Insolvency Law in Times of COVID-19

Rescuing a viable firm is far more important than failing to liquidate an unviable one. In sync with its primary mandate, the Code must complement every endeavour to rescue lives of firms during times of the COVID-19 pandemic.

An economic law is essentially empiric and it evolves continuously through experimentation. The Insolvency and Bankruptcy Code, 2016 (Code) is no exception; it has been a road under construction for good reasons. It envisaged standard, plain vanilla processes to start with, but anticipated prompt course corrections to continue to remain in the service of the business and economy. Such corrections arose from difficulties encountered while implementing the provisions of the Code and from the changes in the economic environment. The Code has witnessed five legislative interventions since its enactment to strengthen the processes and further its objectives, in sync with the emerging market realities.

The Code recognises that insolvency is an outcome of market forces. It incentivises, facilitates, and empowers market forces to resolve insolvency in normal times. The first order objective of the Code is resolution. The second order objective is maximisation of value of assets of the firm and the third order objectives are promoting entrepreneurship, availability of credit and balancing the interests of stakeholders. This order of objectives is sacrosanct. In pursuance of these objectives, the Code enables market forces to pursue twin complementary remedies in respect of failing firms: (i) rescue a viable firm, and (ii) liquidate an unviable one. It searches for a white knight, who rescues a failing firm. It is unlikely to find a white knight if the firm is unviable. In such cases, the Code facilitates liquidation of the firm.

COVID-19 Pandemic

These are not normal times. The world is in the grip of the COVID-19, with no quick solution in sight. It is fast snowballing to an economic crisis. Some believe that it may hurt deeper than the deepest health pandemonium (1918 Spanish flu), the worst economic disaster (1930 Great Depression), or the most-devastating financial crash (2008 financial crisis), or may be, all of them put together. According to the IMF's World Economic Outlook of June, 2020, the global economy is projected to contract sharply by 4.9% in 2020 in the wake of the pandemic.

As around the world, in India as well, the impact of COVID-19 on the economy has been severe. In view of demand contraction and supply chain disruptions arising from primarily two external factors, namely, COVID-19 and consequential imposition of nationwide lockdown, many companies may have receding top line and bottom line and some of them may default in servicing debt obligations.

In its June 2020 report, the ADB estimates that India is expected to contract by 4.0% in fiscal 2020. According to IMF's World Economic Outlook, June 2020, India's economy is projected to contract by 4.5% following a longer period of lockdown and slower recovery than anticipated in April. RBI's Financial Stability Report released in July 2020 highlights that nominal sales and net profits of 1,640 listed private non-financial companies declined (y-o-y) by 3.4% [10.2% in Q4:2019-20] and 19.3% [65.4% in Q4:2019-20], respectively.

While the impact of the external variables on the economy is very deep, similar shocks of a comparatively lower intensity in the past have witnessed a sharp increase in corporate and personal insolvencies all over the world. In our recent memory, the 2008 global financial crisis had resulted in a similar situation of declining demand, decreasing availability of external finance, declining investments, causing firms around the world to face insolvencies and bankruptcies.

International Response

Such a rare black swan event required a matching response from humanity to save 'lives', that required saving 'livelihood', which in turn required saving lives of firms. Governments around the world have adopted an accommodative stance and acted swiftly to prevent corporates and individuals from being forced into insolvency and bankruptcy. Measures such as moratorium on loan repayments, sector specific forbearance, infusion of liquidity into the banking system to provide credit to financially distressed firms, relief in asset classification banking norms, flexibility in director's obligations to initiate insolvency proceeding, relief from compliance with specific legal obligations etc., have been taken to deal with the situation.

Both World Bank and IMF have listed out the challenges and key responses required to meet those challenges to prevent the economies from facing a fate like the Great Depression. They suggest the implementation of those responses in a three-phased approach to help the economy transition smoothly towards the positive side of the graph. In the first phase, copious interim measures need to be taken to halt insolvency and debt enforcement activities. In the second phase, when a huge wave of insolvencies is anticipated, it may be addressed by transitional measures, such as special out-of-court workouts, to 'flatten the curve' of insolvencies. The third phase calls for regular debt resolution tools to address the remaining debt overhang and support economic growth in the medium term. The key challenges and responses in three phases in the wake of COVID-19 outbreak are summarised in the table overleaf.

Response in India

The Government of India has taken several measures to ameliorate the pains emanating from COVID-19. This piece discusses measures in the space of insolvency only. When every firm, every industry and every economy is reeling under stress, the likelihood of finding a white knight to rescue a failing firm is remote. If all failing firms were to undergo insolvency proceeding, most of them may end up with liquidation for want of saviours to rescue them. Upon such liquidation, the firms would have a premature death, while the assets would have distress sale, realising abysmally little. Rescuing lives of firms being the prime objective of the Code, it must not be used to take away their lives prematurely at these unusual times.

This unprecedented situation called for another experimentation requiring a choice between two competing policy options, namely, suspend the operations of the Code or continue its operations as usual. If the first option is exercised, the market would fail to liquidate an unviable firm. This is not good for an economy, but this can be rectified in the following quarter or the following year. If the second option is exercised, the market would liquidate a viable firm forever, which can never be undone. Rescuing a viable firm is, therefore, far more important than failing to liquidate an unviable one. Further, firms, which are failing solely on account of COVID-19, may bounce back on their own as soon as normalcy restores. Alternatively, they would at least recalibrate their operations and businesses to an 'all-new normal'. The choice, therefore, fell on the first option, which provides breathing time for firms and furthers the objectives of the Code.

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[1] World Bank Policy Research Working Paper 5448, "The Challenges of Bankruptcy Reform", October, 2010

[2] World Bank Group, Financial Series, COVID-19 Notes, "COVID-19 Outbreak: Implications on Corporate and Individual Insolvency", April, 2020 and IMF Special Series on COVID-19, "Private Debt Resolution Measures in the Wake of the Pandemic, May, 2020.

Phases	Key Challenges	Critical Responses
Phase 1: "Freeze" phase to deal with immediate impact of the health emergency by taking interim measures	Preventing viable firms from prematurely being pushed into insolvency	**Implementing one or more extraordinary measures for a limited period of time:** ● Increasing barriers to creditor-initiated insolvency filings; ● Suspending director's duty to file and associated liability; ● Ensuring complementarities with debt repayment emergency measures.
Phase 2: "Transition" phase for response after the pandemic subsides and economic activity resumes	Responding to the increased number of firms that will not survive this crisis without going through insolvency	**Ensuring smooth functioning of workouts and debt restructuring mechanisms such as:** ● Establishing informal out-of-court or hybrid workout frameworks; ● Facilitating business rescue through bridge financing; ● Extending procedural deadlines for a limited period of time; ● Suspending the requirement to proceed to liquidation if the business activity of the debtor has stopped while undergoing reorganisation; ● Encouraging e-filings, virtual court hearings and out-of-court solutions in insolvency cases.
Phase 3: "Fighting debt overhang" during the phase when situation stabilises and there are aftereffects to deal with	Addressing individual financial distress resulting from the crisis	● Implementing modern consumer bankruptcy frameworks; ● Ensuring there are flexible options for debt rescheduling and repayment plans; ● Enabling a debt forgiveness mechanism or discharge is important for facilitating a fresh start.

The first option has two sub-options, namely, suspend the Code in its entirety or suspend some elements, as may be warranted. The first sub-option would not allow liquidation of a failing firm, whether it was unviable before COVID-19 or became unviable on account of the it. It would also not allow rescue of a failing firm even if it were viable before the COVID-19 or remains viable despite it. A delay in rescue of a viable firm may make its rescue impossible. The policy should, therefore, protect those firms which are victims of pandemic, and not protect the undeserving. The choice, therefore, fell on the second sub-option which suspends only such provisions of the Code, for such purposes and for such period, as are necessary under the circumstances, avoiding any unintended consequences.

The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2020

Contrary to general belief that the Code has been suspended for a year, the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2020 is a keyhole surgery that suspends a tiny part of the Code. It suspends filing of applications for initiation of insolvency proceeding against a company for any default arising during COVID-19 period, which is six months commencing on March 25, 2020 to start with, but can be extended up to a year, if warranted. It insulates a company, which did not have a default as on March 25, 2020, but commits a default during the COVID-19 period, from being pushed into an insolvency proceeding.

The Ordinance does not absolve the company of COVID-19 default. It does not even exclude such default from the ambit of default under the Code. Such default remains a default for all purposes under the Code, except for the purpose of initiating insolvency proceeding against the company. For example, such default can be the basis for submission of claim in an insolvency proceeding or initiation of insolvency proceeding against a personal guarantor.

The Ordinance clarifies that an application can be filed for initiating insolvency proceeding against a company for defaults committed before March 25, 2020. It does not suspend the applications already filed before the Adjudicating Authority (AA) for initiation of insolvency proceeding and pending for admission, and ongoing corporate insolvency proceedings - resolution and liquidation, including voluntary liquidation. Not does it suspend provisions relating to and ongoing insolvency proceedings against personal guarantors and financial service providers.

Though the broad rationale of the Ordinance is well understood, the rationale for some of its finer aspects are not obvious. The simplest of them relates to the period of suspension: why not for three months or for three years? What characterises COVID-19, as compared to any other rare event, is the degree of uncertainty surrounding it, making it difficult to figure out the appropriate period of suspension. The initial period is six months, which includes all three lockdowns. It can be extended up to one year based on assessment of the situation on the ground so that it matches the requirement.

Since the objective is to insulate companies which are victims of the pandemic, why should a company, which defaults during COVID-19 period, but not on account of COVID-19, have protection? There is hardly any company which is not impacted by COVID-19. There may be a handful of companies which did not default earlier but defaults during COVID-19 period for reasons other than COVID-19. Identification of such handful of companies would require determination in each case whether the default during the COVID-19 period is on account of COVID-19, or for any other reason, or for a mix of COVID-19 and other reasons. From practical considerations, it makes sense to allow such rare cases have the protection rather than be theoretically correct and waste years in legal battles.

If the objective of the Ordinance is not to push certain companies into insolvency proceedings, why should such a company not have option to commence insolvency proceedings on its own volition? A key design feature of the Code is that it balances the rights and interests of all stakeholders, particularly of the equity and debt suppliers. It creates imbalance if only debtor has the right to initiate insolvency proceeding, while a creditor does not have, and vice versa. Further, irrespective of whether the debtor initiates or a creditor initiates the proceeding, the outcome is the same, which is not acceptable. In any case, the data indicate that only 2% of the insolvency proceedings that commenced during 2019-20 were self-initiated.

The non-availability of resolution applicants is the basis for suspension. Should it not apply to all companies whether they defaulted before or during COVID-19 period? The Ordinance distinguishes failures on account of the COVID-19 and for market pressures (competition and innovation). It is only fair that they are treated differently. The Ordinance prohibits resort to insolvency proceeding where a company, which withstands market pressures, but defaults on account of COVID-19. It enables resort to insolvency proceeding where a company defaults on account of market pressures, should the stakeholders wish, as in such cases, the stress is unlikely to disappear on the other side of COVID-19.

There is a recognition that MSMEs, who defaulted before March 25, 2020, have additional difficulties of resolution during COVID-19 times. The market for resolution plans for them is local, while the entire globe is the market for bigger firms. The value of an MSME often lies in informal arrangements, which a third party may not be able to harness through a resolution plan. Most of them have loans from informal sources and have no access to frameworks for resolution as available for banks. In view of these, the threshold of default for filing of an insolvency application was increased from 1 lakh to 1 crore to prevent MSMEs from being pushed into insolvency proceedings. The Government is working to make available a special insolvency resolution framework for them under the Code.

Why should COVID-19 default be kept out of insolvency proceedings for ever? A company, which was viable before the onset of COVID-19, may earn normal profits from current operations and become viable again, after the impact of pandemic subsides. It would, however, take years to wipe off the deep stress that arose during COVID-19 period. Depending on the nature of the industry and specific strength of a company, one may recoup the loss in one year while another may take many years, or even decades. If the company is pushed into insolvency when it is recouping the loss, the objective of the Ordinance would be frustrated.

A fear has been expressed that a company may deliberately default taking undue advantage of the Ordinance. It is very unlikely because the Ordinance has not suspended the liabilities in respect of COVID-19 default under various other laws. It has not even suspended COVID-19 default for all purposes under the Code. There are several checks and balances to discourage wilful default, including liability under section 29A. Further, it may not be fair to assume that a company would default even when it can repay. A slim possibility of misuse should not deter a policy, which benefits everyone.

With the Ordinance in place, have the stakeholders lost an effective avenue for resolution of stress? It is important to note that the Code is available for resolution for all defaults, except default arising during COVID-19 period. Further, there are several credible options for resolutions outside the Code. The stakeholders may use statutory, court supervised compromise or an arrangement under the Companies Act, 2013. They may use the RBI's prudential framework for resolution of stressed assets. They may sit across a table and work out a resolution without the involvement of court or outside any formal framework. The concern that the Ordinance has taken away an effective avenue for recovery of dues has no basis as recovery of dues is not an objective of the Code. The menu available for creditors for recovery of dues is quite long.

There is an apprehension that there will be a surge of insolvency proceedings on the other side of the pandemic. This is very unlikely given that the stakeholders have many options during the COVID-19 period for recovery of loan as well as for resolution of stress. They may even explore innovative options for resolution in this challenging times. The number could be less as the companies have normal business operations after the pandemic subsides, higher threshold of default for initiation insolvency proceedings keeps MSMEs out of the reach as they resolve under the special insolvency resolution framework, and COVID-19 period defaults remain outside insolvency proceedings.

Some have misconstrued insertion of sub-section (3) to section 66 that it provides undue protection to the directors of a company for any fraudulent transaction during the COVID-19 period. It provides protection to directors in respect of liability under sub-section (2), which deals with exercise of due diligence to minimise the potential loss to creditors. It is necessary to limit the liability before the insolvency commencement date, as insolvency process cannot commence in respect of COVID-19 defaults. It has not touched sub-section (1), which deals with fraud. Further, section 166 of the Companies Act, 2013, which requires a director to discharge his duties with due and reasonable care, skill, and diligence, remains intact. Thus, there is no protection from fraud.

There is a misgiving in some circles that the suspension of the Code is a setback to insolvency reforms. As mentioned earlier, only a tiny part of the Code has been suspended, that too, for a short period. This suspension not only reinforces the prime objective of the Code, that is, to rescue the lives of companies from market pressures, but also endeavours to rescue companies having stress from force majeure circumstances. A study of our 30-year history of economic reforms indicate that some reforms have, at times, changed gears, moved one step back and two steps ahead, moved sideways, and even stood still, yet ultimately reached the destination. We need to stir insolvency reforms with extreme care in these trying times.

There have been concerns about work opportunities for professionals. There are thousands of applications for corporate insolvency proceedings at the admission stage, thousands of ongoing corporate insolvency proceedings, and thousands of ongoing corporate liquidations and voluntary liquidations. Fresh applications in respect of defaults that have occurred before March 25, 2020 would continue to be filed. Applications for insolvency proceedings against personal guarantors and financial service providers can be filed. Special insolvency resolution framework for MSMEs is on the way. Work has begun on development of a prepack insolvency framework. This is besides the professional opportunities available outside the Code. What professionals have on table is much more than what they can take.

Conclusion

The COVID-19 crisis is not the first crisis that has hit the world. The world has fought and overcome many battles in the past. This too shall pass, preparing mankind for still bigger challenges in the future. This war has many warriors in the insolvency space -the Government, the regulator, the service providers (insolvency professional agencies, insolvency professionals, information utility, registered valuers) and the AA. As the Government prepares the insolvency landscape of the country for the post COVID-19 phase in the longer term, one is hopeful that the measures taken in the short and medium term will be successful in preserving the life of companies and livelihood of persons in distress. It must, however, be appreciated that insolvency law is not the panacea to deal with stress of all firms impacted by the COVID-19. It, however, provides a valuable breathing space while the companies as well as the authorities can put in place a comprehensive strategy to wade the economy through the pandemic.

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