actually get a resolution of a CD. After the insolvency process is initiated, the voice of the OC may be totally drowned out by the size of the FCs. From being a coercive wielder of a weapon with a finger on the trigger of the insolvency process, the OC would become a supplicant before the committee of creditors (CoC), with hardly any chance of a realistic recovery.

Therefore, the Code as a coercive tool of recovery would have limited utility for an OC-only CDs who would fear the trigger of the resolution process (with the resultant moratorium leading to the CD being treated as a *pariah* in the business community) would feel the fear of the Code to pay up. A company that is actually insolvent and may in fact be contemplating initiating the insolvency process would not perceive the Code as a coercive threat to pay up. The Code is not even meant to be a coercive recovery tool, but does enable an opportunity for coercive recovery to this limited extent. In the initial months of the Code, the legislation was a far stronger tool of coercive recovery for OCs than it is now.

On the contrary, once the resolution process is initiated, the scope for the OC to be relegated to the unimportant is quite wide. Likewise, the perception that OCs get a raw deal, and that the AA must have regard to fairness to the OC is already subject matter of intense litigation, winding its way in the last stages of a brutal fight now pending adjudication in the Supreme Court (SC). The National Company Law Appellate Tribunal (NCLAT) took the view that OCs got a raw deal and provided its own methodology of computing the size of the hair-cut to be administered to OCs and the FCs.

The conflicts between these two classes of creditors are unlikely to settle down and much may come to depend on a case-by-case assessment of fairness in a resolution plan. Yet, it must be remembered that getting a fraction in a resolution would still give an OC more than what liquidation upon failure of resolution may yield. Likewise, unless a company is truly insolvent, the Code is not meant to be used at all. It would be the usage of a sledgehammer to swat a mosquito. Indeed, this was the position under the old company law where anyone who would seek recovery would serve a winding up notice, but the Code has evolved into a really serious process for real resolution leading to liquidation, and therefore, creditor behaviour will indeed be impacted.

### DISCONNECTING EXPENSIVE CONNECTIONS

The introduction of section 29A to disqualify any and every person 'connected' to an insolvent from resolving any other insolvent came up for close constitutional scrutiny. The SC indeed upheld the constitutional validity of this provision, ruling that the provision, although crude, would not be rendered unconstitutional. Crude, it indeed is – what with a blanket ban across the board for anyone who is a related party to any party related to an insolvent. Many types of disqualifications in the provision are objectively clear and justifiable but indeed the restriction on every related party is dangerously expansive and wide.

There has indeed been a behavioural impact due to this provision. Connections are fast being shed. And where connections are not easy to shed, debts are unexpectedly being repaid. Either the connection with the insolvent is being severed, or the insolvency is being cured. This provision can be regarded as an expected source of a bonanza for some of the lenders who had taken into account the connections with powerful business houses, which for purposes of credit appraisal were regarded as providing comfort and standing behind the credit of the CD. Faced with a total disqualification from authoring any resolution plan for any other company, this provision has forced many a powerful hand to pay up dues of companies they are connected to, even if for the record, they protested the inference of the connection.

The urge to disconnect has led to provisions in other legislation to come into sharp focus. Securities regulations stipulate in detail how someone who has been historically regarded as a promoter may cease to be a promoter. Compliance requirements for reclassification of a person who was a promoter but whose shareholding has come down to below 10 per cent are stipulated. The impact of the Code has sharpened the focus on enforcement of regulations governing listing obligations and disclosure requirements. In fact, an externality of this behavioural change has led to stock exchanges get so conservative that even a promoter whose holding has been totally wiped out is pushed to go through the process for reclassification.

#### INTERSECTION BETWEEN CHOICE AND MANDATE

An interesting economic impact of the Code is the manner in which a completely controversial policy choice was made about the usage of the legislation by those outside the administration of the legislation. The framework for 'prompt corrective action' formulated by the Reserve Bank of India led to the choice provided by the Code being converted into a mandatory use of the choice under law governing banking regulation. The decision to invoke the Code and initiate an insolvency process, leading up to potential liquidation was a matter of a right of the bank. Forcing the bank to actually exercise that right, by issue of an edict that the banks must use this process, led to a very piquant and nuanced challenge to the policy of the central bank from the standpoint of arbitrariness.

The SC ruled that the blanket forced usage of the Code across the board, regardless of the industry, regardless of the company in an industry and regardless of facts, was an arbitrary policy choice. Each of the actions to initiate the Code process taken by each of the banks under this framework would have been fully valid had these actions been taken voluntarily as a matter of choice and as a matter of case-specific assessment of facts warranting such action. However, the same actions taken, not by application of mind, but by forced mandatory usage of a power made available under the Code, rendered the same actions to be set aside.

#### REGULATION OF CONDUCT AND CONDUCTION OF THE REGULATED

The same policy also led to another interesting facet of the behavioural impact of the operation of the Code coming to the fore. When the law confers a right and thereby a protection, and that too as a matter of choice, taking away the choice and the discretion and making it mandatory for banks to exercise a particular choice was a new dimension hitherto unheard of. It led to many other nuances and facets of behavioural economics come to the fore.

The central bank, which is the regulator, placed itself in the shoes of the regulated, taking decisions that they ought to take. Such a policy change led to undermining the sovereignty of the governance mechanisms of the bank – with the supervisor and regulator taking the decisions for the supervised and the regulated. The actions were still those of the bank, but the actual decision was being taken outside the bank. Lessons in regulation of conduct have been learnt and this has presented a great opportunity to learn about the core difference between choice and force – the former always being more resilient, truthful and apt for a democratic system like ours.

Finally, there is still one question that remains at large – does the Code have any preference between liquidation and resolution? Many legal and judicial minds tend to take an approach that liquidation is avoidable and that one must do the most to make resolution work. There is nothing in the Code to make any expression of such a preference. The choice between resolution and liquidation is a sovereign right of the CoC. They can choose in their wisdom to liquidate a company once they form a view that the CD is a basket case. The SC has upheld such sovereignty of the CoC.

However, in cases where the resolution plan does go through, obviating liquidation, when there is a challenge to the terms of the resolution, the question rears its head again. The SC would now decide whether one can at all second-guess the CoC and its choice of the nature and scale of haircut to be given to individual creditors and classes of creditors. The SC would also need to decide on whether the discretion and sovereignty of the CoC is absolutely sovereign without being attended with the need to be fair and be seen to be fair. Whether the obligation to accord equitable treatment of stakeholders, a mandate for fiduciary role of directors under company law, would need to be imported to treatment meted out by the CoC is the question to ask. The jury is out on this one.

#### CONCLUSION

To summarise, while the Code is purely a legislation that codifies the run of the rule of law governing insolvency and bankruptcy proceedings in relation to companies (insolvency of individuals is yet to be brought under the ambit of this law), its sheer operation in the ecosystem has led to various consequences on behaviour of parties involved and persons affected by it. A continuous study of these developments, backed by empirical data and statistical analysis of its impact would hold the key to regulatory impact assessment of the Code. The legislation is still young, and presents a rich opportunity for study. This space has to be keenly watched.

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## The Code: A Behavioural Perspective

Anuradha Guru<sup>1</sup>

*“Law is defined as a task of social engineering designed to eliminate friction and waste in the satisfaction of unlimited human interests and demands out of a limited store of goods in existence.”*

*Roscoe Pound<sup>2</sup>*

According to Marxist theory,<sup>3</sup> the legal system of a society constitutes one of the components of its 'superstructure' being influenced and in-turn influencing the base or substructure of a society comprising of '*the forces and relations of production through which the necessities of life are produced*'. The design of law in a particular society is dependent upon the collective thinking of the society in terms of what is a desirable and what is a not-so-desirable action. The structure of incentives and deterrents in the law is dependent on this collective thinking which then encourages socially desirable actions and penalises non-desirable actions. It, in some sense, puts fetters on freewill of individuals and their behaviour in the interest of harmonious social existence. Roscoe Pound, a distinguished American legal scholar and educator, posits law as an applied science serving as a tool for resolving individual and social problems. He called 'jurists' as 'social engineers' tasked with maintaining a balance between the competing interests in a society. Social engineering is based on the perception that laws are used as a means to shape society and influence people's behaviour. Thus, according to Pound's theory of 'social engineering', law is an attempt to mold the behaviour of humans. Its effectiveness can be judged by the behavioural changes it is able to bring about. The same sentiments are echoed by Friedman who suggested that '*legal rules are to be judged by the structure of incentives they establish and the consequences of people altering their behavior in response to those incentives.*'<sup>4</sup>

While law seeks enforcement of a certain kind of behaviour in a society, economics, in particular behavioural economics, helps explain an economic agent's choice behaviour from the menu of choices presented to him. The evolution of the law and economics movement, established the paradigm style for the economic analysis of law. This approach to law theorises that legal rules are best analysed and understood in light of standard economic principles. Gary

<sup>1</sup> The author is grateful to Ms. Medha Shekar, Ms. Surbhi Kapur and Ms. Pihu Mishra, her colleagues in the Research Division of IBBI, for their research assistance.

<sup>2</sup> Pound Roscoe (1942). Social Control through Law. *Journal of Philosophy*, 39 (20), pp. 559-560.

<sup>3</sup> The Marxist theory suggests that a capitalist society consists of the base (or substructure) and superstructure. The substructure which includes the forces and relations of production through which the necessities of life are produced, determines society's other relationships and ideas to comprise its superstructure, including its culture, institutions, political power structures, laws, rituals, and state.

<sup>4</sup> Friedman D. David (2000). *Law's Order: What Economics Has to Do with Law and Why It Matters*. Princeton University Press, 2000.

Becker<sup>5</sup>, referring to such principles, postulates that '*...human behavior can be viewed as involving participants who maximize their utility, from a stable set of preferences and accumulate an optimal amount of information and other inputs in a variety of markets.*' Appropriately designed legislation and efficient enforcement can provide incentives to agents to choose what is the best, or the most desirable, outcome, or, in the language of economics, the most efficient outcome. The study of law and economics involves determining the implications of such utility maximising behaviour of individuals for the entire economic ecosystem. To achieve this, it is necessary to understand the economic behaviour of economic agents under different circumstances. The Insolvency and Bankruptcy Code, 2016 (Code) serves as a good example to understand the interplay between law and economics.

The Code has been hailed as one of the most important economic legislation in recent times, having reformed the much-needed exit mechanism for corporates, to start with, and having addressed an important aspect of ease of doing business in the country. The law, being preventive in nature, is also being touted as having brought about a cultural shift in the dynamics between lenders and borrowers, and promoters and creditors. The Code has made an impact in the way repayment of debts are being viewed and treated by promoters and management of the defaulting firms. The first signs of distress now serve as early warnings for management to take corrective actions to avoid defaults. One can posit that the Code is emerging as a behavioural law aiming to draw various stakeholders of the entity in distress to work together, in a non-adversarial manner, towards laid down objectives of the law viz.

'...reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders...'<sup>6</sup>

This article explores the interplay between this law and aspects of behavioural economics in an attempt to elucidate upon the choice architecture the law offers in order to drive the stakeholders in the system towards envisaged outcomes. It examines the Code with the lens of economic behavioural principles to assess how it is using these principles to 'socially engineer' a particular behaviour amongst the key players in the insolvency and bankruptcy framework. In particular, being inspired by Chapter 2 of the Economic Survey 2018-19,<sup>7</sup> the article focuses on various 'behavioural nudges' in the Code which are steering the stakeholders in an insolvency process towards overall utility maximising outcomes.

#### INFORMATION ASYMMETRIES IN CREDIT MARKETS AND NEED FOR AN INSOLVENCY LAW

Ease of access to credit is the cornerstone of economic development of any country. An established body of literature points to the positive influence of well-functioning credit markets on economic performance. The willingness of banks and investors to support new businesses is, to an extent, a function of the rules that govern the procedures when they fail, i.e. the ease of exit of capital. Effective insolvency regimes, while coming into play at the end of the business life cycle, have an overwhelming impact on the commencement of the cycle, ensuring the willingness of banks and investors to lend and that of entrepreneurs to enter the market

<sup>5</sup> Becker S. Gary (1976). *The Economic Approach to Human Behavior*. University of Chicago Press Books.

<sup>6</sup> Long title of the Code.

<sup>7</sup> Economic Survey, Ministry of Finance. Government of India, 2018-19.

taking some amount of risk. The Cork Committee, which was tasked to redraft the UK Insolvency Law in 1982, succinctly noted the importance of effective insolvency regimes in the following words: *'It is important to recognize that the world in which we live and the creation of wealth depends upon a system founded on credit and that such a system required as a correlative, an insolvency procedure to cope with its casualties.'*

An effective insolvency regime stipulates provisions for dealing effectively with the financial distress of corporates; entrepreneurs (operating in the form of sole proprietorships or partnerships) and other individuals without business. Rescue processes through the apparatus of insolvency law involves participation by different economic agents viz. the creditors, debtors, employees, Government etc., fostering a fair and equitable distribution of funds of the defaulting entity. This process, crucially, hinges on mutuality of information between these agents. However, credit markets are often plagued by information asymmetries. This means that one of the parties to a credit has superior knowledge about the underlying product and associated risks. This situation leads to two potential concerns. One is 'adverse selection' as the creditor charges an interest rate commensurate with the average risk-profile of all the debtors in the market as it has difficulties, in view of incomplete information, in correctly assessing the risk of lending to a debtor or for a purpose. The high-risk borrowers find the rate to be attractive and borrow willingly, while the low risk borrowers exit the market, leaving behind a high-risk 'lemons'<sup>8</sup> market. The second concern is 'moral hazard' as the debtor, who has superior information, changes his behaviour after the credit is availed, while the creditor suffers the consequence of changed behaviour of the debtor. A creditor usually resorts to secured lending to partially address both the concerns instead of meritocratic lending.

Thus, when the 'game' is set, i.e. an insolvency process of a corporate debtor (CD) is triggered, there are asymmetries in information available to each of these stakeholders. Which card a player will play and how the insolvency process will progress will depend upon the information available to the players, each's utility maximizing behavior and how their moves interplay with each other. The mechanics of this game raise fundamental questions concerning the nature of the insolvency process. These range from an enquiry into whether the Code guides players towards any particular outcome to whether it seeks to provide incentives and choices, drawing upon certain behavioral aspects of the agents, and eventually drives them towards that outcome? The collective nature of insolvency and bankruptcy proceedings envisaged by the law requires it to be facilitative in correcting these problems of information asymmetries and molding the behavior of the economic players in the resolution process to ensure its success. When a debtor is unable to pay its debts as they become due, the diverse interests of a range of stakeholders come into play. These stakeholders include the debtor; the owners and management of the debtor; the creditors, secured or unsecured; employees of the debtor, guarantors of debtors and suppliers of goods and services to the debtor in default. The legal regime of insolvency and bankruptcy law in an economy, provides a mechanism to deal with this default in a manner so as to provide collective satisfaction of all these players. Largely, the law would also need to ensure a balance not only between the different interests of these stakeholders, but also between these interests and the larger relevant social, economic and

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<sup>8</sup>George A. Akerlof (1970). The Market for "Lemons": Quality Uncertainty and the Market Mechanism. *The Quarterly Journal of Economics*, Vol. 84, No. 3, pp. 488-500.

political considerations that the entity in default would require to be addressed. Some aspects of behavioural economics can help throw some light on how the various players in a corporate insolvency resolution process may behave. This is discussed in the next section.

#### ASPECTS OF BEHAVIOURAL ECONOMICS

The basic assumption of neoclassic economic analysis is that economic agents are 'rational' in their choices, i.e. their decision-making process is based on making choices that result in an optimal level of benefit or utility. However, individuals are not always 'rational' in their behavior. Behavioural economics draws on psychology and economics to explore why people sometimes make irrational decisions, and why and how their behaviour does not follow the predictions of economic models. The field of behavioural economics takes cognisance of the fact that individuals often make irrational choices subject to cognitive biases, emotions, and social influences.<sup>9</sup> The theory suggests that in practice individuals interpret situations and based on the same, take decisions, under influence of their individual belief systems, societal practices and cultural norms. Some of these biases may play out in an unconscious and automated manner. These have been elaborated in following paras.

Individuals may actually rely too heavily on one piece of information, usually the first piece of information found, serving as an 'anchor', when taking decisions. This is what is termed as 'anchoring bias'. Further, they would like to rely on only those material which confirm to their pre-conceptions, ignoring any other contrary information, thus being subjected to what is called the 'confirmation bias'. Another example of a cognitive bias is called the 'loss aversion bias', i.e. the tendency of individuals to prefer avoiding losses as opposed to commensurate gains. Yet another form of a cognitive bias is the 'failure bias', under which individuals seem to be influenced by failures of a particular action that they see around them as opposed to success stories which can lead to false conclusions.

These are only a few examples of some of the cognitive biases that afflict an individual's decisions in his day to day life. However, being mindful of the effects of these biases and the time of their occurrence, along with utilising certain techniques available in behavioral economics, one can go a long way in mitigating any of their adverse consequences and actually use these biases to influence the behavior in a socially optimal manner.

Behavioural law and economics explores the implications of actual, as opposed to hypothesised human behavior for the law. Behavioural economics provides a number of principles that can be used to positively use these cognitive biases in order to influence the behavior of individuals towards desirable outcomes.

#### **Nudge Theory**

A relatively new area of behavioural economics is the 'nudge theory' suggesting that instead of taking the path of providing incentives to encourage a particular behaviour, one can help influence the choice architecture of individuals by providing delicate policy shifts or 'nudges' in particular directions, taking a cue from the patterns of functioning of human psychology. In other words, Nudge theory is essentially an indirect approach, which seeks to modify situations for people, arguing that if we wish to alter people's behaviour in a particular direction, it can be

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<sup>9</sup> Loewenstein, G. and Sutherland, R. (2014). An Introduction to Behavioral Economics. The Behavioral Economics Guide.

more effectively done by encouraging positive choices rather than trying to restrict undesirable behavior with some kind of sanctions.

The idea of 'nudging' falls between the two extremes of a *laissez-faire* economic policies which suggests that an individual's preferences are better known to the person himself and the concept of 'revealed preference' which is essentially defined by what one chooses. While conventional economic policy provides 'economic' solutions (e.g. taxes, incentives, regulation) to issues arising out of market failures such as information asymmetries, 'nudges', in contrast, provide behavioural solutions to problems that can be seen to have originated from human decision made under the influence of cognitive biases.

The principles of 'nudge theory', first articulated by James Wilk around 1995, were, in some sense, rediscovered by Thaler and Sunstien<sup>10</sup> in their renowned book *Nudge: Improving Decisions About Health, Wealth, and Happiness* in 2008. They suggested that human behaviour can be influenced without any coercion as 'libertarian paternalism', viz. the idea that it is legitimately possible for private and public institutions to be able to affect behaviour of individuals while also respecting their freedom of choice. The principles of nudge theory suggest creating a choice architecture with such features that influence the decisions of people without changing their incentives or payoffs. The right 'nudge' can, therefore, produce the desired outcomes. In the words of Thaler and Sunstien, 'A nudge is any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives.'

#### INSOLVENCY AND BANKRUPTCY CODE AND BEHAVIOURAL NUDGES

The choice architecture of the Code, though perhaps not envisaged *ex-ante*, in terms of behavioural principles can, *ex-post*, be seen as following these principles and hence yielding some visible behavioural changes in the debtor-creditor relationship. In the following paras, an attempt is made to relate each of these principles with the architecture of the Code to see how this law is using the behavioural principles, taking advantage of cognitive biases of individuals, 'nudging' the stakeholder(s) to achieve the objectives of the Code.

The National Company Law Appellate Tribunal (NCLAT), in its judgment dated 14<sup>th</sup> November, 2018 in the matter of *Binani Industries Limited v. Bank of Baroda & Anr.*,<sup>11</sup> held that the first order objective of the Code is resolution of the entity in distress. The second order objective is maximisation of value of assets of the firm and the third order objective is promoting entrepreneurship, availability of credit and balancing the interests. This order of objectives is sacrosanct. Further, in *Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.*,<sup>12</sup> the Supreme Court (SC) held that the primary focus of the legislation is to ensure revival and continuation of the firm by protecting it from its own management and from death by liquidation. In an attempt to emphasise upon the policy shift in law, the SC also observed that with the enactment of the Code the defaulter's paradise is lost and, in its place, the economy's rightful position has been regained.<sup>13</sup> This is, perhaps, an enunciation of the biggest evidence of outcome from 'nudge' in the form of a bar/an embargo being placed upon the erstwhile

<sup>10</sup> Thaler, R. H., & Sunstein, C. (2008). *Nudge: Improving Decisions about Health, Wealth, and Happiness*. New Haven, CT: Yale University Press.

<sup>11</sup> Company Appeal (AT) No. 82,123,188,216 & 234 -2018

<sup>12</sup> (2019) 4 SCC 17

<sup>13</sup> *Ibid.*

defaulting promoters' of the CD from making a backdoor entry through bidding. The Code lays down a built-in mechanism in which the first order objective or default choice is resolution and thus stakeholders automatically 'opt-in' for resolution of the CD in the very first instance. Liquidation follows if resolution fails. This default choice is given to all the stakeholders. Thus, the Code is 'leveraging default rules', which is a behavioural principle given the 'anchoring bias' of individuals, by providing default choices to the economic agents, such that the default choice maximises their own welfare and that of the society as a whole.

The Code enables the best outcomes for all stakeholders by requiring them to first attempt a resolution of the entity in distress and creating a collective process where the value of the firm is preserved by not allowing creditors to recover at the very first instance. The Code, in other words, works on the basic principles of the insolvency and bankruptcy law, viz. incentivising socially optimal behavior of the stakeholders of the entity in distress in a manner which causes least loss and disruption to each of them. This would happen when the resolution process is time bound, fair and equitable, ensuring highest recovery to cost ratio. Also, it is paramount to take into consideration *ex-ante* efficiency which is an incentive-based device aimed at prompt filing of applications triggering insolvency resolution process. Without timely initiation of and pursuit of *ex-ante* mechanisms, *ex-post* mechanism is rendered nugatory. The Code relies on the behavioral principle of 'making it easy to choose', i.e. it provides easy to comprehend options with reduced administrative impediments to choosing. The Code affords convenient choices in the form of providing a two-way solution to the stakeholders. Firstly, it provides them with the automatic choice of resolution and simultaneously, it serves them a choice to exit by providing a withdrawal mechanism. The Code also provides an option of voluntary liquidation in instances where both debtor and creditor are of the opinion that the entity should not continue as a going concern.

The Code establishes a linear, collective process of resolution which is binding on the debtor, creditor and all other stakeholders thereby making it the 'go-to' option to resolve insolvency of a CD. It provides creditors a chance to assess the viability of the CD. Read with the RBI circular<sup>14</sup> of June 7, 2019, which provides a framework for early recognition, reporting and time-bound resolution of stressed assets, the Code is an easy option to choose for the purpose.

For an effective resolution, assembling the assets of the CD is a principal task. In this respect, the Code provides enough protection to the assets of the CD. During the process of resolution, a 'moratorium' on proceedings against the CD is afforded, providing a 'calm period' for a resolution to be explored. While such a 'stay' is secured, no assets of the CD can be invaded upon or attached by any authority. Also, when an order for liquidation of a CD has been passed, no legal proceeding can be instituted by or against the CD. Moreover, during liquidation, the liquidator is expected to take into custody or control all the assets, property, effects and actionable claims of the CD. The applicability of moratorium and the overriding powers of the Code have been one of the most debated provisions of the Code. It is a useful shield to the against individual enforcement actions by the financial creditor (FCs). In the matter of Swiss Ribbons, the SC observed that '*...the moratorium imposed by Section 14 is in the interest of the corporatedebtor itself, thereby preserving the assets of the corporate debtor during the resolution process.*'

<sup>14</sup> Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019 issued on June 7, 2019.

Another principle of 'nudging' human behavior is 'leveraging loss aversion' of individuals, which suggests designing of incentives to reward good behaviour *ex-ante*. Loss aversion is an important concept encapsulated in the expression 'losses loom larger than gains'<sup>15</sup>. It is said that the pain of losing is psychologically about twice as powerful as the pleasure of gaining. The Code, through its process design, which divests the promoters of the rights on their company as soon as a corporate insolvency resolution process (CIRP) is initiated, has effectuated fear amongst them, thus maneuvering them towards avoiding defaults. There have been instances where CDs have paid the default amount after filing of CIRP application or have repaid their debts immediately after receipt of notice from an creditors. The CIRP process under the Code is a non-adversarial and Court approved process giving it a sense of comfort for both creditors and debtors. Thus, the law has become preventative in nature so that real damages can be avoided by simply signaling to the market participants that the consequences of non-compliance might be heavy and that good credit behavior will be rewarded.

Taking a cue from 'failure bias' of individuals, the third principle talks about 'emphasising social norm' to enhance good behaviour by focusing on influencers that people can relate to. Our ancient scriptures have guidance to offer in respect of the borrowing behaviour, saying:

अग्निशेषम् ऋणशेषम् शत्रुशेषम् तथैव च ।  
पुनः पुनः प्रवर्धत तस्मात् शेषम् न कारयेत् ॥

Meaning, 'If a fire, a loan, or an enemy continues to exist even to a small extent, it will grow again and again; so do not let any one of it continue to exist even to a small extent.'

Thus, the guidance is to repay your loans. Subsistence of default results not only in individual harm but of the economy. Reducing the possibility to become an insolvent begins with sound financial preparation. However, honest business failures cannot be ruled out. Thus, the Code looks upon such honest business failure as a normal and legitimate part of the functioning of the market economy. It strives to address the stigma associated with financial failure by providing a structured and swift mechanism to resolve it. In this regard, the provisions pertaining to fast track insolvency resolution pave the way for promotion of the burgeoning entrepreneurial and investment sentiment in India. Accelerated resolution attracts investors and, in this way, the Government of India, as a part of the Start-up India Initiative, is facilitating an easy option for smaller firms to exit and start afresh.

Further to overcome the 'failure bias', the next principle suggests that the Government/regulator should 'disclose outcomes' which are the realised benefits of good behavior which others can look up to as examples to follow. Measurable desired outcomes of the Code have come to fore over the past two years with a number of CIRPs yielding resolution, wherein realisation by FCs in comparison to the liquidation value of the CD has been almost 188 per cent. Further, both FCs and operational creditors (OCs) are realising almost equivalent proportions of their admitted claims, indicative of balanced outcomes under the Code. Active disclosure of these outcomes has imparted greater credibility to the Code and encouraged greater recourse to it. Further, the Adjudicating Authorities has played a vital role in the

<sup>15</sup>Daniel Kahneman, D. and Tversky, A. (1979). Prospect Theory: An Analysis of Decision under Risk, *Econometrica*, Vol. 47, No. 2, pp. 263-291

emergence of rich jurisprudence around the Code. They have been successful in setting up a behavioural insight through the interpretations that has developed with their decisions.

Mere disclosure of desirable outcomes would not be effective unless the same is reinforced so as to alter the behavioural pattern of the stakeholders. Need for 'reinforcing desirable outcomes' repeatedly is what the next principle of behavioral economics suggests. In furtherance to this, the Government and IBBI have been regularly engaging with various stakeholders in the context of the new legal framework for insolvency and bankruptcy regime in the country, making them aware of the details of the processes. The positive outcomes of the same are being informed through various communication channels, hence reinforcing its merits.

As noted earlier, individuals suffer from 'confirmation bias'. To use this to nudge a behavioral change, the behavioural principle, viz., 'making messages match mental models' i.e. training people to shift to new rules of thumb, can come in handy. Heuristics or mental shortcuts are often used by people as simple rules of thumb to help them take decisions. Given the growth of Code's jurisprudence and the way in which the Code has evolved as a problem solver to debtors and creditors in the society, it is expected that taking recourse to the provisions of the Code for resolving insolvency will be the new thumb rule.

#### CONCLUSION

Taking recourse to the Code is absolutely voluntary. Where one exercises its voluntary options in favour of the Code, the fall out is compulsory for all other stakeholders. Therefore, it is one of the parties to the insolvency process and not the State who imposes an outcome on all other players. This can be viewed as one of the most powerful 'nudge' requiring all stakeholders to exhibit their best behaviour, firstly to prevent triggering of an insolvency and if triggered, to ensure that interests of all stakeholders are taken care of.

Behavioural principles have strengthened the efficacy of principles of governance and economics. The relation between law and economics is that of complementarity, wherein the 'justness' of law and 'efficiency' of economics come together into a state of equilibrium. In fact, law can be said to be an enabler of economic activities. If the current order is less enabling, then the economy and its agents cannot perform to their full potential, leading to inefficient allocation of scarce resources. The objective is to encourage regulation that is designed to be efficient, accessible to all and simple to implement. Law or rather regulation making has gone one step further to imbibe the behavioural principles into achieving the desired economic outcomes, leading to maximisation of social welfare. The Code tests positive on all these fronts and is slowly and progressively 'nudging' its way towards achieving its statutory objectives.

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Part V

On the Anvil



## *Economic Aspects of Personal Insolvency*

Shashank Saxena

**T**he history of debt relief framework for individuals goes back to the past five millennia, but Kilborn (2012)<sup>1</sup> explains that three distinct phases are visible. The rulers in ancient Sumer and Babylon mandated sporadic debt remissions to maintain social stability and military advantage. The Roman and later Islamic law imposed only a limited form of debt forgiveness, encouraging creditors to permit complete remission of distressed debts around the time of Christ. The time up until the late 1900s and the beginning of the twenty-first century witnessed a general criticism of compulsory debt relief when modern democracies re-emphasised mandatory debt remission to maintain social stability and maximise economic competitiveness with foreign countries, rather than maximise comparative advantage militarily.

Therefore, the new personal insolvency laws were designed to maximise the potential to promote efficiency and economic development. However, the design of a personal insolvency law and its impact on efficiency and growth are relatively less explored considering that this law is relatively new and still evolving compared to the law on corporate insolvency. The international standard setting bodies have also not provided clear and comprehensive guidance on an efficient legal framework for personal insolvency. The attempt of this paper is to evaluate the available theoretical and empirical evidence in India and other jurisdictions to provide some policy guidance on strengthening the personal insolvency framework which may be implemented in due course.

### OBJECTIVES OF PERSONAL INSOLVENCY AND BANKRUPTCY REGIMES

The objective of any personal debt clemency law has to be based on two important premises of grant of personal relief to economically distressed individuals and achievement of inclusive economic growth. It is argued that the personal insolvency regime is said to reduce the negative externalities of a system which may not appropriately estimate the risk of enforcing uncollectible debt and also designed to force a sharing of losses to entities which are better prepared to deal with such losses (Kilborn, 2009)<sup>2</sup>. Shukla (2016) traces the personal debt and debt relief in India to the legal structure of the colonial period.<sup>3</sup> In India, the legal system of debt

<sup>1</sup> Kilborn, Jason J. (2012). The 5000-Year Circle of Debt Clemency: From Sumer and Babylon to America and Europe. *Nederlands Tijdschrift voor Burgerlijk Recht*, pp. 1-7

<sup>2</sup> Kilborn, Jason J. (2009). Twenty-Five Years of Consumer Bankruptcy in Continental Europe: Internalizing Negative Externalities and Humanizing Justice in Denmark. *International Insolvency Review* 18, no. 3, pp. 155-185.

<sup>3</sup> Shukla, Aditi. (2016). The Constitutional Framework Surrounding Debt Relief in India. *International Journal of Law and Legal Jurisprudence Studies*, no. 1, pp.353-365.

relief was intertwined with laws on agricultural credit in view of the fact that a majority of working population was employed in agricultural sector, which faced persistent famines and rural indebtedness. To ameliorate the conditions of farmers, several Acts regulating the agricultural credit and rationalisation of interest on loans such as Land Improvements Loan Act, 1883, the Agriculturists Loans Act, 1884, and the Usurious Loan Act, 1918 have been passed. Post-independence, several State Acts have also been passed to regulate the money lending and to provide debt relief. The efficacy and comprehensiveness of such State Acts in reducing the rural indebtedness has been a matter of debate. A country-wide natural experiment in introducing comprehensive debt relief and debt waiver (a kind of 'fresh start' under the Insolvency and Bankruptcy Code, 2016 (Code)) was conducted in the form of Agricultural Debt Waiver and Debt Relief Scheme, 2008, which holds significant insights into formulation of future policy on debt relief and inclusive economic growth, which theme would be examined later.

According to Feibelman (2018), while rural indebtedness could be used as a ground to argue for formulating a general law on debt clemency, there is no immediate consumer debt crisis in India – a situation which has forced many countries to formulate such laws.<sup>4</sup> Thus, it is very appropriate that the Code has provided a framework of personal insolvency in the calm period and relatively early stages of consumer credit growth where there is no over-indebtedness or consumer credit crisis impacting financial stability. However, according to Sane (2019), the individual credit has grown in recent times where individuals account for almost 38 per cent of non-food credit and the stress on personal loans is increasing.<sup>5</sup> Therefore, this is the most appropriate time to learn from the experiences of other countries that have implemented personal insolvency law in the recent period. This may also be conducive to formulate policies to further develop credit markets for individual loans.

#### LEARNINGS FOR INDIA

According to White (2016), personal bankruptcy law is based on conflicting objectives and these decide the structure of the legal regime, whether it is 'too harsh' (high repayment conditions and /or high punishments for applying) or 'too lenient' (low repayment conditions and/or low punishments).<sup>6</sup> While on one hand, the personal insolvency law is supposed to provide partial consumption insurance, on the other hand, it should also improve credit supply through a fair distribution of debtor assets between a debtor and a creditor. White (2014) also opines that a larger distribution of debtor assets under a harsh regime may improve credit supply, but it may reduce the consumption of debtors and disincentivise and reduce their work efforts.<sup>7</sup> Therefore, it may be both welfare-minimising and efficiency-retarding. Since individual debtors cannot be liquidated in modern democracies unlike in medieval times when enslavement and corporal punishment for debt default was common, they would always be reorganised and their personal and other exempt assets protected so that such personal

<sup>4</sup> Feibelman, Adam (2018). Legal shock or false start? The Uncertain Future of India's New Consumer Insolvency and Bankruptcy Regime. *Tulane Public Law Research Paper*, no.17-16.

<sup>5</sup> Sane, Renuka (2019). The Way Forward for Personal Insolvency in the Indian Insolvency and Bankruptcy Code. *NIPFP Working Paper 251*, pp. 1-31.

<sup>6</sup> White, Michelle J. (2016). Economics of Personal Bankruptcy and Insolvency. CESifo DICE Report 4/2015. *CESifo Institute – Journal for Institutional Comparisons* 13, No. 4, pp. 3-7.

<sup>7</sup> White, Michelle J. (2014). Economics of Corporate and Personal Bankruptcy  
Law. <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.497.7830&rep=rep1&type=pdf>

insolvency laws could be not only welfare maximising, but also growth-enhancing. Using the data of 27 countries over the 2005–2010 period, a research study by Fu et.al (2018) found that a personal insolvency regime reducing barriers to failure in terms of World Bank measures of insolvency time, insolvency cost (percentage of estate), and recovery rate had expected impact on individual businesses.<sup>8</sup> Time and cost are negatively related to entrepreneurship, whereas recovery rate is positively associated with entrepreneurship. Further, the personal insolvency regime provides strong incentive to opportunity-and innovation-oriented entrepreneurship. These findings are corroborated in another study of Japan by Eberhart (2016) which suggests that a lenient insolvency regime is conducive to qualitatively better entrepreneurship.<sup>9</sup>

The empirical evidence produced by Gross et. al.(2018) on personal insolvency regime in US before and after the bankruptcy reforms in the form of the Bankruptcy Abuse Prevention and Consumer Protection Act, 2005 (BAPCPA) provides interesting insights into theoretical debates of 'generous' versus 'harsh' personal insolvency regimes on the insurance and credit supply aspects.<sup>10</sup> BAPCPA can be categorised as a harbinger of a relatively restrictive personal insolvency regime in US which increased the cost of filing and restricted the financial benefits. It applied the 'means test', restricting the high-income individuals to freely use the bankruptcy law and also ensured that defaulted debt may be repaid to the maximum extent which could be afforded by debtors. There were contradictory positions taken by proponents and opponents of the insolvency reform. While the supporters argued that the cost of credit would be reduced as the creditors pass on the benefits of higher recovery rates, the opponents were sceptical about the benefits and apprehended that the insurance value of bankruptcy would decline and the interest of filers affected by medical bills and job-losses would be adversely affected. The results of the one of the most comprehensive studies of personal insolvency regimes (Gross et.al., 2018) indicated that the reduced filings actually helped in passing the benefits of reduced borrowing cost to consumers, however the BAPCPA reduced the insurance value of bankruptcy, as the Act significantly reduced the share of uninsured individuals who accessed bankruptcy as implicit health insurance.<sup>11</sup> The other interesting finding of the study is that the 'means test' embedded in the bankruptcy reform was designed with the objective to reduce filing by high income filers, which was not achieved. This brings into sharp focus the optimum trade-off between the 'harsh' and 'generous' personal bankruptcy regimes which may have implications for design of social insurance schemes and regulation of credit markets.

The economic theory of over-indebtedness or financial stress of individuals provides two major channels which negatively impact investment, productivity and the macro economy. The 'poverty trap' models of Banerjee and Newman (1993),<sup>12</sup> Banerjee (2000),<sup>13</sup> Mookherjee and Ray (2003)<sup>14</sup> explain the constant entrapment of individuals in low-

<sup>8</sup> Fu, Kun, Wennberg, Karl and Falkenhall, Björn (2018). Productive Entrepreneurship and the Effectiveness of Insolvency Legislation: a Cross-Country Study. *Small Business Economics*, 2018. <https://link.springer.com/article/10.1007/s11187-018-0040-6>.

<sup>9</sup> Eberhart, Rober N., Eesley, Charles, E., and Eisenhardt, Kathleen M (2017). Failure is an Option. Institutional Change, Entrepreneurial Risk and New Firm Growth. *Organization Science* 28, no. 1, pp. 93-112.

<sup>10</sup> Gross, Tal, Kluender, Raymond, Liu, Feng, Notowidigdo, Matthew, J., and Wang, Jialan (2018). The Economic Consequences of Bankruptcy Reform. <https://economics.mit.edu/files/16255>.

<sup>11</sup> Ibid.

<sup>12</sup> Banerjee, Abhijit and Newman, Andrew F (1993). Occupational Choice and the Process of Development. *Journal of Political Economy* 101, no. 2, pp. 274–298.

<sup>13</sup> Banerjee, Abhijit (2000). The Two Poverties. *Nordic Journal of Political Economy* 26, no. 2, pp. 129–141.

<sup>14</sup> Mookherjee, Dilip and Ray, Debraj (2003). Persistent Inequality. *Review of Economic Studies* 70, no. 2, pp. 369–393.

productivity equilibrium through investment constraints caused by insufficient capital and human investments, which, in turn, are a result of low net income after repayment of debt. The models of 'debt overhang and risk shifting' of Jensen and Meckling (1976)<sup>15</sup> and Myers (1977)<sup>16</sup> focus on concentration of risk (as only creditors have to bear the downside risk) and overlooking of profitable investments by debtors with low net investible surplus in explaining the deleterious impact of debt on productivity and growth. Both the models recognise that debt relief would encourage investment and productivity. The opposing view is that the beneficial effect of the debt relief may have to be weighed against the moral hazard and behavioural response of the borrowers embedded in the possibility of future debt reliefs or bail-outs.

These theories have been examined in the context of a very large debt relief experiment conducted in India through the Agricultural Debt Waiver and Debt Relief Scheme, 2008, which was one of the largest debt relief programmes in the world that accounted for about 1.6 per cent of GDP and affected 45 million farmers. Empirical studies conducted by Kanz (2012<sup>17</sup> and 2016<sup>18</sup>) use this natural experiment in the history to obtain evidence on the effectiveness and efficiency aspects of debt relief. The intended objective of the Scheme was to make the collateral (land) free from debt so that the beneficiary farmers get integrated with the formal financial system. The findings indicate that debt relief had a perceptible effect on the level of household debt, but it did not lead to increase in investment and productivity as forecast by theories of debt overhang. Instead, the behavioural expectation of future credit constraints resulted in more dependence on informal financing, lower investment and a decline in productivity among the beneficiary farmers who received debt relief. The findings indicate that a one-time debt settlement may not facilitate new investment, but may have substantial real effects through their impact on borrower expectations. Therefore, it is important to create the long-term credit relationships between borrowers and lenders and supplement the policies to augment formal credit access with 'fresh start' schemes. This brings us back to the lender response behaviour under a personal insolvency regime and what type of personal insolvency regime would improve the supply of credit and cost of credit. This aspect is worth exploring because very little guidance is provided under the Code for discharge from insolvency in the fresh start or earned start.

## CONCLUSION

While the Indian personal insolvency regime incorporates many useful features of personal insolvency laws of other countries in allowing both 'fresh start' and 'earned starts' based on the repaying capacity of debtors, applying the means-tested criteria (which may be flexibly determined going forward) and timeliness in resolving insolvency, there are complementary policies to improve credit access like the length of maintenance of credit default record and the role and emphasis on credit counselling as the condition of discharge, which need to be amplified and clarified. What are the costs and benefits of mandatory financial management

<sup>15</sup> Jensen, Michael C. and Meckling, William H (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics* 3, no. 4, pp. 305–360.

<sup>16</sup> Myers, Stewart, C. (1977), Determinants of Corporate Borrowing, *Journal of Financial Economics* 5, no. 2, pp. 147–175.

<sup>17</sup> Kanz, Martin (2012). What Does Debt Relief Do for Development? Evidence from India's Bailout Program for Highly-Indebted Rural Households. *World Bank Policy Research Working Paper* 6258, pp. 1–62.

<sup>18</sup> Kanz, Martin (2016). What Does Debt Relief Do for Development? Evidence from India's Bailout for Rural Households. *American Economic Journal: Applied Economics* 8, no. 4, pp. 66–99

counselling or training and making such training a prerequisite of debt discharge? It is illustrative to learn from the long-term experience of the countries, like, Canada since 1992 and the United States since 2005, which have mandated that individual debtors are required to receive such counselling or training prior to discharge, even when it is evident, including through evaluation studies that this mandate was not appropriate to achieve the objective of avoidance of insolvency. According to Kilborn (2016), it is prudent to question the effectiveness of such counselling for an applicant who seeks relief from personal financial distress that may have been caused by unanticipated accidents of life and not by the lack of basic financial knowledge or mismanagement of finances or over-borrowing.<sup>19</sup> The final question is if the substantial costs of mandating financial education are justified by its limited and possibly unreal benefits or such requirements cause deadweight loss on a nation that is difficult to justify. Indian studies on financial inclusion also indicate that the recall value of financial inclusion is very low in adult financial literacy programmes. It is appropriate that in the absence of explicit financial management counselling provisions in the Code, any such policy in subordinate legislation may be based on hard evidence, both theoretical and empirical.

While the institutional mechanism of courts, insolvency professionals and information utility has been inbuilt in the insolvency law to deal with personal insolvency, however several policy issues are still open, as mentioned above. The costs of a formal discharge from personal insolvency could be substantial in view of small transaction size of a case. In view of this, efforts may be made to create a personal insolvency regime which is balanced: neither too harsh nor very generous, cost-effective and efficient. The implementation challenges would need to be constantly weighed against the hard evidence on some of the economic policy issues mentioned above. Further, establishment of long-term credit relations between debtors and creditors may be ensured so that the moral hazard and behavioural expectations should not overshadow the beneficial effects of the personal insolvency regime.

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<sup>19</sup> Kilborn, Jason J. (2016). Mandatory Financial Education as Prerequisite to Personal Insolvency Relief: The North American Experience. pp. 1-17. [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2837287](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2837287)



## *Fresh Start Process*

Renuka Sane\*

**T**he Fresh Start (FS) Chapter under the personal insolvency provisions in the Insolvency and Bankruptcy Code, 2016 (Code) has generated a fair bit of controversy. Reports in the media seem to have given the impression that this is a 'loan waiver' for all small borrowers.<sup>1</sup> The micro-finance industry has raised concerns that the fresh start provisions will threaten its very existence for fear of *en masse* defaults by borrowers.<sup>2</sup>

This article presents provisions of the FS, and provides rough estimates of how many people is it likely to cover, and what implications it may have for credit culture going forward. It suggests that there are about 20-25 million borrowers who may become eligible. It also makes the case that the fresh start process is a more structured form of debt waiver which will force debtors to make the trade-off between a waiver in the present and potentially more expensive credit in the future.

### ABOUT FRESH START

The process of FS under Part III of the Code allows for a complete waiver of debts to those who meet certain eligibility conditions. The most important of the eligibility conditions are as follows:

- A debtor with a gross annual income of less than Rs. 60,000, assets less than Rs. 20,000, qualifying debts of less than Rs. 35,000, and no home-ownership will be eligible to get a complete waiver of debts. In addition, the debtor must not be a discharged bankrupt.
- FS filing can only be made on debt that is not excluded. The Code includes the following in its category of excluded debts<sup>3</sup>:
  - liabilities for court or tribunal fines;
  - liability to pay damages for negligence, nuisance or breach of a statutory, contractual or other legal obligation;
  - liability to pay maintenance to any person under any law for the time being in force;
  - liability in relation to a student loan; and
  - any other debt as may be prescribed.

While the Code has left open the possibility that regulations will specify other kinds of debts in the class of excluded debts, current provisions suggest that certain debts cannot be waived of.

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\* The author thanks Mr. Dwijaraj Bhattacharya from Dvara Research for useful conversations.

<sup>1</sup> Karunjit Singh and Deepshikha Sikarwar (May 13, 2019), Universal debt relief scheme on cards for small borrowers, *The Economic Times*.

<sup>2</sup> Tamal Bandyopadhyay (June 23, 2019), A new challenge for the micro-finance industry?, *The Business Standard*.

<sup>3</sup> Section 79 (15) of the Code.

FS is possible only for qualifying debts. These include amount due, which includes interest or any other sum due in respect of the amounts owed under any contract, by the debtor for a liquidated sum either immediately or at certain future time. In addition to excluded debts, secured debts and debts incurred three months prior to the date of the application cannot be discharged.

The Insolvency and Bankruptcy Board of India (IBBI) is expected to keep a record of the FS which will be available to creditors making a lending decision in the future. An individual can apply for a FS again after a gap of at least six months between subsequent applications.

These conditions suggest that the FS is not a free-for-all loan waiver process. It is applicable only to certain category of individuals, for certain kinds of debt with records maintained on the use of these provisions.

### **Coverage of Fresh Start**

A natural question to ask is under these eligibility conditions, how many people could possibly be eligible for a fresh start? This is important because even a rough estimate of the numbers makes it possible to get a sense of scale of the possible debt waivers, and for both the lending industry and the government to prepare the processes and institutional machinery for the eventuality of some filings.

While formal and informal debt would get covered under the Code, the ability to enforce a moratorium, as well as deal with a FS, is likely to be limited to formal debt, at least in the short run, till such time the enforcement machinery gets developed to deal with money lenders, or other sources of informal debt. For this reason, the focus on coverage is restricted to sources of formal debt. This largely includes banks and micro-finance institutions. Unfortunately, neither source is able to provide information on income, assets and debt outstanding.

### **Data: Banking System**

Since FS is applicable to outstanding debt below Rs. 35,000, it makes sense to look at the lending of banks where the size of loans is less than Rs. 25,000. While the next size category (between Rs. 25,000 - Rs. 50,000) will cover some of those with less than Rs. 35,000 of debt, limiting the analysis to the first category is likely to give more precise estimates.

Banks in India had given loans of less than Rs. 25,000 to 36.5 million accounts in 2017-18, with total credit outstanding in this category of Rs. 400 billion.<sup>4</sup> However, not all of this credit is likely to be unsecured credit, and not all of the credit is likely to be given to those with annual income and assets less than Rs. 60,000 and Rs. 20,000 respectively. The income and asset profile of these borrowers is not known.

The same source of data suggests that two kinds of debt are more likely to be unsecured - direct finance to agriculture and credit card debt. These two categories were at 15.9 million (credit outstanding of Rs. 245 billion) and 5.7 million accounts (credit outstanding of Rs. 23 billion) respectively, bringing the total to 21.6 million accounts. The remainder of the 15 million accounts in the less than Rs. 25,000 category may or may not be unsecured credit. If 10 per cent of these are unsecured credit, there would at least be 23.5 million accounts in the banking system that could become eligible for FS.

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<sup>4</sup> Outstanding Credit of Scheduled Commercial Banks : Size of Credit. Less than 25,000. CMIE Economic Outlook and Basic Statistical Returns of Scheduled Commercial Banks in India. Reserve Bank of India.

## Data: Micro-Finance

Industry reports suggest that as of 2017-18, there were a total of 35 million clients of Micro Finance Institutions (MFIs), with a gross outstanding portfolio of Rs. 688 billion.<sup>5</sup> The average loan per borrower was about Rs. 14,700 suggesting that a large proportion of MFI borrowers may become eligible for a FS under the debt criteria. It is extremely difficult to assess the income and assets of this set of individuals, and a Below Poverty Line (BPL) card may be a useful proxy. According to industry reports, 65 per cent of micro-finance clients have a BPL card. The other condition for eligibility is that the borrower should not be a home-owner. Since 96 per cent of MFI clients are women, it is likely that they are not primary home-owners and therefore eligible for the FS process. This suggests that about 23 million MFI borrowers (those with BPL cards) are likely to become eligible for FS. Here again, the actual number may depend on the outstanding debt of these households, and it is quite possible that several of them have debt outstanding greater than Rs. 35,000 (since we only have an average estimate of Rs.14,700).

## Data: Household Surveys

Banking sector plus micro-finance gives us a total of about 46 million accounts. Since these are accounts and not individuals, they may not be unique. That is, it is possible that the same individual has multiple accounts across banks, and micro-finance. In addition, many of these individuals may actually get disqualified on the basis of their income and assets.

Household surveys can provide a comprehensive picture of an individual's portfolio. Unfortunately, there is no one nationally representative household survey in India that gives us all three metrics. The National Sample Survey Office All India Debt and Investment Survey (AIDIS) is not able to provide details on income, and is also dated - the last available release is as of 2012-13. Other surveys, such as the National Bank for Agriculture and Rural Development (NABARD) All India Financial Inclusion Survey (NAFIS) do not provide a comprehensive picture at both the urban and rural levels.<sup>6</sup>

The AIDIS data suggests that the average cash dues outstanding per household was Rs. 32,522 and Rs. 84,625 respectively for the rural and urban areas, higher than the FS threshold of Rs. 35,000.<sup>7</sup> There is, however, a huge variation depending on how asset-rich the household is. The average value of outstanding debt is lower than Rs. 35,000 for the bottom seven deciles (by asset holding) in rural areas and five deciles (by asset holding) in urban areas. However, the average value of assets of even the lowest decile in rural India was about Rs. 25,071 higher than the Rs. 20,000 limit set under the FS, while that of the first two deciles in urban India was under the Rs. 20,000 FS limit.<sup>8</sup> This suggests that at most the bottom two deciles of households in India will be eligible for the FS.

India has about 252 million households. The bottom two deciles would constitute about 50 million households. If about 46 per cent of households are indebted<sup>9</sup> then this brings us to about 23 million households. If, however, the incidence of indebtedness is 20 per cent, then the number of households is 10 million.<sup>10</sup>

<sup>5</sup> Sa-dhan. The Bharat Micro-Finance Report, 2018.

<sup>6</sup> NAFIS was launched in 2016-17 as a national level survey to provide an overview of the rural population in terms of their status of livelihoods and level of financial inclusion.

<sup>7</sup> Key Indicators of Debt and Investment in India, NSSO 70<sup>th</sup> Round, January - December 2013, Statement 3.15, pp. 28.

<sup>8</sup> Key Indicators of Debt and Investment in India, NSSO 70<sup>th</sup> Round, January - December 2013, Statement 3.2, pp. 11.

<sup>9</sup> Subhamoy Chakraborty and Renuka Sane (2019), Household Debt in India, *The Leap Blog*; Also see the NAFIS 2016-17.

<sup>10</sup> Key Indicators of Debt and Investment in India, NSSO 70<sup>th</sup> round, January - December 2013, Statement 3.4, pp. 19.

### Estimates of Coverage

The numbers from the banking and micro-finance industries point towards approximately 23 million accounts being eligible for a FS. If these are exclusive of each other than one can expect about 46 million accounts that might be eligible. If each individual holds at least two accounts, then we have about 23 million individuals who might become eligible for a fresh start on the basis of the debt outstanding. The AIDIS survey suggests that between 10-23 million households might be eligible depending on the actual incidence of indebtedness. The coverage, therefore, through a very rough estimate is likely to be around 10-25 million borrowers.<sup>11</sup> This may be an overestimate if either of the thresholds bind, or if the same households have multiple borrowings. The actual update of the FS will obviously be lower than this number.

#### LOAN WAIVERS VS. FRESH START

Even though the FS will not cover every individual debtor, there remain concerns that these thresholds will have an adverse impact on the credit industry. First, it is argued that if individuals are allowed to get a debt waiver, then it may create moral hazard and destroy credit culture. Second, some believe that local politicians may incite individuals to default using the provisions of the Code, as was done after demonetisation, and this may wipe-off the micro-finance industry. The formal sector may become reluctant to lend, increasing the cost of credit, pushing individuals further to the informal sources of credit.

It is important to remember that a politically declared loan waiver is not the same as a FS. The decision to apply for a waiver is that of the individual, and each instance of availing of the FS will be recorded at IBBI. As a result, the individual is forced to evaluate the trade-off between a waiver of debts in the present vs. potentially higher cost of credit in the future. This is likely to act as a check against abuse of these provisions, as the waivers are not 'free'.

The existence of FS would make it possible to implement the waivers through a more structured process, and also ensure that the benefits actually reach the intended recipients, which cannot be said of loan waivers implemented earlier.<sup>12</sup> The FS would now be available at any point in time, and one can hope that the political gains from declaring something that is available by law are lower. Finally, the waiver of debts might actually make the borrowers more creditworthy as their balance sheets will now be clean. For a lender, the process of going through resolution of this debt is likely to be more expensive than the write-off from a waiver.

#### CONCLUSION

In conclusion, the FS provisions of the Code will apply to a small subset of the most vulnerable borrowers. While preliminary estimates suggest that these would be in the range of about 20-25 million households, this may be an overestimate if either of the thresholds bind, or if the same households have multiple borrowings. Not all of these households will be in distress and have reason to file. There is evidence from across the world that many people who are qualified and would benefit financially from getting bankruptcy relief, fail to do so, for various reasons such as lack of information, access, stigma. These factors are also likely to be present in India as well.

<sup>11</sup> This assumes about one borrower per household.

<sup>12</sup> Renuka Sane and Amey Sapre (2017). Implementing loan waivers: Lessons from the 2008 All India Debt Waiver Scheme experience. *The Leap Blog*. <https://blog.theleapjournal.org>

The actual number of filers is almost certainly going to be far less than the number of people who are eligible.

The FS will provide them with a dignified means of availing a waiver, without having to resort to a politically motivated process that destroys credit culture. There may be an initial overreaction by industry until they get a sense of how many actual filers there are, but it should stabilise over time. The implementation of the process is not going to be without its set of challenges.<sup>13</sup> If done well, then it might prove to be an effective means of providing relief to distressed borrowers.

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<sup>13</sup> Renuka Sane (2018). Loan waivers as fresh start in bankruptcy. *The Leap Blog*. <https://blog.theleapjournal.org>



## *Cross-Border Insolvency: Challenges and Opportunities*

T. K. Viswanathan

**G**lobalisation of markets has necessitated unification of legal principles governing commercial transactions. Capital searches the Globe for best returns. With the advent of digital technology and interconnected computer networks it is easy to move money out of a nation's financial system by a click of a button. In a modern society, substantial business transactions take place between businesses operating in multiple jurisdictions. In the event of an insolvency, businesses are often involved in coordinating cross-border insolvency proceedings through a number of jurisdictions in which that business may operate, or in which that business may have assets or be due accounts receivable from various third parties. To address this need, many sophisticated economies have well developed cross-border insolvency laws.

The Insolvency and Bankruptcy Bill, 2015 as recommended by the Bankruptcy Law Reforms Committee (BLRC) Report<sup>1</sup> did not contain provisions to address cross-border insolvency issues. But when the Bill was examined by the Joint Committee of Parliament, the Committee expressed the need to address the cross-border insolvency issues.

Since adequate institutional back up was not readily available to deal with cross-border insolvencies, the Insolvency and Bankruptcy Bill, 2015 did not address cross-border issues when it was introduced in the winter session of Lok Sabha in 2015. The requisite institutional backups were dedicated bankruptcy courts, well-organised resolution professionals, information utilities and seamless communication between bankruptcy courts of different jurisdictions. To address the lacunae the Joint Committee of Parliament which examined the Insolvency and Bankruptcy Bill, 2015 recommended two sections which were added as a stop gap measure and was enacted as the Insolvency and Bankruptcy Code, 2016 (Code) to deal with cross-border insolvency issues<sup>2</sup>. However both these provisions do not provide the adequate framework to deal with cross border insolvency issues effectively.

As early as in 2002, the Prof. Mitra Committee Report on Bankruptcy Laws,<sup>3</sup> *inter alia*, identified some of the issues which may arise in cross-border insolvency and highlighted the need for a cross border insolvency law. However, the Report was not acted upon. Due to the inadequacy of the bilateral treaty approach to deal with cross-border insolvency, it is necessary to explore other mechanisms to address the problem.

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<sup>1</sup> Report of the BLRC: Volume 1 – Design and Rationale. Insolvency and Bankruptcy Board of India. [https://www.ibbi.gov.in/uploads/resources/BLRCReportVol1\\_04112015.pdf](https://www.ibbi.gov.in/uploads/resources/BLRCReportVol1_04112015.pdf).

<sup>2</sup> Section 234 to provide for agreements with foreign countries and section 235 to provide for letter of request to a country outside India in certain cases. Para 62, Report of the Joint Committee on the Insolvency and Bankruptcy Code.

<sup>3</sup> The Report of the Advisory Group on Bankruptcy Laws. Reserve Bank of India. February 2002.

## THREE LEGAL THEORIES

A brief discussion about the theoretical basis for cross-border insolvency will help us to understand the issue in the proper perspective. According to Irit Mevorach, the theoretical basis for cross-border insolvency veers around three legal theories, namely Universalism, Territorialism and Modified Universalism.<sup>4</sup> Universalism aims to provide a single forum applying a single legal regime to administer the debtor's assets and liabilities on a worldwide basis. In contrast, territorialism is founded on the idea of state sovereignty, where each country employs its own insolvency laws to grab the assets and administer them locally according to the procedures and priorities of that country's laws. In such a system, there is no recognition of foreign proceedings because it envisages that insolvency proceedings within a jurisdiction have effect only within that jurisdiction.<sup>5</sup> In other words, local assets are meant for local creditors, regardless of proceedings occurring elsewhere. Universalism implies that property owned by the foreign debtor in any part of the world back to the debtors home jurisdiction in order for the property can be distributed to the debtors' creditors in conformity with the local jurisdiction's distribution scheme.<sup>6</sup> Modified Universalism incorporates the philosophy of universalism but accepts that a country may only unilaterally control its own territory and laws and uses private international laws and rules and shapes them to fit global insolvency in line with Universalist theory to provide a global collective process. Under the Modified Universal regime, a country does not try to coordinate its legislation with another country but rather creates a system that is open to cooperation while seeking broadest impact for its own laws. It prescribes that courts should, as far as is consistent with justice, public policy and unique domestic considerations, actively assist and cooperate with the courts of the country of the principal liquidation. It combines the theories of universality and territoriality wherein one forum hosts a primary insolvency proceeding to which other jurisdictions supplement with ancillary or secondary proceedings.<sup>7</sup>

## UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY

The United Nations Commission on International Trade Law (UNCITRAL) Model law on Cross-Border Insolvency [MLCBI/ Model Law]<sup>8</sup> adopts Modified Universalism and finds favour with most of the international community. It is the most widely accepted blue-print to effectively deal with cross-border insolvency issues, while ensuring the least intrusion into each country's internal insolvency and bankruptcy laws. MLCBI contains uniform rules concerning large portions of modified universalism norms, specifically regarding recognition of main, as well as non-main, proceedings, a range of relief that should be provided to foreign proceedings, assistance to foreign courts and foreign representatives, and mechanisms to enhance cooperation and coordination between courts and insolvency representatives.

The Model Law allows the determination as to when a foreign insolvency proceeding should be accorded 'recognition' and what the consequences of such a recognition may be. It

<sup>4</sup> Mevorach, Irit. *The Future of Cross-Border Insolvency* (p. x). OUP Oxford. Kindle Edition.

<sup>5</sup> Justice A. K. Sikri (2009). *Cross Border Insolvency: Court to Court Cooperation*, *Journal of the Indian Law Institute* Vol. 51, No. 1, pp. 468-69.

<sup>6</sup> Mevorach, Irit. *supra* note 4;

<sup>7</sup> Mevorach, Irit. *supra* note 4;

<sup>8</sup> The Model Law was adopted in 1997 by the General Assembly by Resolution 52/158 of December 15, 1997. Prior to this, the UNCITRAL adopted the Model Law by consensus on May 30, 1997.

provides the person administering a foreign insolvency proceeding ('foreign representative') with access to the courts of the enacting country. In this way, it permits the foreign representative to seek a temporary breathing space, and allows the courts in the enacting country to determine what coordination among the jurisdictions or other relief is warranted for optimal disposition of the insolvency. It permits courts in the enacting country to cooperate more effectively with foreign courts and representatives involved in an insolvency matter; authorises courts in the enacting country and persons administering insolvency proceedings in the enacting country to seek assistance abroad; provides for court jurisdiction and establishing rules for coordination where an insolvency proceeding in the enacting country is taking place concurrently with an insolvency proceeding in a foreign country; and establishes rules for coordination of relief granted in the enacting country to assist two or more insolvency proceedings that may take place in foreign country regarding the same debtor.

The Model Law is supplemented by:

- UNCITRAL Legislative Guide on Insolvency Law (Legislative Guide), which, together with the World Bank Principles on Creditor– Debtor Regimes (World Bank Principles), constitutes the international best-practice standard for insolvency regimes (the Insolvency Standard);
- UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation (2009) (Practice Guide)<sup>9</sup> which addresses two main subjects:
  - Possible forms of cooperation under Article 27 (Section II);
  - Cross-border insolvency agreements (Section III) - Containing agreements contemplated by Article 27(d) of the Model Law. The Practice Guide includes 'sample clauses', which are based to varying degrees upon provisions found in actual insolvency agreements.<sup>10</sup> The Practice Guide also provides information for insolvency practitioners and judges on practical aspects of cooperation and communication in cross-border insolvency cases. It illustrates how the resolution of issues and conflicts that might arise in those cases could be facilitated by cross-border cooperation, in particular through the use of cross-border insolvency agreements, tailored to meet the specific needs of each case and the requirements of applicable law.<sup>11</sup>
- UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective, (2011)<sup>12</sup> which contains a chapter entitled 'Cooperation and Coordination'.<sup>13</sup> It discusses the UNCITRAL Model Law on Cross-Border Insolvency from a judge's perspective.

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<sup>9</sup> Date of adoption: July 01, 2009;

<sup>10</sup> Annexe 1 to the UNCITRAL Practice Guide includes summaries of the cases in which the cross-border insolvency agreements that form the basis of the Practice Guide were concluded.

<sup>11</sup> Chapter I of the Practice Guide discusses the increasing importance of coordination and cooperation in cross-border insolvency cases and introduces various international texts relating to cross-border insolvency that have been developed in recent years. Chapter II expands upon article 27 of the UNCITRAL Model Law, discussing the various ways in which cooperation in cross-border cases might be achieved. Chapter III examines in detail the use of cross-border insolvency agreements, a number of which have been entered into in cross-border insolvency cases over the past two decades, ranging from written agreements approved by courts to oral arrangements between parties to the proceedings. The analysis in this chapter is based on practical experience, in particular, in the cases summarised in annex I. "Sample clauses", based to varying degrees upon provisions found in these agreements, are included to illustrate how different issues have been or might be addressed in practice.

<sup>12</sup> The UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective was finalised and adopted by the UNCITRAL on July 01, 2011.

<sup>13</sup> UNCITRAL Model Law on Cross-Border Insolvency: The Judicial Perspective (2012) *United Nations Commission on International Trade Law*. [https://www.uncitral.org/pdf/english/texts/insolven/V1188129-Judicial\\_Perspective\\_ebook-E.pdf](https://www.uncitral.org/pdf/english/texts/insolven/V1188129-Judicial_Perspective_ebook-E.pdf).

Recognising that some enacting States have amended the Model Law to suit local circumstances, different approaches might be required if a judge concludes that the omission or modification of a particular article from the text as enacted necessitates such a course. The purpose of this Perspective is to use the decided cases solely to illustrate particular strands of reasoning that might be adopted in addressing specific issues. In each case, the judge will determine the case at hand on the basis of domestic law, including the terms of legislation enacting the Model Law.

- Recognition and enforcement of insolvency-related judgments: draft Model Law<sup>14</sup>

The purpose of this Model Law is:

- to create greater certainty for parties in regard to their rights and remedies for [recognition and] enforcement of insolvency-related judgments;
- to avoid the duplication of proceedings;
- to ensure timely and cost-effective recognition and enforcement of insolvency-related judgments;
- to promote comity and cooperation between jurisdictions regarding insolvency-related judgments;
- to protect and maximise the value of insolvency estates; and
- where legislation based on the Model Law on Cross-Border Insolvency has been enacted, to complement that legislation.

The four broad features of the Model Law are as follows:

- Access to Adjudicating Authority (AA) for representatives of foreign insolvency proceedings and authorisation to resolution professional (RP) and Liquidator appointed under the Code to seek assistance elsewhere;
- Recognition of certain orders issued by foreign courts;
- Relief to assist foreign proceedings; and
- Cooperation among the courts of countries where the debtor's assets are located and coordination of concurrent proceedings.

#### CHALLENGES AND AVENUES FOR JUDICIAL COOPERATION

There are two main challenges which must be addressed while dealing with cross-border insolvencies. The first relates to judicial cooperation between bankruptcy courts of different jurisdictions and the second relates to the concept of Centre of Main Interests (COMI).

Articles 25 and 27 provide for cooperation between courts (and between courts and foreign representatives) in the cross-border insolvency matters that are referred to in Article 1 of the Model Law.<sup>15</sup> The Model Law does not specify any mode of communication. However, the UNCITRAL Guide to Enactment of the Model Law (UNCITRAL Guide to Enactment)<sup>16</sup> notes that the ability of courts, with the appropriate involvement of the parties, to communicate 'directly' and to request information and assistance 'directly' from foreign courts is intended to avoid the use of time-consuming procedures traditionally in use, such as letters rogatory.

Article 25 is 'designed to overcome the widespread problem of national laws lacking rules

<sup>14</sup> Official Records of the General Assembly, 69<sup>th</sup> Session, Supplement No. 17 (A/69/17), para. 155. A/CN.9/WG.V/WP.150 4/4 V.17-06658.

<sup>15</sup> Cooperation with Foreign Courts and Foreign Representatives- Chapter IV of the Model Law

<sup>16</sup> UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html), [218].

providing a legal basis for cooperation by local courts with foreign courts in dealing with cross-border insolvencies.<sup>17</sup> The UNCITRAL Guide to Enactment contemplates that 'enactment of such a legal basis would be particularly helpful in legal systems in which the discretion given to judges to operate outside areas of express statutory authorisation is limited. However, even in jurisdictions in which there is a tradition of wider judicial latitude, enactment of a legislative framework for cooperation has proved to be useful.<sup>18</sup>

Article 27 identifies relevant forms of cooperation.<sup>19</sup> It was included in the Model Law in recognition that the idea of cooperation: '*might be unfamiliar to many judges and insolvency representatives.*'<sup>20</sup> The Guide states that the list is indicative '*to avoid inadvertently precluding certain forms of appropriate cooperation and limiting the ability of courts to fashion remedies in keeping with specific circumstances.*'<sup>21</sup>

The UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation (2009) (UNCITRAL Practice Guide) identifies certain potential benefits of establishing communication in cross-border insolvency proceedings<sup>22</sup> and states that:

'[j]udicial cooperation is increasingly viewed as essential to the efficient and effective conduct of cross-border insolvency cases, increasing the predictability of the process, because debtors and creditors do not have to anticipate judicial reactions to foreign proceedings, and enhancing the equitable treatment of all parties.'<sup>23</sup>

#### GUIDELINES FOR COMMUNICATION AND COOPERATION BETWEEN COURTS

To supplement the requirements of the aforementioned Articles, the Judicial Insolvency Network (JIN) issued the Guidelines for Communication and Cooperation between Courts in Cross-Border Insolvency Matters (JIN Guidelines) also known as the JIN Guidelines, in its inaugural Conference in 2016. The JIN Guidelines have been adopted by England and Wales on May 04, 2017. An interesting part of the Guidelines is Annex A which relate to Guidelines on the Conduct of Joint Hearings by courts of different jurisdictions. The JIN serves as a platform for sustained and continuous engagement, for the furtherance of the following three objectives:

- judicial thought leadership in cross-border insolvency and restructuring;
- to develop best practices in cross-border insolvency and restructuring; and

<sup>17</sup> UNCITRAL Guide to Enactment, [213].

<sup>18</sup> Ibid.

<sup>19</sup> It outlines the Forms of Cooperation as follows -

Cooperation referred to in articles 25 and 26 may be implemented by any appropriate means, including:

- (a) Appointment of a person or body to act at the direction of the court;
- (b) Communication of information by any means considered appropriate by the court;
- (c) Coordination of the administration and supervision of the debtor's assets and affairs;
- (d) Approval or implementation by courts of agreements concerning the coordination of proceedings;
- (e) Coordination of concurrent proceedings regarding the same debtor;
- (f) [The enacting State may wish to list additional forms or examples of cooperation].

<sup>20</sup> Id. at 41

<sup>21</sup> Id. at 220.

<sup>22</sup> The Practice Guide identifies the following potential benefits of establishing communication in cross-border proceedings:

- (a) assisting parties in better understanding the implications or application of foreign law, particularly the differences or overlaps that may otherwise lead to litigation;
- (b) facilitating resolution of issues through a negotiated result acceptable to all;
- (c) eliciting more reliable responses from parties, avoiding inherent bias and adversarial distortion that may be apparent where parties represent their own particular concerns in their own jurisdictions;
- (d) serving international interests by facilitating better understanding that will assist in encouraging international business and preserving value that would otherwise be lost through fragmented judicial action; and
- (e) the possible revelation of some fact or procedure that will substantially inform the best resolution of the case and may, in the longer term, serve as an impetus to law reform

<sup>23</sup> UNCITRAL Practice Guide, [56] [http://www.uncitral.org/pdf/english/texts/insolven/Practice\\_Guide\\_english.pdf](http://www.uncitral.org/pdf/english/texts/insolven/Practice_Guide_english.pdf).

- to facilitate communication and cooperation amongst national courts in cross-border insolvency and restructuring matters.

The overarching aim of the JIN Guidelines is the preservation of enterprise value and the reduction of legal costs. It adds to the other sources of guidance about judicial cooperation by providing a framework for parties to cross-border insolvency proceedings to customise protocols that will facilitate court-to-court communication and cooperation in the relevant case.

The JIN Guidelines sets out the following six matters which the Guidelines aim to promote:

- efficient and timely coordination and administration of parallel proceedings;<sup>24</sup>
- the administration of parallel proceedings with a view to ensuring relevant stakeholders' interests are respected;
- identification, preservation, and maximisation of the value of the debtor's assets, including the debtor's business;
- management of the debtor's estate in ways that are proportionate to the amount of money involved, the nature of the case, the complexity of the issues, the number of creditors and the number of jurisdictions involved in parallel proceedings;
- sharing of information in order to reduce costs; and
- avoidance or minimisation of litigation, costs, and inconvenience to the parties in parallel proceedings.

#### JOINT HEARINGS UNDER JIN GUIDELINES

The JIN Guidelines include the following principles for application in connection with a joint hearing of courts in different jurisdictions, noting that by the implementation of the principles, 'neither a court nor any party shall be deemed to have approved or engaged in any infringement on the sovereignty of the other jurisdiction':

- Each court shall have sole and exclusive jurisdiction and power over the conduct of its own proceedings and the hearing and determination of matters arising in its proceedings;
- Each court should be able to simultaneously hear the proceedings in the other court(s). Consideration should be given as to how to provide the best audio-visual access possible;
- Consideration should be given to coordination of the process and format for submissions and evidence filed or to be filed in each court;
- A court may make an order permitting foreign counsel or any party in another jurisdiction to appear and be heard by it. If such an order is made, consideration needs to be given as to whether foreign counsel or any party would be submitting to the jurisdiction of the relevant court and/or its professional regulations;
- A court should be entitled to communicate with the other court in advance of a joint hearing, with or without counsel being present, to establish the procedures for the orderly making of submissions and rendering of decisions by the courts, and to

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<sup>24</sup> Parallel Proceedings' is defined in the JIN Guidelines to mean: cross-border proceedings relating to insolvency or adjustment of debt opened in more than one jurisdiction.

coordinate and resolve any procedural, administrative or preliminary matters relating to the joint hearing; and

- A court, subsequent to the joint hearing, should be entitled to communicate with the other court, with or without counsel present, for the purpose of determining outstanding issues. Consideration should be given as to whether the issues include procedural and/or substantive matters. Consideration should also be given as to whether some or all of such communications should be recorded and preserved.

#### EU JudgeCo PLATFORM, PRINCIPLES AND GUIDELINES

The EU JudgeCo Platform provides another forum for valuable sources on cross-border insolvency court-to-court cooperation and communication in the context of the European Union (EU).<sup>25</sup> The EU Cross-Border Insolvency Court-to-Court Cooperation Principles<sup>26</sup> cover 26 Court-to-Court Cooperation Principles (EU JudgeCo Principles) and 18 EU Cross-Border Insolvency Court-to-Court Communications Guidelines (EU JudgeCo Guidelines).

These 26 non-binding EU JudgeCo Principles encompass subjects such as the objectives of cooperation in cross-border insolvency cases, case management by a court, the equal treatment of creditors, the approach to a stay or moratorium, cooperation in achieving a cross-border sale or an international reorganisation plan, and principles about judicial decisions itself, such as the giving and publication of reasons.<sup>27</sup> Several principles relate to aspects of the conduct of the proceedings, such as language, the provision of notice to creditors and insolvency practitioners, and the authentication of documents.

According to the EU JudgeCo Guidelines<sup>28</sup> commentary, a joint hearing requires that either court can also question a person who has appeared before the other court or allow one or more persons to speak and includes the following 'safeguards' for direct 'judge-to-judge' cross-border communication in international insolvency cases:

- direct 'judge-to-judge' cross-border communication should occur only where such communication is necessary;
- direct 'judge-to-judge' cross-border communication should relate to matters which do not concern the substantive merits of the case; and
- direct judicial cross-border communication can only take place where there are sufficient procedural safeguards in place to ensure that parties have an opportunity to be heard on the application to communicate and (if appropriate) to attend (or be represented at) the occasion on which the communication takes place.

#### COMI AND LESSONS FROM JURISPRUDENCE

The second area where we can encounter some initial difficulties in dealing with cross border insolvencies relates to the concept of COMI. The concept of a debtor's COMI is fundamental to

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<sup>25</sup> EU JudgeCo Platform. Leiden University. <https://www.universiteitleiden.nl/en/research/research-projects/law/eu-judgeco-platform>.

<sup>26</sup> EU Cross-Border Insolvency Court-to-Court Communications Guidelines; [http://www.ejtn.eu/PageFiles/16467/EU\\_Cross-Border\\_Insolvency\\_Court-to-Court\\_Cooperation\\_Principles.pdf](http://www.ejtn.eu/PageFiles/16467/EU_Cross-Border_Insolvency_Court-to-Court_Cooperation_Principles.pdf)

<sup>27</sup> Wessels, B. EU Courts Can Rely on Soft Law Principles for Cooperation in Cross-border Insolvency Cases.

<https://www.law.ox.ac.uk/business-law-blog/blog/2016/04/eu-courts-can-rely-soft-law-principles-cooperation-cross-border>. Wessels, B. Cross-border Insolvency Court-to-Court Cooperation Principles gain wide support. <https://leidenlawblog.nl/articles/cross-border-insolvency-court-to-court-cooperation-principles-gain-wide-sup>.

<sup>28</sup> Guideline No. 10

the operation of the Model Law. In practice, simultaneous application of the divergent and conflicting COMI tests opens the door to forum shopping, jurisdictional conflicts and even situations in which the COMI of the same company is found in different states at the same time. The Model Law accords proceedings commenced in that location greater deference and, more immediate and automatic relief.

The essential attributes of the debtor's COMI correspond to those attributes that will enable those who deal with the debtor (especially creditors) to ascertain the place where an insolvency proceeding concerning the debtor is likely to commence.

The corporate debtor's (CD) COMI may be identified by the ordinary place of its business. To determine that the following factors may be relevant namely:

- location of the CD's books and records;
- location where financing was organised or authorised, or from where the cash management system was run;
- location in which the CD's principal assets or operations are found;
- location of the CD's primary bank;
- location of employees;
- location in which commercial policy was determined;
- site of the controlling law or the law governing the main contracts of the company;
- location from which purchasing and sales policy, staff, accounts payable and computer systems were managed;
- location from which contracts (for supply) were organised;
- location from which reorganisation of the CD was being conducted;
- jurisdiction whose law would apply to most disputes;
- location in which the debtor was subject to supervision or regulation; and
- location whose law governed the preparation and audit of accounts and in which they were prepared and audited. For an individual, their habitual place of residence shall be the centre of main interest.

Due to the vague nature of the COMI concept and the absence of its definition, determining the place of the COMI has thus been quite problematic. A brief outline of a few cases involving COMI from the US and the EU will shed light on the complex issues which come into play when courts are confronted with cross-border insolvency cases.

The Model Law was incorporated into UK legislation through the Cross-Border Insolvency Regulations in 2006 (CBIR), in the US in the form of Chapter 15 of the Federal Bankruptcy Code in 2005<sup>29</sup> and in the EU as the European Insolvency Regulation (EIR). EIR Recast (Article 3) and Chapter 15 (11 USC § 1516(c)) presume that the debtor's registered office coincides with its COMI. However, European courts have set a rather high bar for the rebuttal of the presumption and require the applicant to provide sufficient evidence that COMI is

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<sup>29</sup> The stated purpose of Chapter 15 is to "incorporate the Model Law on Cross-Border Insolvency so as to provide effective mechanisms for dealing with cases of cross-border insolvency." 11 U.S.C. § 1501(a). Section 1501(a) provides that Chapter 15 is intended to serve the following objectives:

- (i) cooperation between courts of the United States, United States trustees, trustees, examiners, debtors, and debtors in possession; and the courts and other competent authorities of foreign countries involved in cross-border insolvency cases;
- (ii) greater legal certainty for trade and investment;
- (iii) fair and efficient administration of cross-border insolvencies that protects the interests of all creditors, and other interested entities, including the debtor; protection and maximization of the value of the debtor's assets; and
- (iv) facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

somewhere else whereas the US courts treat the presumption as merely indicative for 'speed and convenience'.<sup>30</sup>

The EU Regulation 1346/2000, Article 3 (1) states that the place which has the debtor's COMI gives jurisdiction to the court of the concerned Member State to initiate main insolvency proceedings. Furthermore, if there is no proof of contradiction, COMI is presumed to be the place where the company has its registered office. Although the regulation does not define COMI, it is stated in Recital 13 of the regulation that the location/setting where a debtor carries out administration in pursuance of its interests on a consistent basis and 'ascertainable by third parties' should be the COMI of the debtor.

The European Court of Justice in *Interedil Srl*, case<sup>31</sup> on a reference<sup>32</sup> for a preliminary ruling concerning the interpretation of Article 3 of Council Regulation (EC) No. 1346/2000 of May 29, 2000 on insolvency proceedings, by a judgment dated October 20, 2011, defined the term 'COMI'. The Court ruled that the term 'Centre of a debtor's main interests' in Article 3(1) of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings must be interpreted by reference to EU law. That concept is peculiar to the Regulation and must therefore be interpreted in a uniform way, independently of national legislation.<sup>33</sup>

#### **According to the Court:**

For the purposes of determining a debtor company's main centre of interests, the second sentence of Article 3(1) of Regulation No 1346/2000 on insolvency proceedings must be interpreted as meaning that a debtor company's main centre of interests must be determined by attaching greater importance to the place of the company's central administration, as it may be established by objective factors ascertainable by third parties. If the bodies responsible for the management and supervision of a company are to be found in the same place as its registered office and the management decisions of the company are taken, in a manner ascertainable by third parties, in that place, the presumption in that provision cannot be rebutted. If a company's central administration is not to be found in the same place as its registered office, the presence of company assets and the existence of contracts for the financial exploitation of those assets in a Member State other than that in which the registered office is situated cannot be regarded as sufficient factors to rebut the presumption unless a comprehensive assessment of all the relevant factors makes it possible to establish, in a manner ascertainable by third parties, that the company's actual centre of management and supervision and of the management of its interests is located in that other Member State.

When a debtor company's registered office is transferred before a request to open insolvency proceedings is lodged, the company's centre of main activities is presumed to be the place of its new registered office.<sup>34</sup>

<sup>30</sup> Wessels, B. COMI under European and American Insolvency Law. <https://www.law.ox.ac.uk/business-law-blog/blog/2019/02/comi-under-european-and-american-insolvency-law>.

<sup>31</sup> Case C-396/09, *Interedil Srl*, in liquidation v. *Fallimento Interedil Srl and Intesa Gestione Crediti SpA*. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A62009CJ0396>. (Reference for a preliminary ruling from the *Tribunale di Bari*.)

<sup>32</sup> The reference was made in proceedings between *Interedil Srl*, in liquidation, on the one hand and *Fallimento Interedil Srl and Intesa Gestione Crediti SpA*, of which *Italfondario SpA* is the successor, on the other, concerning a petition for bankruptcy filed by *Intesa* against *Interedil*. *Interedil* challenged the jurisdiction of the Italian court on the ground that, as a result of the transfer of its registered office to the United Kingdom, only the courts of that Member State had jurisdiction to open insolvency proceedings.

<sup>33</sup> *Ibid*; See paras 43-44, operative part 2

<sup>34</sup> *Ibid*; See para. 59, operative part 3.

Finally, the Court added that the term 'establishment' within the meaning of Article 3(2) of Regulation No. 1346/2000 must be interpreted as requiring the presence of a structure consisting of a minimum level of organisation and a degree of stability necessary for the purpose of pursuing an economic activity. The presence alone of goods in isolation or bank accounts does not, in principle, meet that definition.

One of the questions that arose in relation to the CBIR and the Model Law is whether the key concepts of COMI and establishment have the same meanings in the Model Law as they have in the EIR that was entered into force in 2016. In particular, some of the US case law on Chapter 15 of the US Bankruptcy Code seemed to develop a concept of COMI rather different from that put forward in the Eurofood case.

In the *Eurofood* case<sup>35</sup> the Irish High Court decided that, according to Irish law, the insolvency proceedings in respect of Eurofood had been opened in Ireland on the date on which the application was submitted by the Bank of America NA, namely January 27, 2004. Taking the view that the COMI of Eurofood was in Ireland, it held that the proceedings opened in Ireland were the main proceedings. It also held that the circumstances in which the proceedings were conducted before the District Court, Parma, Italy were such as to justify the refusal of the Irish courts to recognise the decision of that court. Finding that Eurofood was insolvent, the High Court made an order for winding up and appointed Mr Farrell as the liquidator. On appeal against that judgment, the Supreme Court considered it necessary, before ruling on the dispute before it, to refer various questions concerning the interpretation of the Regulation to the European Court of Justice (ECJ). The ECJ was asked to determine whether the Irish or the Italian court had jurisdiction to commence 'main' insolvency proceedings in respect of Eurofood IFSC Limited. The ECJ first considered what was the determining factor for identifying the COMI of a subsidiary company, where it and its parent have their respective registered offices in two different Member States. The ECJ confirmed that the principle of 'mutual trust' requires member states to recognise a decision opening main proceedings without being able to review the assessment made by the first court as to its jurisdiction (*Article 16 and Recital 22, the Regulation*). If an interested party with a different view on the debtor's COMI wishes to challenge that decision, he may only do so using the remedies prescribed by the national law of the member state in which the main proceedings were opened. Finally, the ECJ ruled in favour of the Irish court.

*In re Ocean Rig Udw Inc.*<sup>36</sup> the debtors earlier maintained their COMI, in the Republic of the Marshall Islands (RMI), which did not have a statute or any procedures permitting reorganisation. The debtors therefore sought to move their COMI to Cayman Islands, which had statutory law and procedures permitting restructuring. The bankruptcy court found that

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<sup>35</sup> Eurofood was registered in 1997 with its registered office in Dublin. It is a wholly owned subsidiary of Parmalat SpA, a company incorporated in Italy. On December 24, 2003, Parmalat SpA was admitted to extraordinary administration proceedings by the Italian Ministry of Production Activities, who appointed Mr Bondi as the extraordinary administrator. On January 27, 2004, the Bank of America NA applied to the High Court (Ireland) for compulsory winding up proceedings to be commenced against Eurofood and for the nomination of a provisional liquidator. On the same day the High Court appointed Mr Farrell as the provisional liquidator. On February 09, 2004, the Italian Minister for Production Activities admitted Eurofood to the extraordinary administration procedure and appointed Mr Bondi as the extraordinary administrator. On 10 February 2004, an application was lodged before the District Court, Parma, for a declaration that Eurofood was insolvent. The hearing was fixed for February 17, 2004, Mr Farrell being informed of that date on February 13, 2004. On February 20, 2004, the District Court in Parma, taking the view that Eurofood's COMI was in Italy, held that it had international jurisdiction to determine whether Eurofood was in a state of insolvency.

<sup>36</sup> 585 B.R. 31, 36-37 (S.D.N.Y. 2018).

none of the debtors have ever maintained administrative, management, or executive offices in the Marshall Islands RMI, have ever had any directors who were residents or citizens of the Marshall Islands RMI, or have ever held a meeting of its directors or shareholders in the Marshall Islands RMI. In contrast, the bankruptcy court determined that, in light of the fact that several directors of the debtors had residences in the Cayman Islands, the debtors held regular board meetings in the Cayman Islands, several significant officers of UDW resided and worked in the Cayman Islands, office and administrative, services for the debtors were performed from the Cayman Islands, the share certificates of UDW's subsidiaries securing the various debt obligations were held in the Cayman Islands, the debtors all had bank accounts used for the debtors' business in the Cayman Islands, and the debtors' books and records were held in the Cayman Islands, that the debtors' COMI was the Cayman Islands.<sup>37</sup>

### CONCLUSION

The Code is a jewel in the Indian statute book and is a historic law reform legislation undertaken by the Government of India. Apart from reforming the credit market, the Code also represents a new direction of law reform which is likely to take shape in the coming years. The Central Government followed up the enactment of the Code with a continuous monitoring mechanism by constituting a Standing Committee on the Code<sup>38</sup> to respond to the challenges arising in the operation of the Code. This has given a great force to the Code by energising it to realise its stated objectives. So far Law reform in India revolves around doctrinal research and depends upon the accidents of litigation. Law in action studies and impact analysis are absent. There was no systematic and continuous law reform based on empirical and socio-legal research reflecting what Ehrlich calls as the living law<sup>39</sup> of the people. The Code is likely to change this trend and usher a new wave of law reform which will extensively use data and market indicators to keep the law in tune with current economic and social realities.

We have brilliant judges adorning the courts and tribunals who are charged with the duty of laying the foundation of new legislations enacted by Parliament. The appointments of Justice Sikri as international Judge of the Singapore International Court by the President of Republic of Singapore and Justice Madan B. Lokur as a Judge of the non-resident panel of the Supreme Court of Fiji sends a strong signal to the Global legal fraternity that our Judges are second to none and are of world class material. Since no legislation can be comprehensive so as to cover all possible situations which may arise in future judges of our Tribunals have deal with

<sup>37</sup> The bankruptcy court further determined that the debtors had not manipulated their COMI in bad faith and that the requirements of sections 109(a) and 1517(a) of the Bankruptcy Code, necessary for a bankruptcy court to confirm a foreign proceeding under Chapter 15, were met. In view of the above the Court held the Cayman Proceedings as 'foreign main proceedings' within the meaning of section 1502(4) of the Bankruptcy Code because each Debtor's COMI is the Cayman Islands and that scheme of adjustment proceedings pending in the Cayman Islands should be recognized as 'foreign main proceedings' under chapter 15 of the Bankruptcy Code, even though the debtors' COMI had been shifted to the Caymans less than a year before the proceedings were commenced, because the country in which the debtors' COMI had previously been located did not have a law permitting corporate restructurings.

<sup>38</sup> Reconstitution of the Insolvency Law Committee as Standing Committee for review of the Insolvency and Bankruptcy Code, 2016; Order No. 30/3/2019, Insolvency Section, Ministry of Corporate Affairs, dated March 06, 2019;

<sup>39</sup> The central point in *Ehrlich's* theory is that 'the law of a community is to be found in social facts and not in formal sources of law'. He says: 'At present as well as at any other time the centre of gravity of legal development lies not in legislation nor in juristic science, nor in judicial decision, but in society itself.' The living law is the law which dominates life itself even though it has not been posited in legal propositions. The source of our knowledge of this law is, first, the modern legal document; secondly, direct observation of life, of commerce, of customs and usages and of all associations, not only those that the law has recognised but also of those that it has overlooked and passed by, indeed even of those that it has disapproved. See Ziegert, Kurt A. (2001). *Fundamental Principles of Sociology of Law*. Walter L. Moll trans., Transaction Publishers. p. 19 (Originally published in 1936).

new situations and decide cases. As stated by Justice Cardozo<sup>40</sup> when a Judge is faced with a difficult case where legislation or precedent does not guide him he has to rely upon reading of life itself. Justice Holmes' prophecy more than hundred years ago that for the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics,<sup>41</sup> is going to be tested through the provisions of Code since the decision as to the revival of a firm will be a decision based on sound economic principles in tune with market realities and not on the dry bones of the black letter law. Accordingly, the Code reposes great faith in the wisdom of the market players in the credit market by empowering the financial creditors to take the final decision on the prospects of revival of a business enterprise.

With introduction of Cross-Border provisions our Tribunal Members will have more opportunities to interact with bankruptcy judges from other jurisdictions. With technology facilitating virtual court proceedings and tele-immersion hearings where judges sitting in different hemispheres in different time zones can seamlessly collaborate and lay down the foundation for a robust global insolvency Jurisprudence.

In the US, the American Bankruptcy Institute<sup>42</sup> (ABI) :

- plays a leading role in providing congressional leaders and the general public with non-partisan reporting and analysis of bankruptcy regulations, laws and trends and is often called on to testify before Congress, analyse proposed Bills, and conduct periodic briefings for congressional committees and legislative staff;
- provides professional service to its members with high-quality conferences, comprehensive continuing education, effective legal research, and dynamic networking opportunities;
- is engaged in numerous educational and research activities, as well as the production of a number of publications both for the insolvency practitioner and the dedicated to research and education on matters related to insolvency.

We need to emulate the ABI example and set up an institution like ABI where our bankruptcy judges and resolution professionals and other stakeholders can collaborate and contribute towards the development of insolvency jurisprudence.<sup>43</sup> We failed to capitalise the fruits of industrial revolution for historical reasons, but digital revolution is triggered by our youth. It is our revolution. If knowledge is capital, then we are all knowledge capitalists. We can leverage the benefits of knowledge revolution to our advantage and become a global power. If

<sup>40</sup> 'It is when the colors do not match, when the references in the index fail, when there is no decisive precedent, that the serious business of the judge begins' — Cardozo B. (1921). *The Nature of the Judicial Process*; Yale University Press p. 21; <https://archive.org/details/natureofthejudic008454mbp/page/n23>;

<sup>41</sup> 'For the rational study of law, the black letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics.' Jr. Holmes O.W. (1897). *The Path of the Law*. *Harvard Law Review* 10, 457; [https://www.constitution.org/lrev/owh/path\\_law.htm](https://www.constitution.org/lrev/owh/path_law.htm)

<sup>42</sup> American Bankruptcy Institute (ABI)- ABI is the nation's largest association of bankruptcy professionals, made up of over 12,000 members in multi-disciplinary roles, including attorneys, auctioneers, bankers, judges, lenders, professors, turnaround specialists, accountants and others. <https://www.abi.org/about-us>;

<sup>43</sup> I had the opportunity of addressing the U.S bankruptcy Judges who had gathered at the ABI Head Quarters in July 2016 for Annual Dinner during my visit to Washington after the enactment of the Code. There was so much enthusiasm among the Judges who had assembled there to interact with our bankruptcy Tribunal Members and share their experiences and also to learn from our perspective. They evinced keep to visit our country and learn first-hand from our stakeholders how our tribunals deal with the challenges they face. Our insolvency professionals and judges should interact with the ABI to learn from their experience.

resolution professionals, lawyers, bankers and other participants in the resolution process evince interest in this fast emerging field and familiarise themselves quickly with the basics of reviving and restructuring firms, then sky will be the limit for striking gold in the new expertise and will accelerate India`s efforts to emerge as a Major Restructuring Hub of Asia.

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## *Group Insolvency – The Need for Codification*

Shardul Shroff

**T**he Insolvency and Bankruptcy Board of India (IBBI) constituted a Working Group on Group Insolvency (WG) under the Chairmanship of Mr. U. K. Sinha (Former Chairman, Securities and Exchange Board of India) through an order dated January 17, 2019. The WG was required to submit a report recommending a complete regulatory framework to facilitate insolvency resolution and liquidation of corporate debtors (CD) in a corporate group (Framework).

With the introduction of the Insolvency and Bankruptcy Code, 2016 (Code), the consolidation of fragmented laws relating to reorganisation in distressed situations, insolvency resolution to reconstitute the company's promoters, novate the loan agreements, settle dues of workmen and employees and pay the financial creditors (FCs) and operational creditors (OCs) and provides for liquidation relating to corporate persons.

The Code currently lists detailed provisions to deal with the insolvency of single standalone CD but it does not provide for a dedicated framework to synchronise insolvency proceedings of different group companies. Hence, the insolvency of different companies belonging to the same group but registered in different jurisdictions are dealt with through separate insolvency proceedings for each company. In the case of Videocon, Era Infrastructure, Lanco, Educomp, Amtek, Adell, Jaypee and Aircel, special issues were noticed due to the interconnection with other group companies. Some of the Adjudicating Authorities (AA) under the Code and the Hon'ble Supreme Court passed unique orders to ameliorate the issues being faced in group situations. This highlighted the need to examine the necessity of providing a group insolvency framework. The final recommendations of the WG are not yet complete.

In the meantime, cases pertaining to Videocon Industries Limited and 14 other group companies had been filed under separate applications by the State Bank of India (SBI) for itself as a FC and subsequently on behalf of all other secured creditors having common securities.

15 companies listed hereunder were proceeded against by the SBI under section 7 of the Code and in case of other few companies, OCs had filed insolvency petitions under section 9 of the Code. Particulars of these 15 companies, the status relating to admission, the dates of admission and the resolution professionals appointed are set out below.

S. No.	Name of Videocon Group Company	Status before NCLT	Date of Order	Name of IRP / RP
1.	VTL	Admitted	11.06.2018	Anuj Jain
2.	Electro World	Admitted	30.08.2018	Avil Menezes
3.	Value Industries	Admitted	30.08.2018	Dushyant Dave
4.	Evans Fraser	Admitted	30.08.2018	Avil Menezes
5.	CE India	Admitted	14.09.2018	Mahender Khandelwal
6.	VIL	Admitted	06.06.2018	Anuj Jain
7.	Trend Electronics	Admitted	25.09.2018	Dushyant Dave
8.	Applicomp	Admitted	25.09.2018	Avil Menezes
9.	Techno Kart	Admitted	25.09.2018	Divyesh Desai
10.	Century Appliances	Admitted	25.09.2018	Dushyant Dave
11.	KAIL	Admitted	08.06.2018	Mahender Khandelwal
12.	Millennium Appliances	Admitted	31.08.2018	Avil Menezes
13.	SKY Appliances	Admitted	31.08.2018	Mahender Khandelwal
14.	PE Electronics	Admitted	31.08.2018	Divyesh Desai
15.	Techno Electronics	Admitted	31.08.2018	Divyesh Desai

In unusual circumstances Mr. Venugopal Dhoot, the ex-director/promoter of the Videocon Industries Limited filed an application that all matters relating to CDs must be heard by one and the same court of Mumbai Bench of the National Company Law Tribunal (NCLT). Another application was filed by the SBI before the Principal Bench, NCLT, New Delhi seeking the same relief as was sought in Mr. Dhoot's application for consolidation of corporate insolvency resolution processes (CIRPs) of all the CDs.

The Principal Bench disposed off both these applications by a common order on October 24, 2018 whereby the Hon'ble Principal Bench transferred all matters where CIRP under the Code had commenced (for the 15 CDs) to the NCLT Mumbai Bench. This transfer was based on the principle that it would serve the basic purpose of tagging of all matters to avoid conflicting orders, in connected matters.

The transfer was also justified on the ground that '*there appears to be consensus amongst the counsels for all the parties, that all the petitions be placed before one Bench. Accordingly, we find that the lead case and majority of the matters are posted before the Bench headed by Hon'ble Justice MK Shrawat, Member, Judicial.*'

The reason provided was serving the basic purpose of avoiding conflicting orders and facilitating the hearing, if the matters are posted before a single bench.

The request that all petitions be treated as part of one CIRP was not dealt with by the Principal Bench but was left open to be decided by the AA – NCLT, Mumbai.

After several hearings held in June 2019, the NCLT, Mumbai Bench in *State Bank of India and another v. Videocon Industries Limited and others*<sup>1</sup> vide its order dated August 8, 2019 dealt with and disposed off the request to treat all the FCs driven petitions as part of one corporate insolvency resolution process as consolidated by a common order.

The SBI in Application No. 1306 of 2018 filed on October 30, 2018 had sought for an order of consolidation of the CIRP of the 15 companies referred above as each of these companies were promoted by the Dhoot family and formed part of the Videocon Group of Companies.

<sup>1</sup> MA 1306/2018 (and 8 other MAs) in CP No. 02/2018 and 14 other Company Petitions

22 secured FCs of the Videocon Group were named in the application for consolidation as these had lent and advanced to some or several or all the 15 Videocon Group Companies.

It was also prayed that despite different insolvency commencement dates for each of the 15 CDs, by a common order, the NCLT ordered that September 25, 2018 may be considered as a common insolvency commencement date and that the maximum period for completing the CIRP be computed from that date onwards. The NCLT Mumbai did not alter the insolvency commencement days, but declared that the 180 days for CIRP of the consolidated corporate debtors will be counted from August 8, 2019.

Under the common order of August 8, 2019, from a total of 15 companies belonging to the Videocon Group, 13 companies had been consolidated as a group procedurally as well as substantively. Kail Limited and M/s. Trend Electronics were treated as single CDs and were not included in the group of 13 companies for which the consolidation order applied and a single resolution professional Mr. Khandelwal was appointed.

The need for consolidation was recognised since the businesses of most Videocon Group Companies were intertwined in a manner which made it a single economic unit e.g. a consortium of lenders have extended Rupee Term Loans to 13 group companies pursuant to a Rupee Term Loan Agreement where all 13 companies were co-obligators. This meant that all 13 companies were liable for the debts of one another. Isolated proceedings for each such CD did not yield any interest from resolution applicants as buyers.

The SBI, besides praying for substantial consolidation of proceedings into a single proceeding for the purpose of CIRP, should merge the assets and liabilities and guarantees *inter se* the Videocon Group Companies, and provide for a common resolution professional, committee of creditors and a resolution plan.

#### RECENT AMENDMENTS TO THE CODE: NEW MODES OF RESOLUTION

In the meantime, after the pronouncement of the order on August 8, 2019 the Central Government appointed August 16, 2019 as the effective date of coming into force of the Insolvency and Bankruptcy Code (Amendment) Act, 2019.

The definition of a resolution plan was amended by an explanation which was issued as a clarification. It was clarified that a resolution plan may include provisions of the restructuring of the CD including by way of merger, amalgamation and demerger.

Hitherto, the introduction of a transferee company as a recipient of demerged undertakings or an amalgamating company as recipient of amalgamated undertakings of the transferor company were not being permitted by the AA. Applications of merger of the loss making CD were not being permitted under the resolution plans with a new transferor company as the surviving enterprise or transferee company.

With this amendment, several new possibilities of newer modes of resolution will clearly emerge. This will also pose several problems on multiple opportunities and options of resolution being proposed by a resolution applicant. This will create complications in evaluation of different types of resolution plans as a single criteria cannot be proposed as a universal criteria for all different kinds of restructuring proposed by different resolution applicants.

There could be several other complications of consolidation of information memorandum in a single document with myriad possibilities of different kinds of plans

emerging whereby the consolidated CD could be moved into separate transferee companies by order of the NCLT as the AA.

In its order of August 8, 2019, the AA–NCLT Mumbai extensively relied on American jurisprudence. Based on the American precedents, the AA was clear on its stance that consolidation must be done on a case to case basis. It was observed that every entity of the group is likely to have different debt to asset ratio and consolidation would invariably lead to redistribution of wealth among the creditors of various entities.

The AA however, held that consolidation must give fair treatment to all creditors and while consolidation may result in redistribution of wealth, such inequities must be heavily outweighed by practical consideration and expediency. The burden of an objector to the consolidation has to demonstrate the prejudice that will be posed if consolidation is granted and this objection must point out overwhelming inconvenience to persuade the court to reject the consolidation.

#### CRITERIA FOR CONSOLIDATION OF CORPORATE DEBTORS

The NCLT Mumbai, based on several illustrative factors that needed to be considered for consolidation of group companies, enumerated 14 different reasons or circumstances which would persuade an AA to consolidate several individual constituent CDs of a group into one single CD (consolidated) under a single process of CIRP with its attendant merger of assets and liabilities and guarantees, common resolution professional, common committee of creditors of the Group and a common resolution information memorandum and common resolution plan (with individual variants for parts of the treatment for standalone companies of the Group).

Such criteria for considering consolidation in the 13 Videocon companies were: (a) common control (b) common directors (c) common assets (d) common liabilities (e) interdependence (f) inter lacing of finance (g) pooling of resources (h) co-existence for survival (i) intricate link of subsidiaries (j) intertwined accounts (k) interlooping of debts (l) Singleness of economic units (m) common financial creditors (n) common group of corporate debtors.

The AA held that as long as such criteria can be demonstrated, the corporate insolvency resolution proceedings against the set of individual CDs of the group can be consolidated for the purpose of a consolidated corporate insolvency resolution proceeding for the group as a whole.

#### **Procedural Propriety and Coordination: Conflicting Terrains**

Since there is no substantive provision for group insolvency in the Code, as is currently in force, there is no form under the Code or in the National Company Law Tribunal Rules, 2016 (NCLT Rules) for filing a consolidation application.

Rule 4 of the NCLT Rules require that Forms annexed at Annexure A, where no form is prescribed to cover a contingency necessitates a form as may be approved by the Registrar for usage.

Rule 11 of the NCLT Rules provides for the inherent powers of NCLT and reads as follows:

‘Nothing in these Rules shall be deemed to limit or otherwise affect the inherent powers of the Tribunal, to make such orders, as may be necessary for meeting the ends of justice or to prevent abuse of the process of the Tribunal.’

Rule 14 of the NCLT Rules further provides that:

'The Tribunal may on sufficient cause being shown, exempt the parties from compliance with any requirement of these rules and may give such directions in matters of practice and procedure, as may be considered just and expedient on the application moved in this behalf to render substantial justice.'

While these are general regulations concerning NCLT Rules of procedure, there are separate special regulations concerning the insolvency resolution process for corporate persons, viz, the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (CIRP Regulations) which have been notified on November 30, 2016 and further amended from time to time. It is a normal rule of interpretation that when there are special regulations for procedure for insolvency resolution, which are different from general rule of procedure, the special rules or regulations under the insolvency law, will prevail.

The special CIRP Regulations embody the procedure pursuant to regulation 2 to regulation 39 thereof. Regulation 39A to regulation 40 onwards deals with the provisions of liquidation costs and assessment of sale as a going concern. Regulation 40A deals with the model timelines for CIRP under the Code.

There is no provision in the CIRP Regulations for dealing with group insolvency and therefore, they are distinctly short and uncertain for the procedure to be adopted by the AA, the resolution professional (RP) and resolution applicant for a group insolvency.

Whether the AA, which is a creature of the Code can make its own rules and regulations for dealing with consolidation, is highly doubtful as a legal proposition. Section 239 of the Code provides that Central Government will prepare the form, the manner and fee for making an application before the AA for initiating corporate insolvency resolution process by FCs under section 7(2). Similarly, section 239(2)(e) provides the same in relation to OCs. Section 239(2)(f) provides for the procedures and forms for a CIRP by the corporate applicant. All these indicate that only the Central Government can make rules and the Tribunal, as the AA, is not competent to make either the forms or the manner and the fee for initiating CIRP by either the FC or the OC or the CD itself, when these are a consolidated group of a single promoter group. The AA would be transgressing into an area which is an exclusive domain of the Central Government of making Rules. Under Section 240 the IBBI is the competent authority to make regulations consistent with the Code and rules made thereunder and the AA cannot step in and take over IBBI's power.

The CIRP Regulations are made in exercise of the powers under section 5, 7, 9, 14, 15, 17, 18, 21, 24, 25, 29, 30, 196 and 208 read with section 240 of the Code. Under all these Sections of the Code only enable the IBBI as the Authority empowered to make regulations under the Code.

Once again, as explained above, the AA and the Appellate Authority constituted for conducting the CIRP or the liquidation process are creatures of a statute and are not competent by law to create adhoc procedures not sanctioned under the Code. The AA or the Appellate Authority cannot usurp the rule/regulation making authority and power of either the Central Government or the IBBI to do so. The AA or the Appellate Authority are not authorised to do so within the powers conferred on them under the Code.

The CIRP Regulations will have to be amended for dealing with group insolvency as there are no inherent powers under the Code nor a specific power to exempt anything in

relation to the CIRP Regulations under the Code. Existing regulations will require amendments to deal with group insolvency.

There is no scope of introducing Tribunal made procedures (equivalent to a regulation) for determining their own process, for deciding the rules of the game concerning group insolvency both on a substantial basis or on a procedural basis. The unique manner in which the AA has extended the concept of individual CD, CIRP Regulations to group CDs consolidated by the AA is a leap of faith but not sanctioned by the Code or regulations made thereunder. The Code as law must have substantive provisions for dealing with group insolvency and the CIRP Regulations must also have substantive provisions and procedure for dealing with group insolvency. The complications arising from this judicial extension of CIRP based on individual CDs to group CDs consolidated can be demonstrated from the lack of procedure legislatively provided. The chaos that this can cause is that each AA in separate jurisdictions will prepare its own ad hoc process, which could be arbitrary or uncommon with other Tribunals destroying the comity of NCLTs and uncommon standards to test the procedure when the same is not legislatively provided by either the Central Government or the IBBI. No such freedom of making procedure is available without standard common regulations applicable to all AAs or NCLTs across India.

The WG for group insolvency, as constituted, is precisely for the purpose of avoiding adhocism when group insolvency is to be undertaken by the Tribunals.

#### PROPOSED FRAMEWORK FOR GROUP INSOLVENCY

In order to have a legally enforceable framework for incorporation by amendment to the Code and for modification of the regulations, the WG has to provide the outline for draft Bill, which will first apply to domestic companies and thereafter to cross-border domestic and/or foreign subsidiaries of Indian companies. It is a moot question whether there will be different phases in building up substantive consolidation at the first phase itself. Such an outline for group insolvency may first need to deal with only holding companies' subsidiaries and associate companies and may not extend to companies broadly described as part of the group. The test for determining the group in cross-border transactions may pose difficulties for determining a single economic unit test especially when it could have multiple tax jurisdictions.

Some of the other issues for consolidation for the purposes of group insolvency may require procedural coordination mechanisms which would be applicable only for the purposes of group insolvency where insolvency applications under sections 7, 8 and 10 of the Code are filed.

Companies that have not defaulted and companies that are financial service providers, where the Code is not applicable, may not be covered under the procedural mechanism unless the same are integrally and inextricably linked. Besides the statutory amendments, the regulations to be amended by IBBI will have to provide for cooperation, communication and information between insolvency professionals (IPs) or, after first hearing appointing a single insolvency professional.

Similarly, requirements of a group committee of creditors (CoC) and a single AA for all members of the group will be required. A separate procedure for a joint application for initiation of a group insolvency of multiple companies in multiple jurisdictions will have to be

drafted and included the regulations so as to enable a single AA to deal with all companies within the group at a single location rather than with multiple AA. This would encourage reduction of conflict of interest rules, sharing of costs among FCs of the entire group. The group creditors committee has to have legal sanction whilst not replacing the CoC of each company, so as to facilitate distribution among the creditors of individual CDs from the pool of total receipts for settlement of the group sale or reorganisation. There will have to be a change in the mandatory content of the resolution plan for a group, where the novations will be made to the individual securities and substitution of lenders in each company of the group where secured creditors are not being substituted or replaced. The role of the majority has to be prescribed in the group CoC where at the option of such majority of FCs a group coordination committee is set up. A statutory form of an agreement coupled with provisions which enable declaration of facts pertaining to creditor details of the entire group and their priorities *inter se* will have to be prepared.

The powers, duties and responsibilities of the group coordinators will have to be stipulated. They would have to propose an expression of interest and an invitation to submit a consolidated resolution plan for synchronised resolution of the group by way of invitation of a common expression of interest, the draft resolution plan of a group, the certified balance sheets of each of the constituents of the group as of the commencement date of the resolution plan, the segregated payments of the constituents from the group payment by the resolution applicant, in the event of a sale of the group. For the sake of clarity of the group CoC, particulars of the sacrifices sought for each of the constituent members of the group will have to be provided in the common draft resolution plan.

There would have to be a provision whereby a company may opt out of the group coordination proceedings by vote of a majority of its CoC, which are constituents of the group creditors committee.

The jurisdiction of the AA may also be chosen under the statutory agreements under the applicable regulations or new provisions inserted therein.

Since dealing with a group is far more complicated and requires far more coordination, the Parliament will have to consider more time than the current 330 days applicable to a single CD undergoing a resolution proceeding.

The new amendments to the Code, would have to also enable IBBI to cover regulations applicable in relation to group insolvencies right from the stage of commencement of group insolvency proceedings both for the CIRP phase and the insolvency resolution provisions. If Rules under the Code have to be changed, these must be undertaken by the Central Government.

Even in relation to remedies against perverse behaviours either by the constituents of the group or by several of the group members, principles for avoidance of certain transactions and imposition of liability for wrongful and fraudulent trading would be required to capture group transactions that have been value destructive. A statutory agreement form will be required under the regulations which will have to provide for the consent of the FCs constituted as a group, for *inter se* adjustment of securities or modification of securities or relinquishment of securities from the individual constituents of the group committee of creditors and the provisions applicable when a fraud is discovered in a constituent group company.

Just as the inter-creditor agreements facilitate single company resolution, in case of a group insolvency the creditors must facilitate an economic case for group insolvency as part of the Code and the regulations and the manner of group distribution and the changes in the security, pursuant to sanction of a resolution plan of the group. This should be facilitated by amending the Code and amending the regulations. Essentially the security of a secured creditor will extend to the money realised from a sale or other form of resolution plan. The regulations for a group resolution plan will have to provide for satisfaction or modification of the charges when new lenders are introduced or when they continue as creditors.

Even the moratorium provisions under section 14 will have to be amended to enable a group moratorium being declared. The factors judicially examined in the Videocon case are not approved legislatively as these can only be considered as suggestions for the amendment of the Code for evaluation of whether a group amenable to group insolvency exists in fact. Interconnectedness of transactions and various group companies operating as a single economic unit has to be used to justify the introduction of a codified framework for resolution of group companies.

Procedural coordination at a group level, enabled by law, but implemented as decisions of the CoC and on the basis of cooperation among creditors, IPs and the Adjudicating/Appellate Authority and courts would be obligatory.

Substantive consolidation of group companies, which is essentially treating all group companies consolidated by the AA as one for the purpose of resolution.

### **Defining 'group'**

The amendments to the Code will have to define the term 'group', leaving some free play in the joints for the AA to determine whether any entity outside the definition forms part of the group in the commercial sense. There has to be a legislative sanction for the law applicable to group insolvency both in respect of resolution plan and in relation to insolvency procedures applicable for a consolidated group insolvency.

### **Gaps in the Procedure in the Absence of Amendment of the Law**

The Videocon order of August 8, 2019 does not incorporate the rules of accountancy, and Accounting Standards for consolidation of distressed CDs of a group and the computation of loss for the purposes of taking benefit in matters concerning Minimum Alternate TAX (MAT) as a group versus MAT in the context of a single assessee CD, the constitution of multiple boards of each CD under the Code, the individual restructuring of standalone accounts, the consolidated restructuring of consolidated accounts, the fractured treatment of continuity of employees vis-à-vis each constituents of the group, the procedure of allocation of fresh capital structures of individual constituent corporate debtors, the appointment of Key Managerial Personnel (KMPs) for each CD as persons to be held responsible for individual CDs for the non-performance of part or whole of the resolution plan and several other procedures are absent and cannot be made up by the AA or the Appellate Authority, based on situations or circumstances in the adjudicating process. These have to be part of the Code and the regulations as otherwise these would be unenforceable and not benchmarked across the several NCLTs constituted in different parts of India.

However, in the Videocon order, the NCLT has not delved into what constitutes a 'group'

or how should it be defined. This was facilitated by the promoter Mr. Dhoot's application, which specified the Videocon Group. The NCLT has laid down a set of tests (not exhaustive) to determine the financial and operational interconnectedness of a set of companies. This is a unique feature of group insolvency, that each case may present a new set of challenges with an ever expanding definition of the term 'group'. As such, defining a 'group' while leaving residual powers to the NCLT to expand its definition may not be a good idea, to begin with.

The NCLT in the Videocon order has effectively done, under the extant provisions of the Code, what the legal amendments to the Code and the regulations needs to do. The Videocon order questions the very need for amendments to the Code for enabling group insolvency law and procedure. The NCLT through its order has achieved both the above mentioned objectives of a group insolvency procedure: (i) procedural coordination by appointing a single NCLT, common RP and CoC, and (ii) substantive consolidation by merging the assets, liabilities, guarantees of 13 group entities but with total uncertainty on what next as enforceable law under the Code and regulations for group insolvency. It is unclear how the proposed amendments will enable group insolvency proceedings, given that the NCLT has found a way to commence a group insolvency under the law as it exists today (albeit with great uncertainty on enforceability).

The American Bankruptcy Code also does not expressly authorise substantive consolidation, but it recognises that a Chapter 11 plan may provide for the '*consolidation of the debtor with one or more persons*' as a means of implementation. A majority of courts have concluded that bankruptcy courts have the power to substantively consolidate debtor entities under section 105(a) of the Bankruptcy Code, which provides that a court '*may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions*' of the Bankruptcy Code.

Under Section 60(5) of the Code as well, the AA is vested with the power to dispose of '*any question of priorities or any question of law or facts, arising out of or in relation to the insolvency resolution or liquidation proceedings of the corporate debtor or corporate person.*' The NCLT in its order has also observed that '*the extent to which assets of the corporate entities are found to be hopelessly commingled must necessarily be decided on a case-by-case basis.*'

#### CONCLUSION

The NCLT order establishes the absence of any disabling provisions under the Code for group insolvency proceedings. However, any amendment to the Code will not necessarily change *status quo* for domestic group insolvency proceedings, which treatment of CIRP to a group *prima facie* appears to be *ultra vires* the Code, and unconstitutional as arbitrary.

Thus, this enforceable law of group insolvency has a long way to go if it is to be validly adopted as a uniform law and procedure under the Code and regulations applicable throughout the territory of India.

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# Epilogue

## *Debts in Ancient India*

Rajiv Mani

*'We are happy to note that in the working of the Code, the flow of financial resource to the commercial sector in India has increased exponentially as a result of financial debts being repaid.....The defaulter's paradise is lost. In its place, the economy's rightful position has been regained.'*

Epilogue, *Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.*<sup>1</sup>

**T**he above observations of the Supreme Court succinctly sum up the gains from the Insolvency and Bankruptcy Code, 2016 (Code). They bear witness to the well-known adage that efficient and predictable insolvency and debt resolution frameworks are key drivers to increased access to credit, reduction of the cost of credit and efficient allocation of scarce capital resources of an economy.

While this modern legislation is working towards bringing a paradigm shift in the manner of resolution of distressed firms in the country, it is important to note that the practice of recovery of debt from the person of the debtor has been a common practice since the inception of insolvency law. Though the law in every region has had its own mode of evolution, this practice of recovery can be found in most of the depicts of law. It was a debtor himself and his family members (and not a debtor's property) that formed a debt insurance guarantee.

We dwell here on some interesting aspects of the 'law of debt', as was in ancient India.

The *Dharamashastras* are the collection of important *Smriti* texts. *Smritis* were authored by the sages in ancient times and are a repository of the body of rules which gave form and steps to the Hindu Law—a law that catered to the needs of the multitudinous population of the sub-continent from ancient times till the statutory laws amended them.

The concept of debt and its repayment had been a major area wherein, *Smritikars* had commented upon this obligation and its discharge. It is needless to say that the modern laws and the present judicial system have equally maintained the importance of this area in the administration of justice and the Code is a manifest example of the same.

Law of debt is a very important branch of ancient Hindu Law. It has been emphasized that is the legal as well as the moral duty of a person to pay his debts. The *Dharmashastras* go to the extent that the non-payment of debt is a positive sin. Therefore, if a person dies indebted to any person, the rewards of the good deeds of the former are transferred to the latter. The concept was that the unpaid debt will have to be paid in the next life by serving the creditor as slave or as a beast and this will have to be done life after life, until the debt is fully discharged. A

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<sup>1</sup>(2019) 4 SCC 17

person cannot get salvation unless the debt incurred by him is repaid by himself or some other person on his behalf.

In addition to the borrower, the following other persons are liable to pay his debts : (i) Heirs, (ii) Coparceners, (iii) Principal, and (iv) Son.

*Dharmashastras* also provided that the person taking the estate of the deceased is liable to pay his debts. Similarly, a debt contracted by a coparcener shall be repaid by other coparceners and further the debts incurred by an agent or representative of family for family purposes is to be paid by family members.

Lastly a son under Hindu law is under obligation to repay his father's debts. This obligation is irrespective of his inheriting any property from the deceased father. This is known as the 'pious obligation' of the son. This provision has been made so that father may not go to '*narak*' (hell) for non-payment of his debt. The term 'son' included grandson and great grandson also. As regards the possibility the father's debt is to be paid before one's own debt and great grandfather's debt before either of these. A son is liable to pay the debt of his father like his own debt. The grandson is to pay the debt of his grandfather without interest but the grandson shall not be compelled to discharge the debt of his great grandfather unless he is an heir and has assets. There is no obligation to repay that ancestral debt which is unconscionable or *avyavaharika* (immoral).

The obligation of discharging the debt generally arises on the death of the debtor ancestor, but in certain circumstances, it arises even during his life time i.e. when the father goes to distant place, or is afflicted with an incurable disease etc. However, as stated earlier debt incurred for immoral purpose or *avyavaharika* debts are not payable. Thus *avyavaharika* debt is that debt, the recovery of which could not be enforced through law.

Also, the money due on account of 'surety ship', or lost at play, or due to for spirituous liquor, or promise made without any consideration, or under the influence of lust, or of wrath or for purpose repugnant to good moral, unpaid fine, tax or duty, and also the debts which are *avyavaharika* are not to be paid by the son.

### **The Concept of Surety**

'Surety ship' is of four kinds: for appearance, for honesty, for payment, and for delivering the assets of the debtors.

The son is under no duty to discharge the obligation(s) arising from the first two kinds of surety ships, but the obligation incurred by the last two kinds binds the son also. Agreements entered into or transaction(s) made by an intoxicated, insane, wholly dependent infant or a very aged person or which are contrary to law or settled usage or are fraudulent or caused by force were treated invalid. A wife and husband and mother and son were not mutually liable for the debt of each other unless it is contracted on account of family. A father is not liable for the debt of his son, unless it is incurred for family purposes or is contracted in time of distress. Given the concept of debt and the importance attached to its repayment in the *Dharmashastras*, it is relevant to highlight the texts of the *Smritikars* who have commented upon the subject.

Some of the important learnings from the *Smritikars* are encapsulated here.<sup>2</sup>

Vyasa (व्यासः)

तपस्वी चाग्निहोत्री च ऋणवान्भ्रियते यदि ।  
तपश्चैवाग्निहोत्रं च सर्वं तद्धनिनो भवेत् ॥

When a person, being either an ascetic, or keeper of a perpetual fire, dies indebted to any one, the future rewards of the austerities of the one, and the sacred duties of the other, shall all be transferred to the account of the account of the creditor. (quoted in *Smriti Chandrika* 161)

Katya. (कात्याः)

उद्धारादिकमादाय स्वामिने न ददाति यः ।  
स तस्य दासो भृत्यः स्त्री पशुर्वा जायते गृह ॥

He who shall not pay to his creditor what he has received from him in loan (*uddhara*) or other way, shall most certainly be born again, either as his slave, servant, wife, or beast of burden.

Narada (नारदः)

याच्यमानं न दद्याच्चूट्टणं वापि प्रतिग्रहम् ।  
तद्व्यं वर्धते तावद्यावत्कोटिशतं भवेत् ॥  
ततः कोटिशते पूर्णे बेष्टिस्तन् कर्मणा ।  
अश्वः खरा वृषो दासी भवेज्जन्मनि जन्मनि ॥

If a man does not repay what he has borrowed for use, and a debt, as well as what he has promised, that sum may be increased, even to ten million times its original amount. And after that, if it be allowed to increase still more, until by its own accumulation it has amounted to a hundred (times) ten million, it must then stop, the debtor shall become, in each successive birth, a horse, an ass, a bullock, and a slave. (IV.7-8)

#### Persons Taking the Estate of Deceased to Pay his Debts

Gautama (गौतमः)

रिक्थभाज ऋणं प्रतिकुर्युः ।

They who share the inheritance must pay the debts (XXIX.7)

Vishnu (विष्णुः)

सपुत्रस्य वाप्यपुत्रस्या वा रिक्थग्राही ऋणं दद्यात् ॥

He who takes the estate of one whether leaving a son or no male issue must pay his debts. (VI.29)

<sup>2</sup>Compiled from: Mani B. N. (1989). Laws of Dharmashastras. South Asia Books.

Yajna (याज्ञ०)

रिक्थग्राह ऋणं दाष्यो योषिद्ग्राहस्तथैव च  
पुत्रेनन्याश्रितद्रव्यः पुत्रहीनस्य रिक्थिनः ॥

He who has received the estate, must pay the debts of it, and in like manner, he who takes the wife (of the deceased), or the son, whose (father's) assets are not held by another (*ananyashrita*), but of one having no son, the other heirs (*rikthinahi*), must pay the debts; or may levy them (II.51)

### Coparceners to Pay the Debt of a Deceased Coparcener

Visnu (विष्णुः)

अविभक्तः कृत् ऋणं यस्ति ठेत् स दद्यात् ॥

A debt contracted by coparceners shall be paid by any one of them who is present (VI.34)

Yajna (याज्ञ०)

अविभक्तैः कुटुम्बार्थं यत् ऋणं तु कृतं भवेत् ।  
दद्युस्तद्रिक्थिनः प्रेते प्रोष्यिते वा कुटुम्बिनि ॥

The debt that has been contracted by unseparated members of the family, for purposes of the family, shall be paid by the coparceners, when the head of the family is dead or gone abroad (II.45).

### Debts Incurred by an Agent or Representative of Family for Family Purposes to be Paid

Visnu (विष्णुः)

.....कुटुम्बार्थं कृतं च ।

And (so must be (the householder) pay that debt) which was contracted by and person for the behalf of the family. (VI.39)

Manu (मनुः)

ग्रहीता यदि नष्टः स्यात्कुटुम्बार्थं कृतो व्ययः ।  
दातव्यं बान्धवैस्तत्स्यात्प्रविभक्तैरपि स्वतः ॥

If the debtor be dead and (the money borrowed) was expended for the family, it must be paid by the relatives out of their own estate even if they are divided. (VIII.166)

कुटुम्बार्थंऽअध्यधीनोऽपि व्यवहारं यमाचरेत् ।  
स्वदेशे वा विदेशे वा तं ज्यायान्न न विचालयेत् ॥ ११ ॥

A transaction for the benefit of family, even though effected by a servant, should not be repudiated by the master, whether in his own country or abroad. (VIII. 167)

Katya. (कात्या०)

प्रोषितस्यामतेनापि कुटुम्बार्थमृणं कृतम् ।  
दास्त्रीमातृशिष्यैर्वा दद्यात्पुत्रेण वा भृगुः ॥

Debts incurred for domestic uses, by the salve, wife, mother, or disciple, of one gone to a far country, or deceased, and also by his son, must be paid so says *Bhrigu*. (See *Aprarka*, II. 46)

### Pious Obligation to Pay Debts Insured by One's Ancestors

Visnu (विष्णुः)

धनग्राहिणि प्रेते प्रब्रजिते द्विदश समाःप्रोषिते वा  
तत्पुत्रपौत्रर्घनंदेयम् । नातः परमनिच्छुभिः ।

If he who contracted the debt should die, or become a religious ascetic, or remain abroad for twenty years, that debt shall be discharged by his sons or grandsons. But not by remote descendants against their will. (VI. 27-28)

पैतृकमृणमविभक्तानां भ्रातृणान्च ।  
विभक्ताश्च दायानुरूपमंशम् ।

And so shall the debt of the father (be paid) by (any one of) the brothers (or of their sons) before partition.

But after partition they shall severally pay according to their shares of the inheritance. (VI. 35-36)

Yajna (याज्ञ०)

पितरि प्रोषिते प्रेते व्यसनाभिलुप्तेऽपि वा ।  
पुत्रपौत्रैः ऋणं देयं निहनवे साक्षिभावितम् ॥

The father being dead, or gone abroad, or laid up with an incurable disease, the debt, proved in case of denial, is to be paid by the sons and grandsons. (II. 50)

Narada (नारदः)

अतः पुत्रेण जातेन स्वार्थमुत्सृज्य यत्नतः ।  
ऋणात् पिता मोचनीयो यथा न नरकं ब्रजेत् ॥

Therefore by a son born, in disregard of this personal interest, is the father to be diligently liberated from debt, so that he (the father) may not go to 'naraka' (hell). (II. 6)

पितर्युपरते पुत्रा ऋणं दद्युर्यांशतः ।  
विभक्ता अविभक्ता वा यो वा तामुद्धहेद्वरम् ॥

The father being, dead, his sons, whether after partition or before it, shall discharge his debt in proportion to their shares; or that son alone who has taken the burden upon himself. (I. 14)

Brih. (बृह०)

ऋणं पितृकृतं देयं पश्चात् आत्मीयमेव च ॥  
तयोः पैतामहं पूर्वं देयमेवमृण सदा ॥

Father's debt is to be paid (first), one's own afterwards, but the debt of the paternal grandfather must even be paid before either of those. (quoted in *Aprarka*, II.50)

ऋणमात्मीयवत्पित्र्यं देयंपुत्रै विभावितम् ।  
पैतामहं समं देयं देयं तत्सुतस्य च ॥

The sons must pay the debt of their father, when proved, as it were their own (that is, with interest) the son's son must pay the debt of his grandfather (but) without interest; and his son (that is, the great-grandsons) shall not be compelled to discharge it (unless he be heir, and have assets). (quoted in *Mita*. II.50)

Katya (कात्या०)

पित्रर्णे विद्यमाने तु न च पुत्रो धनं हरेत् ।  
देयंतद्वनिके द्रव्यः मृते गृहस्तु दाप्यते ॥

If any debt exists against the father, his son shall not take possession of his effects. They must be given to his creditors, and if he dies without wealth, still his son must pay his debts. (quoted in *Smriti Chandrika* 169)

Vyasa (व्यास०)

ऋणं पैतामहं पौत्रः प्रातिभाव्यागतं सुतः ।  
समं दद्यात्तत्सुतौ तु न दाप्याविति निश्चयः ॥

The son of a son shall (in general) pay the debt of his grandfather, but the son (only) shall pay the debt of his father incurred by his becoming a surety, (and both of them) without interest; but is clearly settled, that their sons (the great-grandson and grandson respectively) are not (normally) bound to pay. (quoted in Sen P. N. General Principles of Hindu jurisprudence p. 323).

Mita (मिता०)

पिता यदि दातव्यं ऋणं अदत्त्वा प्रेतो दूरदेशं गतः अचिकित्सनीय—व्याघ्राद्यभिभूतो वा तदा तत्कृतं ऋणं आख्यापने अवश्यं देयं, पुत्रेण पौत्रेण वा पितृ धनाभावेऽपि पुत्रत्वेन पौत्रत्वेन च, तत्र ऋमोऽपि अयं एव—पित्रभावे पुत्रः, पुत्राभावे पौत्रः इति ॥

If the father, without having paid the debt which he is liable to pay, has gone to a distant place, or is affected with an incurable disease etc., then the debt contracted by him must be paid by the son or the grandson, even if there is no property of the father (in their possession). They must pay because they are son or grandson. And this is the order (of the liability)—son has to pay in the absence of the father, and the grandson in the absence of the son. (II.50)

### **The Obligation to be Enforced when Son becomes Major**

Katya (कात्या०)

नाप्राप्तवृयहारैस्तु पितयूर्युपरते क्वचित् ।  
काले तु विधिनां देयं वसेयर्नरकेऽन्यथा ॥

The duty to pay off the father's debt does not create an enforceable obligation until the son attains majority, and so the creditor's right to sue him is till then postponed. (quoted in *Aprarka*, II.50)

### **Immoral Debts of the Father not to be Paid by the Son**

Manu (मनुः)

प्राप्तिभाव्यं वृथादानामाच्छिकं सौरिकं च यत् ।  
दण्डशुल्कावशं त्रष च न पुत्रो दातुमर्हति ॥

But money due by a surety, or idly promised, or lost at play, or due for spirituous liquor, or what remains unpaid of a fine and a tax or duty, the son (of the party owing it) shall not be obliged to pay. (VII.159)

Yajna (याज्ञ०)

सुराकामद्युतकृतं दण्डशुल्कावशिष्टकम् ।  
वृथादानं तथैवेह पुत्रो दद्यात् न पैतृकम् ॥

Debt contracted by the father for purposes of spirituous liquors, prostitution, and gambling; unpaid fines and tolls, as also debt for promises without consideration-these the son may not pay. (II.47)

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