

IBC: Ushering In A New Era

*An anthology of articles
on
The Insolvency &
Bankruptcy Code, 2016*

Vinod Kothari & Company
Practising Company Secretaries

ABOUT THIS BOOK



Megha Mittal
Editor

*The Insolvency and Bankruptcy Code, 2016 (“Code”/ “IBC”), was introduced amidst various other reforms introduced by the Government, with focused emphasis on the “Ease of Doing Business in India.” Ease of Doing Business not only means speedy and easy entry, and ease of carrying out operation of businesses; it also covers in its ambit, the **ease of exit**. Of the 10 indices based upon rankings are given, “Resolving Insolvency” is one such index.*

The Indian scenario of Insolvency, prior to implementation of the Code was a mosaic of pieces that did not fit with each other. A long list of statutes governed insolvency, and hence, there was confusion, and lack of policy direction. In many cases, the provisions of law were running counter to a centralised theme; in many cases, there was a need for a complete rethinking as well. While insolvency and business failure are inevitable outcome of running any business, the existing regime did not provide incentive for easy resolution of insolvency. Therefore, continuation of a stalemate was often in combined interest of both the creditors and the debtor. As for the creditors, mostly banks, there were huge losses due to such failed businesses, but bankers could afford to not call a spade a spade, and carry on the deadwood still, under various judicial and non-judicial structures such as the SICA, corporate debt restructuring (CDR) schemes, and so on.

The foundation of any developing country is a well-functioning credit system, and resolution of distress is an integral part of the ecosystem of credit extension and recovery. If the resolution of distress in lending is inefficient, lenders face prolonged defaults. This would mean, lenders add risk premiums to their lending, thereby resulting into the cost of risk affecting the entire credit space. Economically, the very essence of secured lending is for lenders to place value on the collateral backing the loan, and thereby minimise the risk of default, and hence, the risk premium. However, if secured lenders are unable to realise the value of their assets due to inefficiency of the resolution mechanism, secured lending becomes as costly as unsecured lending.

Simultaneously, the log-jammed assets in defaulted entities, under the aegis of Board for Industrial and Financial Reconstruction under the SICA, was a huge running cost for the country. These sick entities had failed years ago, and yet were kept alive under the SICA with potentially no prospects for resolution.

The situation also promoted defaults, as a defaulter less disincentive against defaulting. Having defaulted, one could still take succour under SICA, and continue to own and run a business. The benefit of limited liability would mean there was very little downside for the equity shareholders, while lenders’ losses would continue to deepen.

Why IBC?

- **Expeditious insolvency resolution**
- **Quick reorganization**
- **Maximization of value of assets**

About this Book

While the situation was sufficiently grave, political strong will required for such a major economic reform was missing. Several committees in the past had recommended various reforms of the insolvency law. The agenda was on the backburner for over 50 years, considering that the 26th Law Commission in 1964 had recommended rewriting of insolvency laws.

The Interim Report submitted by the Bankruptcy Law Reforms Committee in February, 2015 set the stage for IBC, followed by its final report. Finally, IBC was given the Hon'ble President's assent on 28.05.2016, and hence, was ready to take the centre stage in the Indian economic scenario. Consequentially, the age-old and highly discredited SICA was given a farewell.

Regarded as one of the biggest economic reforms in the country, IBC claims to have provided a robust roadmap for dealing with insolvency in India. At the point of writing this, only the provisions about corporate insolvency have been enforced; there are indications that the rule-making and infrastructure development for personal insolvency are also in rapid progress.

On 28th May, 2019, IBC turned 3, at least on the statute book. Its performance in numbers may not be very satisfactory, given the high percentage of liquidations that it has resulted into. The Quarterly newsletter of IBBI for Jan-March, 2019 shows that while the total number of successful resolutions upto March 2019 was 94, the commencement of liquidations is 378. However, the over-4:1 ratio of liquidations-to-resolutions must be viewed in light of the fact that a large number of early insolvency cases are matters that were long under SICA, and were, therefore, only waiting for a formal initiation of liquidation.

The biggest impact of IBC is that provisions like section 29A have contributed in developing a well-behaved "credit-culture" in the corporate arena. It must have been a serious cultural shock to defaulters who, over the years, had framed the firm belief that it is possible to run a sick business, but pink-healthy promoters. Section 29A, uniquely so in the world, disqualifies defaulters from either submitting resolution plans or even buying the assets of the company in liquidation. So, every defaulter knows that if one does not pay what one has committed to pay, one will lose the reins of control over business forever. This has resulted into a new cult of healthy borrowing – where borrowers shun over-leveraging, over-capitalisation, and borrow only what they may service with reasonable certainty.

The three years of IBC have also seen several potential challenges – from challenges to Constitutionality of the law, to infrastructural issues (inadequate Benches, even more inadequate Appellate Benches, etc), bulging number of pending cases before NCLTs, even in the midst of stringent hard timelines of the law. However, the infrastructural machinery of the Code currently has all elements needed – IBBI, IPAs, IPs, IU, AA, and the appellate authority.

.Thus, the law has evolved a lot over a short time span of 3 years with active contribution from professionals, corporate participants, and of course, the judiciary – the adjudicating authorities, the appellate authority and the Apex Court. As would be apparent, the law was/is sketchy at places and was/is open to multiple interpretations – the judiciary in an array of legal cases has delved into the intent and provisions of IBC to enable smoother implementation.

At Vinod Kothari & Company, we have been witness to the development of the Code right since its embryonic stage. We had opportunity of interacting while the law was being enacted, and consistently thereafter. Since academic writing has been as much a part of our daily agenda as any other engagements, we have been continuously writing and commenting on IBC developments, right from the time of the Interim Report of the BLRC.

With 3 years behind us, it was thought apt to cherry-pick some of our writings on IBC that remain relevant and useful in understanding the law.

Some of views and analyses were later either modified by subsequent statutory changes, or there were rulings of courts that either supported or obverted our views. While the anthology has picked up our writings spanning over more than 3 years, we have put relevant updates wherever required. There are, of course, several issues where the law is yet to develop.

For ease of reading, the topics have been categorised into 8 sections:

- Section I covers the background and emergence of IBC.*
- Section II provides clarity on certain basic definitional concepts.*
- Section III covers aspects of corporate insolvency resolution process (including moratorium, resolution plan, etc).*
- Section IV deals with liquidation process.*
- Section V provides perspectives on vulnerable transactions, relevant for both resolution and liquidation processes.*
- Section VI deals with non-corporate insolvency – the relevant provisions though have not been enforced yet.*
- Section VII covers certain recent and major judicial developments.*
- Lastly, section VIII covers our views on the much awaited group insolvency regime.*

Hope you find the Book relevant and useful. Happy reading!

*10th June, 2019
Kolkata*

WHAT'S INSIDE

ABOUT THIS BOOK	2
LIST OF ABBREVIATIONS	8
SECTION I: ADVENT OF IBC	10
USHERING OF A NEW BANKRUPTCY CODE	11
SICA BIDS ADIEU	19
SECTION II: SOME BASIC DEFINITIONAL CONCEPTS	24
DECIPHERING “DISPUTE”	31
THE CONCEPT OF RELATED PARTY:	38
NBFCs AND IBC: THE LOST CONNECTION	42
STATE OF PERPLEXITY – APPLICABILITY OF IBC ON NBFCs	47
SECTION III: CORPORATE INSOLVENCY RESOLUTION PROCESS	53
CONSTITUTIONAL POWERS IMMUNE FROM MORATORIUM UNDER IBC	57
ROLE OF INSOLVENCY PROFESSIONALS IN CORPORATE INSOLVENCY RESOLUTION PROCESS	62
RESOLUTION PROFESSIONAL VIS-A-VIS BOARD OF DIRECTORS: GOVERNANCE OF	73
INSOLVENT COMPANIES	73
MEETINGS OF COMMITTEE OF CREDITORS UNDER INSOLVENCY CODE	83
ABSENTEEISM IN VOTING: AN OXYMORON	86
DICTATED DECISION-MAKING	91
INELIGIBILITY CRITERIA U/S 29A OF IBC: A NET TOO WIDE?	93
STREAMLINING SECTION 29A OF IBC	101
FAIRLY CONFIDENTIAL OR CONFIDENTIALLY FAIR	107
APPLICABILITY OF MORATORIUM ON GUARANTOR’S ASSETS: THROUGH MAZE OF RULINGS	115
SIMULTANEOUS CLAIM BY A BENEFICIARY OF GUARANTEE	119
FINANCIAL EXPOSURE OF SECURED CREDITORS AND THE RELEVANCE OF VERTICAL COMPARISON IN RESOLUTION	123
SUBORDINATION OF OPERATIONAL CREDITORS UNDER IBC: WHETHER EQUITABLE	126
THE CURIOUS CASE OF HOME BUYERS: ALL IS WELL?	133
AMENDMENT IN DELISTING REGULATIONS: AXING THE MINORITY RIGHTS	137
ROLE OF ADJUDICATING AUTHORITY IN APPROVING/ REJECTING A RESOLUTION PLAN	141
ADJUDICATORY TIME LIMIT PRESCRIBED BY IBC NOT MANDATORY	146
INTERIM FINANCING BECOMES EFFECTIVE AND ATTRACTIVE	150
FRAUDULENT INITIATION OF INSOLVENCY PROCEEDINGS	155

POST-ADMISSION WITHDRAWAL OF INSOLVENCY PROCEEDINGS	159
LIQUIDATION BEFORE RESOLUTION?	165
SECTION IV: LIQUIDATION PROCESS	168
SCHEMES OF ARRANGEMENT IN LIQUIDATION: A NEW RAY OF HOPE	171
ENABLING GOING CONCERN SALE IN LIQUIDATION	175
CONCERNS ON GOING CONCERN:	192
LIQUIDATION SALE AS GOING CONCERN:.....	197
SCALE-BASED LIQUIDATOR’S FEE	202
RELINQUISHMENT OF SECURITY BY SECURED CREDITORS	208
TO RELINQUISH OR NOT TO RELINQUISH:.....	216
A DISCRETION OF SECURED CREDITORS?.....	216
MORATORIUM DURING LIQUIDATION:.....	221
SCOPE AND EFFECT	221
TAX AUTHORITIES LEFT HIGH & DRY IN IBC CASES.....	226
PROOF OF CLAIM IN LIQUIDATION: WHETHER DISPENSABLE?.....	228
LATECOMERS IN LIQUIDATION – ENTITLEMENTS AND PENALTIES	231
PRIORITY OF TAX DUES IN LIQUIDATION.....	238
INCLUSION OF ASSETS TAKEN ON LEASE IN THE LIQUIDATION ESTATE OF THE LESSEE	242
CAN LIQUIDATOR’S OUTREACH GRAB GUARANTORS ASSETS.....	249
DECISIONS OF INSOLVENCY PROFESSIONAL SCOPE OF JUDICIAL REVIEW.....	252
VOLUNTARY LIQUIDATION REGULATIONS- LAST BUT NOT THE LEAST.....	259
SECTION V: PREFRENTIAL, WRONGFUL & FRAUDULENT TRANSACTIONS	268
DISCERNING THE REACH OF AVOIDANCE PROCEEDINGS:	271
A NOTE ON FRAUDULENT TRADING AND WRONGFUL TRADING	275
LOOK- BACK PERIOD VIS-À-VIS FRAUDULENT TRANSACTIONS.....	288
SECTION VI: NON-CORPORATE INSOLVENCY	291
SECTION VII: MAJOR JUDICIAL DEVELOPMENTS	297
CONSTITUTIONAL VALIDITY OF INSOLVENCY AND BANKRUPTCY CODE	298
SWISS RIBBONS SC RULING: <i>IBC Must Stay On, The Defaulters Paradise Is Lost!</i>	301
APPLICABILITY OF LIMITATION ACT TO INSOLVENCY AND BANKRUPTCY CODE	304
RBI’S 12TH FEBRUARY CIRCULAR: THE LAST WORD BECOMES THE LOST WORLD.....	309
PLIGHT OF A POWER OF ATTORNEY HOLDER VIS-À-VIS INSOLVENCY PROCEEDINGS	315
SECTION VIII: GROUP INSOLVENCY	320
ENTITY VERSUS ENTERPRISE:	321

What's Inside?

DEALING WITH INSOLVENCY OF CORPORATE GROUPS	321
ABOUT US	338
ABOUT THE CONTRIBUTORS	339

LIST OF ABBREVIATIONS

Abbreviation	Meaning
AA	Adjudicating Authority
AAIFR	Appellate Authority for Industrial & Financial Reconstruction
Amendment Regulations, 2018	The Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations, 2018
Appellate Authority	National Company Law Appellate Tribunal
ARC	Asset Reconstruction Company
BIFR	Board of Industrial & Financial Reconstruction
BLRC	Bankruptcy Law Reforms Committee
CoC	Committee of Creditors
Code	Insolvency & Bankruptcy Code, 2016
CDR	Corporate Debt Restructuring
CIRP	Corporate Insolvency Resolution Process
CIRP Regulations	Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons), Regulations, 2016
Delisting Regulations	SEBI (Delisting of Equity Shares) Regulations, 2009
DRT	Debt Resolution Tribunal
FRDI	Financial Resolution and Deposit Insurance (FRDI) Bill
FSLRC	Financial Sector Legislative Reforms Commission
FSP	Financial Service Provider
JLF	Joint Lenders Forum
IBBI	Insolvency and Bankruptcy Board of India
IBC	Insolvency & Bankruptcy Code, 2016
IP	Insolvency Professional
IRP	Interim Resolution Professional
IU	Information Utilities
LGD	Loss given default
LLP	Limited Liability Partnership
LODR	SEBI (Listing Obligations and Disclosure Requirements) Regulations,

List of Abbreviations

	2015
NBFC	Non-Banking Financial Institution
NCLAT	National Company Law Appellate Tribunal
NCLT	National Company Law Tribunal
OTS	One- Time Settlement
RBI	Reserve Bank of India
RDDBF	Recovery of Debts Due to Banks and Financial Institutions Act, 1993
RP	Resolution Professional
SARFAESI	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
SDR	Strategic Debt Restructuring
SEBI	The Securities and Exchange Board of India
SICA	Sick Industrial Companies (Special Provisions) Act, 1985
SICA Repeal Act	Sick Industries Companies Act (Special Provisions) Repeal Act, 2003
UNCITRAL	The United Nations Commission on International Trade Law
VL Regulations	Insolvency and Bankruptcy Board of India (Voluntary Liquidation Process) Regulations, 2017



SECTION I: ADVENT OF IBC

USHERING OF A NEW BANKRUPTCY CODE

Vinod Kothari

Editor's Note: *The journey of IBC so far has had both hits and misses; and as it matures overtime, we expect to see better results from this ambitious piece of economic legislation in our country. However, a nice way to start our journey into the Code may be a bit of a flashback and see how it all started. This piece, contributed in November 2015, discusses the broad recommendations of the Bankruptcy Law Review Committee with respect to the enactment of the Insolvency and Bankruptcy Code, 2016.*

BLRC headed by Dr. T. K. Viswanathan recently submitted its final report ([Final Report](#)) to the Ministry of Finance. Before this, an interim report ([Interim Report](#)) was submitted earlier in Feb 2015. While the Interim Report merely recommended some amendments to the existing scheme of resolution of sickness under the Companies Act 2013, and additionally, some other measures, the Final Report goes to suggest a completely Insolvency and Bankruptcy Bill, complete with the institutional framework, eligibility for applying for resolution, moratorium provisions, interim and final administration of entities during administration, liquidation, priorities, etc.

A messed up insolvency regime

The recommendation of a complete self-contained bankruptcy code for India is a huge step towards cleaning up the mess that bankruptcy and resolution laws in India are in. Presently, there is no comprehensive code for handling business failures in India – we have been working spasmodically to enact the Sick Industrial Companies Act way back during the era of industrial sickness, to grant special rights to banks for recovery of debts via the Recovery of Debts due to Banks or Financial Institutions Act, for non-judicial recovery of assets via the SARFAESI Act, special measures for repayment of debentures under the Companies Act, etc. In the meantime, the basic framework for bankruptcy of companies, under winding up provisions under the Companies Act, 1956 has remained unchanged over last nearly 6 decades, and the framework for personal insolvency has remained unchanged over nearly 100 years!

Not only is the present scene a mosaic of many pieces, the worst part is that the pieces do not fit into each other at all. Winding up is a holistic remedy – looking at the business as a whole, taking a view whether the business can be revived, and if the business cannot be revived, then taking the business down the liquidation path, distributing its assets on a fair and equitable basis. On the contrary, enforcement of security interests by creditors is based on a “might is right” principle a creditor is obviously concerned with his dues rather than the interests of other stakeholders in the business – other lenders, creditors, workers, and others whose livelihood depends on the business. The Sick Industrial Companies Act (SICA) framed on the recommendations of the Tiwari Committee was based

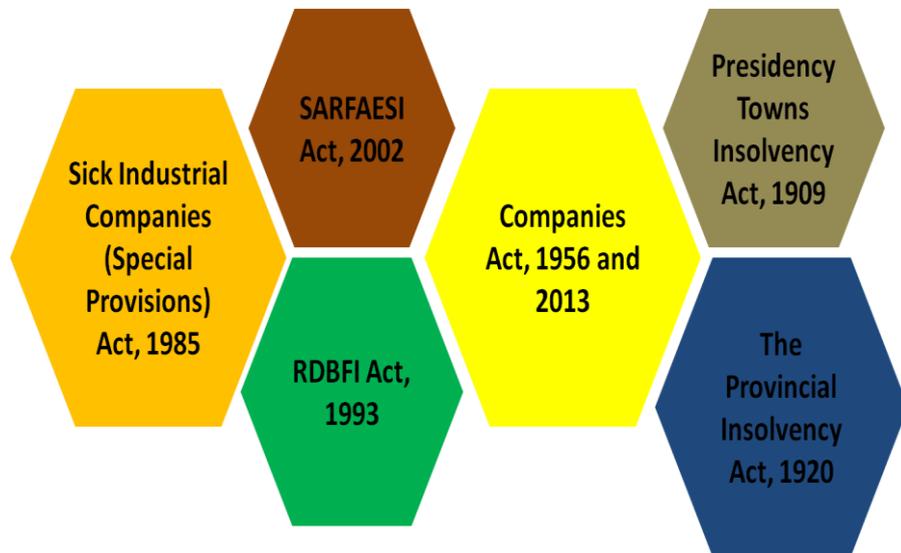


Figure 1: Laws Governing Sickness & Insolvency

on Chapter 11 of US Bankruptcy Code, and aimed at reviving a business if the business was still viable. In practice, the moratorium provisions of SICA were widely used to prolong defaults without attracting any creditor action; while revival might have been the central theme of the SICA, but it became a safe harbour for defaulters, thus creating the landscape for the SARFAESI Act. SARFAESI Act, purporting to base itself on Article 9 of the UCC in the USA was based entirely on creditor-driven enforcement of security interests. Amendments based by the SARFAESI Act into the SICA made SICA virtually irrelevant if the creditors had enforced security interests, or sold their assets to an asset reconstruction company (ARC). This measure, apparently a reaction to the tactics used by defaulters to use SICA as the shield to ward off creditor action, served to be a complete contrast to any possibility of revival, because nothing would be left in a unit to revive, if its core assets had been repossessed by lenders already.

The ARC business, clearly a product of SARFAESI Act and in global sense, a unique business model India, is also based on the “might is right” principle, where the ARC aggregates loans by various lenders to increase its might.

In short, the equitability principle, in which insolvency laws are rooted all over the world, is rarely seen on the Indian scene as of now.

This is for the legal framework; but the way the failure of big business in India is currently managed is by of informal framework –the Corporate Debt Restructuring (CDR), Joint Lenders Forum (JLF) and the Strategic Debt Restructuring (SDR), all of which are based on RBI guidelines. It is these frameworks currently handling much of Rs 2,67,000 crores non-performing loans in the Indian financial system. SARFAESI has mostly been successful in evicting homeowners from their residential

Ushering of New Bankruptcy Code

houses for defaulting EMIs; as for big business, most of it continues to chug on, under the CDR arrangements, with bankers trying to save their revenue statements converting loans into equity.

While all these sporadic and uncoordinated forays of law-making continued, committees and working groups over decades have been talking about reforming bankruptcy laws in India. The trail goes at least as early as 1964 when the [26th Report of the Law Commission](#) recommended reform of personal insolvency laws and suggested a new Insolvency Bill to consolidate the extant two separate insolvency laws. Obviously, this report has not been acted upon to date.

The Tiwari Committee's report, based on whose recommendation SICA was drafted and finally enacted has been referred to above.

In 1999, the Government appointed V B Eradi Committee specifically from the viewpoint of corporate bankruptcy. The Committee revealed some startling facts – that the average time taken in winding up matter was 11 years pan-India, and in the Eastern Region, it took on an average 25 years to resolve a bankruptcy. The idea of the National Company Law Tribunal (NCLT) was born, inclusively,

Observations of Eradi Committee

- Avg. time taken for winding up in India- 11 years
- Avg. time to resolve bankruptcy in Eastern Region- 25 years

out of the recommendations of the Eradi Committee. Accordingly, the Companies Act was amended in 2002 – it is a sad reflection on Indian law-making that the provisions pertaining to shifting of winding up to the NCLT, enacted by the Parliament in 2002, have not been enforced for over 13 years, and if the BLRC recommendations are indeed accepted, the law made in 2002 will die, still born, though having lived in incubator for 13 long years.

In 2001, the [N L Mitra Committee report](#) recommended a comprehensive bankruptcy code – nothing was done to implement any of the Mitra Committee recommendations until the Companies Act 2013 was enacted, based largely on the recommendations of the J Irani Committee, which adopted Mitra Committee recommendation for changing the basis of insolvency from “inability to pay” to “failure to pay”. Of course, the provisions of the Companies Act 2013 on corporate insolvency are yet to be enforced, as the NCLT is yet to be constituted.

Major recommendations of the BLRC

– Scope of applicability

- The law is to cover insolvencies of “corporate persons” (covering companies, LLPs, and all other entities having limited liability), as also individuals, firms etc.
- While the law is admittedly a code for insolvent companies, it covers liquidation of solvent companies as well, and thereby, serves as a complete code on liquidation of companies.

– Institutional Framework

- Insolvency and Bankruptcy Board of India: the primary functions of the Board will include

registration of insolvency professionals, insolvency institutions, information utilities, provide guidelines on the conduct of bankruptcy resolution, etc.

- Adjudicating Authority (AA): the AA is the primary quasi-judicial body presiding over the entire process of bankruptcy.

In case of corporate persons, the NCLT will be the AA

In case of other persons, the DRT will be the AA.

- Insolvency professionals: may be practically read as administrators (pre liquidation stage) and liquidators (post liquidation order) – who have role to play in insolvency, liquidation and resolution. The following are the insolvency professionals

- Interim resolution professional – immediately on admission of an insolvency resolution process

- Final resolution professional - on appointment by the Committee of Creditors

- Liquidator – on commencement of liquidation proceedings. Typically, the final resolution professional will act as liquidator, unless replaced by the AA.

- Resolution applicant: the entity that prepares a resolution plan

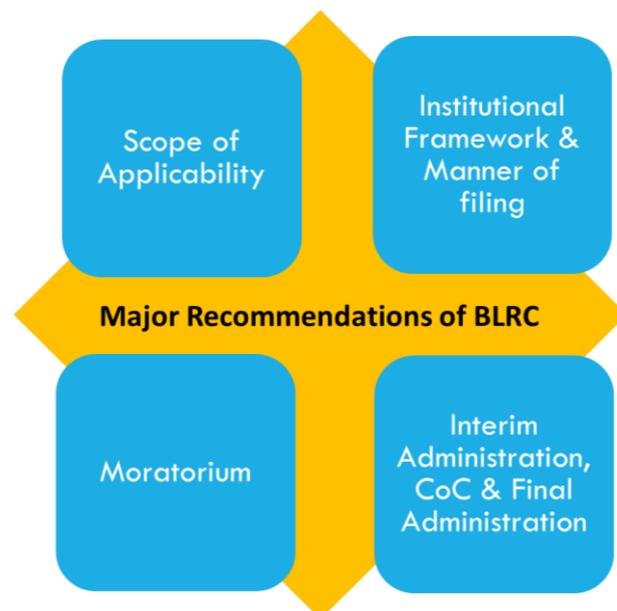


Figure 2: Major Recommendations of BLRC

- Information utilities: the information utilities will be storing financial information– this may be seen as electronic filing of defaults, security interests. There will obviously be an overlap with present filing of defaults with someone like CIBIL, security interests with the Companies Act, etc., which may be eventually resolved.

– **Manner of filing for bankruptcy in case of corporate persons**

- The “corporate insolvency resolution process” may be initiated on application by
 - a financial creditor, meaning a creditor for financial facility (which is a broadly worded expression including financial lease and hire purchase transactions, which are treated as financial transactions under applicable accounting standards)
 - application by an operational creditor, meaning a creditor other than a financial creditor

Ushering of New Bankruptcy Code

- application by the corporate debtor himself, that is, company itself

- In case of financial creditors, the basis of filing is the fact of a default to any financial creditor. This drastically changes the basis of the current provisions of “sickness” under the Companies Act, which is based on default to a majority in value of the creditors. In addition, the only fact on which the application for insolvency will be admitted is the fact of a default, established from the records of the information utility
- In case of operational creditors, if there is no dispute about a debt (there is a process for dispute too), then, if the claim is not paid within 10 days, the creditor may initiate insolvency process. This largely creates a level-playing field between secured and unsecured creditors
- The law puts a very tight timeline of just 180 days for completing the resolution process.

– Moratorium

- One of the most important features of a bankruptcy law is the grant of moratorium during which creditor action will remain stayed, while the bankruptcy court takes a view on the possibility of rehabilitation. In the chapter on Sick Companies under the Companies Act 2013, there is no provision for automatic moratorium – it merely empowers the NCLT to grant a moratorium upto 120 days.
- The Code [clause 13] talks about a mandatory moratorium – thereby, it serves almost like the automatic moratorium under global bankruptcy laws. The moratorium will continue throughout the completion of the resolution process – which is 180 days as mentioned above. However, if in the meantime, the creditors’ committee resolves to approve liquidation of the entity, then the moratorium will cease to have effect.
- Explicitly, the moratorium before liquidation applies to enforcement of security interests under SARFAESI Act as well [clause 14 (1) (c)].
- A moratorium also applies when an order for liquidation has been passed by the AA. [clause 33 (6)]

– **Interim administration, Committee of Creditors and final administration:** these provisions are similar to the existing process of winding up of companies, except for much tighter timelines.

Steps in Corporate Insolvency Resolution Process

Table 1: Steps in CIRP

Particulars	Timelines (in days)
Filing of insolvency application	X
AA shall communicate admission or rejection of insolvency Application	X+2
Moratorium and advertisement of admission of insolvency resolution process	Before appointing an IRP, AA shall declare a moratorium
AA shall appoint an interim resolution professional (IRP)	(X+2) + 2
Tenure of an IRP shall cease to exist	(X+2) + 2 + 14
Constitution of Committee of Creditors	(X+2) + 2 + 14
Appointment of final resolution professional	(X+2) + 2 + 14
Preparation of resolution plan by resolution applicant	
Submission of resolution plan duly approved by the committee of creditors to the AA	
If resolution plan approved – the moratorium shall cease to have Effect	(X+2) + 180
If resolution plan rejected - Initiation of liquidation – this is the culmination of the resolution process, if the entity is not getting revived, but heading for liquidation	(X+2) + 180
The corporate insolvency resolution process shall be completed	(X+2) + 180
The process can be extended	(X+2) + 180 +90

Steps in Corporate Liquidation Process

- **Initiation of the liquidation process**, based on either the recommendations of the resolution plan, or failure to submit the plan within the maximum time period permitted, or based on a vote of the Creditors' Committee – clause 33
- **Appointment of liquidator** - clause 34
- **Formation of liquidation trust** – clause 36. This provision is indeed very significant as it defines the reach of the so-called “liquidation estate”. That is to say, to the extent assets of the corporate debtor form part of the liquidation trust, the assets will be distributed by the liquidator in the manner of priorities laid in the law, and individual claimants or those claiming to have any special rights on such assets will have to form part of the liquidation process.
 - Important inclusions in the liquidation trust are:
 - All assets and interests as evidenced in the balance sheet of the corporate debtor: this issue will continue to cause confusion as it relies on accounting principles which are quite often

Ushering of New Bankruptcy Code

not aligned with legal title. For example, under IFRSs, several securitisation transactions or sale of financial assets do not go off the balance sheets. This may put to question the “true sale” character of several securitisation transactions.

- Important exclusions are:
 - **Third party assets, including**
 - » Trust assets, that is, assets whereof the corporate debtor is merely a trustee
 - » Bailment assets – thereby, leased assets will be excluded from liquidation trust but it may be argued that in case of financial leases, as the assets are on the balance sheet, at least the right to use will be an asset, unless the right to use gets terminated by virtue of the bankruptcy event.
 - » Transactions where there is no transfer of title but merely a right to use.
 - **Assets placed as collateral with financial debtors**, that are subject to netting under multilateral or clearing contracts – thereby giving protection to such derivatives as are settled by multi-lateral clearing. The provision seems to have been picked from international jurisdictions, but multilateral clearing is not currently in vogue in India.
 - **Assets of subsidiaries** – while shares held in the subsidiary form part of the liquidation trust, the assets do not.
- **Collection of creditors’ claims** within 21 days of the commencement of liquidation, and verification of claims – clause 38-41. Clause 42 also includes elaborate provisions about voidable transfers and undue preferences, incorporating several safe harbours for bonafide transactions against “clawback” rights of a bankruptcy court. Under existing law, the court simply has powers to preserve bonafide transactions – the Bill gives several such transactions which are protected from any clawback. In addition to this, there are usual provisions for undervalued transactions, fraudulent transfers, etc. There is seemingly a new provision pertaining to avoidance of “extortionate credit” contracts, entered into within 2 years before the commencement of insolvency process [clause 50-52].
- **Realisation of debt by secured creditors [clause 53]:** This very important section incorporates the classic principle understood over the decades in India – that a secured creditor may either relinquish security interest and force his claim on the overall liquidation trust assets, or may opt to realise security interest outside the winding up process. Clause 53 (4) permits the secured creditor to realise security interest according to such law as may be applicable – thereby preserving the process of self-help realisation under the SARFAESI Act. However, there will be reference to the liquidator for the purpose of the liquidator identifying the asset. This section, however, brings a very important balance in the process of repossession outside the liquidation process under SARFAESI Act, by requiring the secured creditor to return the excess realised by him to the liquidator. Thereby, the liquidator also becomes an interested party in the process of sale of secured assets under SARFAESI Act, throwing greater burden on the creditors in being more transparent in the conduct of the sale.
- **Distribution of assets by the liquidator [clause 54].** Most interestingly, clause 54 starts with a non-obstante clause, giving this section supremacy over conflicting provisions of a vast number of

Central and State laws. There have been several rulings of the courts, including the apex court, on conflict of laws pertaining to claims of the state creditors over assets of companies in winding up. Hopefully, this section, being a dedicated section pertaining to distribution of assets on liquidation, will operate as a special law, and will resolve the cacophony currently existing in the matter. In fact, state dues come at number 5 in the rung. One disturbing point is the provision in clause 54 (2) which seeks to disregard contractual arrangements between claimants of a single class. Usually, in capital market transactions, there are several classes of preference created among creditors – for example, super senior, senior, subordinated, etc. Clause 54 (2) may be interpreted to disregard these priorities as “contractual arrangements”.

- **Application for dissolution [clause 54 (4)].**
- **Order for dissolution [clause 54 (5)]**

Fast Track Resolution

As a notable feature of the Bill, the Bill proposes a fast track resolution process, intended to be completed within 90 days, as opposed to the 180 days’ time for a normal process. The fast track process will be applicable for corporate debtors of a particular class, or having assets or income upto such level as may be notified by the Central government. Essentially the process seems to be targeting small companies.

Voluntary Liquidation

It would have been a pity if the process of liquidation under the Code was to be reserved only for defaulting companies, since voluntary winding up of healthy companies in India currently takes enormously long time and, surprisingly, all attention has been to the speed of incorporating companies, not winding them up. Thus, a healthy company, based on a declaration of solvency, pass a special resolution to liquidate itself. At least 2/3rds of the creditors in value must also support the members’ resolution. The rest of the liquidation mechanics under the Bill will apply to a voluntary winding up as well.

NCLT to mind its timelines

One of the highlight points of the Code is timely completion of the liquidation process. Since most delays take place due to protracted time before the Benches, clause 64 will keep the benches of NCLT and NCLAT serious about timely disposal of matters. Theses sections enact that where the NCLT or NCLAT does not dispose of the matter within the time limits, the president of the forum shall record the reasons for not doing so.

Editor's Note: SICA is been seen as an unsuccessful attempt at combating corporate sickness. Thus, after advent of IBC, the death of SICA was imminent. Interestingly, the law to repeal SICA was enacted way back in the year 2003, when revival and rehabilitation processes for sick companies were incorporated in the Companies Act, 1956, by way of an amendment in 2002. However, the concerned provisions in the Companies Act were never enforced, and thus, the SICA repeal law too, remained dormant. The SICA repeal law was finally enforced after coming of IBC, in the year 2016. This piece tracks the history of repeal of SICA and provides a historical backdrop to the IBC regime¹.

The Ministry of Finance, vide Notifications S.O.3568(E) and S.O. 3569(E), both dated November 25, 2016 has notified December 1, 2016 as the date on which the SICA Repeal Act shall come into force and on and from which any reference or inquiry pending before BIFR and any appeal pending before the AAIFR shall stand abated.



Figure 3: Identification of a Sick Company

Below we have tried to discuss in brief the long journey of SICA and the end thereof.

Enactment of SICA

In 1985, the Government of India enacted SICA on the recommendation of the T. Tiwari Committee. SICA was enacted with a view to—

- securing the timely detection of sick and potentially sick companies owning industrial undertakings;

¹Contributed in November, 2016.

- speedy determination by a Board of experts of the preventive, ameliorative, remedial and other measures which need to be taken with respect to such companies; and expeditious enforcement of the measures so determined and for matters connected therewith or incidental thereto.

Failure of SICA

SICA lacked in many aspects – the Act was made applicable only to industrial undertakings, section 22 of the SICA which dealt with moratorium was misused to defer action by creditors. The institutional machinery was not being able to serve the expected purpose. The [Goswami Committee Report](#) provides critical analysis of the legislation and its effectiveness in meeting the ends SICA was made for. Later, it was decided to shift the provisions relating to revival and rehabilitation of sick companies to the Companies Act, 1956 vide the Companies (Second Amendment) Act, 2002.

The Companies (Second Amendment) Act, 2002

Part VIA (sections 424A to 424L) was introduced in the Companies Act, 1956 to provide for revival and rehabilitation of sick companies. NCLT and NCLAT were to replace BIFR and AAIFR respectively through the said amendment. However, the provisions were not notified and thus never enforced.

The SICA Repeal Act, 2003

Subsequently, the SICA Repeal Act was enacted. Section 3 of the SICA Repeal Act provides for –

1. Repeal of SICA; and
2. Dissolution of Appellate Authority and Board.



Figure 4: Determination of a company as Potentially Sick

However, due to delay in constitution of NCLT, the SICA Repeal Act was never notified. Section 4 (b) prior to amendment provided as follows:

“(b) any appeal preferred to the Appellate Authority or any reference made to the Board or any inquiry pending before the Board or any other authority or any proceeding of whatever nature pending before the Appellate Authority or the Board immediately before the commencement of this Act shall stand abated:

Provided that a company:—

SICA Bids Adieu

(i) in respect of which such appeal or reference or inquiry stand abated under this clause may make a reference under PART VIA of the Companies Act, 1956 (1 of 1956) within one hundred and eighty days from the commencement of this Act in accordance with the provisions of the Companies Act, 1956;

(ii) which had become a sick industrial company as defined in clause (46AA) of section 2 of the Companies Act, 1956 (1 of 1956), before the commencement of the Companies (Second Amendment) Act, 2002 (11 of 2003) may make a reference under PART VIA of the Companies Act, 1956 within one hundred and eighty days from the commencement of the Companies (Second Amendment) Act, 2002 or within sixty days of final adoption of accounts after such commencement, whichever is earlier,

and reference so made shall be dealt with in accordance with the provisions of the Companies Act, 1956 (1 of 1956):

Provided further that no fee shall be payable for making such reference under PART VIA of the Companies Act, 1956 (1 of 1956) by a company whose appeal or reference or inquiry stand abated under this clause:

Provided also that any scheme sanctioned under sub-section (4) or any scheme under implementation under sub-section (12) of section 18 of the repealed enactment shall be deemed to be a scheme sanctioned or under implementation under section 424D of the Companies Act, 1956 (1 of 1956) and shall be dealt with in accordance with the provisions contained in PART VIA of that Act."

The Companies Act, 2013

Chapter XIX (sections 253 to 269) of the Companies Act, 2013, i.e. the successor legislation of the Companies Act, 1956 deals with revival and rehabilitation of sick companies. Section 255 of the Code read with 11th schedule provides for amendments in the Companies Act, 2013 and has been notified vide notification dated November 15, 2016. Para 8 of 11th schedule provides for deletion of sections 253 to 269.

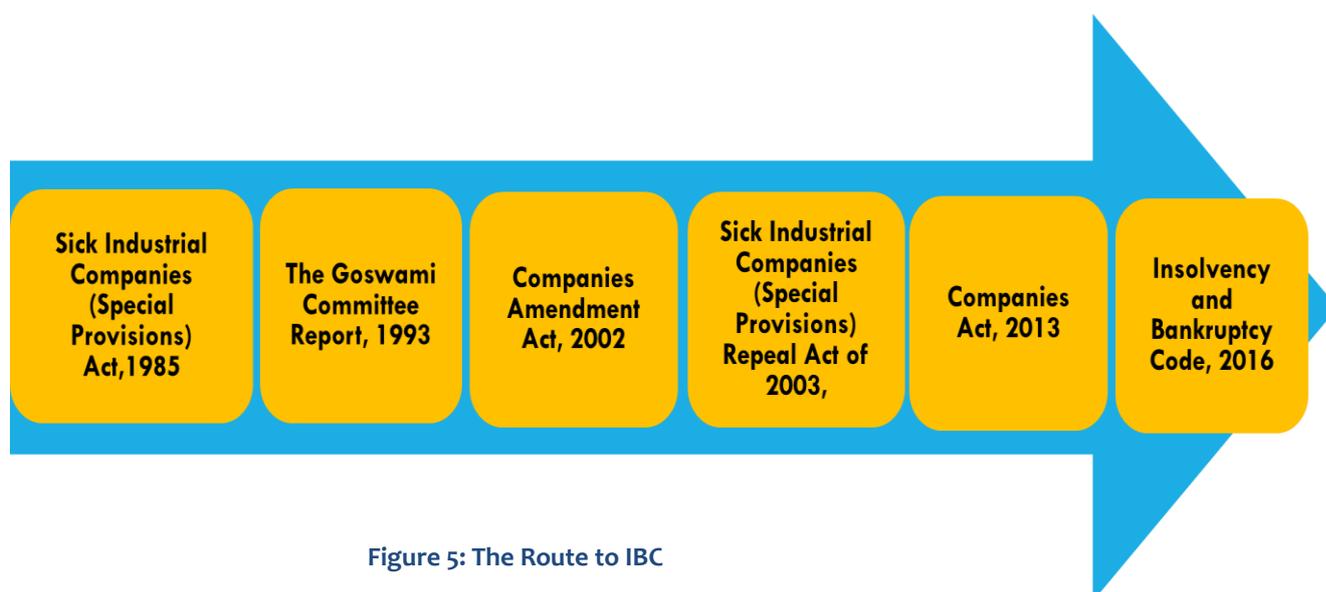


Figure 5: The Route to IBC

Insolvency and Bankruptcy Code, 2016

Section 252 of the recently enacted the Code provides for amendment of the SICA Repeal Act in the manner provided under read with the 8th schedule of section 252. 8th schedule provides for substitution in section 4 (b) of the SICA Repeal Act. The text of such substitution is as follows:

“In section 4, for sub-clause (b), the following sub-clause shall be substituted, namely—

(b) On such date as may be notified by the Central Government in this behalf, any appeal preferred to the Appellate Authority or any reference made or inquiry pending to or before the Board or any proceeding of whatever nature pending before the Appellate Authority or the Board under the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) shall stand abated:

Provided that a company in respect of which such appeal or reference or inquiry stands abated under this clause may make reference to the National Company Law Tribunal under the Insolvency and Bankruptcy Code, 2016 within one hundred and eighty days from the commencement of the Insolvency and Bankruptcy Code, 2016 in accordance with the provisions of the Insolvency and Bankruptcy Code, 2016:

Provided further that no fees shall be payable for making such reference under Insolvency and Bankruptcy Code, 2016 by a company whose appeal or reference or inquiry stands abated under this clause.

The provisions of the Code dealing with amendment to the SICA Repeal Act came into force from November 1, 2016; however, the Ministry has appointed December 1, 2016 as a date on which the provisions of the SICA Repeal Act shall come into force. A question may arise as to which date shall be considered i.e. November 1, 2016 or December 1, 2016. On careful reading, one may note that clause (b) of section 4 states as follows:

*On such date **as may be notified by the Central Government in this behalf**, any appeal.
..... shall stand abated”*

The Central Government, vide notification dated November 25, 2016 has notified the provisions of the SICA Repeal Act. Therefore, any reference made to BIFR, any inquiry pending before BIFR, any appeal preferred to AAIFR, or any proceedings pending before BIFR/AAIFR shall automatically stand abated w.e.f. December 1, 2016.

Further, the proviso to clause (b) of section 4 of the SICA Repeal Act reads as follows:

“Provided that a company in respect of which such appeal or reference or inquiry stands abated under this clause may make reference to the National Company Law Tribunal under the Insolvency and Bankruptcy Code, 2016 within one hundred and eighty days from the commencement of the Insolvency and Bankruptcy Code, 2016 in accordance with the provisions of the Insolvency and Bankruptcy Code, 2016”

SICA Bids Adieu

The proviso provides the companies, who have made any reference made to BIFR, any inquiry pending before BIFR, any appeal preferred to AAIFR, or any proceedings pending before BIFR/AAIFR to make a reference to the NCLT under the Code within 180 days from the commencement of the provisions of the Code. The provisions of section 252 read with 8th schedule came into force from November 1, 2016. Therefore, the period of 180 days shall be calculated from November 1, 2016. Further, no fees shall be payable for making such reference.

Notifications dated 25th November, 2016

On [25th November, 2016](#), the Ministry of Finance, issued a notification notifying the provisions of the SICA Repeal Act². Notably, section 1 (2) of the SICA Repeal Act states as follows:

(2) It shall come into force on such date as the Central Government may, by notification in the Official Gazette, appoint,

which implies that the entire Act shall come into force, there seems to be no possibility of piecemeal enforcement of provisions. Further, the Central Government has appointed December 1, 2016, on which the provisions shall come into force.

On the same day, the Ministry of Finance issued a separate notification notifying the provision of section 4 (b) of the SICA Repeal Act⁵. The notification, further states that such provision shall come into force from December 1, 2016. However, the same seems to be irrelevant, in light of section 1 (2) of the SICA Repeal Act.

Conclusion

The most awaited provision of the SICA Repeal Act, 2003 finally got notified and the erstwhile SICA, 1985 bids adieu. Hopefully, the objective with which SICA was enacted can be attained by the Code.

²S.O. 3568(E)



SECTION II: SOME BASIC DEFINITIONAL CONCEPTS

DIFFERENCE BETWEEN OPERATIONAL AND FINANCIAL CREDITORS

Niddhi Parmar

Editor’s Note: IBC envisages a creditor-driven process. A creditor is one to whom the debtor owes a ‘debt’, and ‘debt’ as defined in the law is a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt. Therefore, the law creates a unique distinction between financial creditors and operational creditors – defining at different places, their rights, entitlements, roles, and limitations. Accordingly, determination of nature of debt is a preliminary exercise in IBC proceedings. In this piece originally contributed in 2016, the contributor briefly collates the points of difference.

The most awaited, IBC, received President’s assent on May 28, 2016. Section 3(10) of the Code, 2016 defines the term creditor as follows –

"creditor" means any person to whom a debt is owed and includes a financial creditor, an operational creditor, a secured creditor, an unsecured creditor and a decreeholder;"

The Code, 2016 differentiates between financial creditors and operational creditors. Financial creditors are those whose relationship with the entity is a pure financial contract, such as a loan or a debt security. Operational creditors are those whose liability from the entity comes from a transaction on operations.

We have analyzed the difference between both the terms i.e. financial creditor and operational creditor below:

Particulars	Financial Creditor	Operational Creditor
Meaning	Section 5 (7) - Financial creditor means any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to.	Section 5 (20) – Operational creditor means a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred.
Meaning of the term “debt”	Section 5 (8) - financial debt means a debt alongwith interest, if any, which is disbursed against the consideration for time value of money and includes items referred to in sub-clauses (a) to (i)	Section 5 (21) - operational debt means a claim in respect of the provision of goods or services including employment or a debt in respect of the repayment of dues arising under any law for the time

		being in force and payable to the Central Government, State Government, or any local authority.
Voting share	Section 5 (28) - Voting right of a financial creditor is based on the proportion of the financial debt owed to such financial creditor. The approval of committee of creditor shall be obtained by a vote of not less than seventy five percent ³ of the voting shares.	Operational creditor shall not have any right to vote at the meeting of committee of creditors.
Initiation of corporate insolvency resolution process	Section 7 (1) – On occurrence of a default, a financial creditor shall either by itself or jointly with other financial creditors may file an application for initiating corporate insolvency resolution process against a corporate debtor before the Adjudicating Authority.	Section 8 (1) – On occurrence of a default the operational creditor may, deliver a demand notice of unpaid operational debtor copy of an invoice demanding payment of the amount involved in the default to the corporate debtor. The operation creditor may file an application after the expiry of 10 days from the date of delivery of the notice or invoice demanding payment under sub-section (1) of section 8, if the operational creditor does not receive payment from the corporate debtor or notice of the dispute under sub-section (2) of section 8.
Appointment of IRP	Section 7 (3) - The financial creditor shall along with the application furnish the name of the resolution professional proposed to act as an interim resolution professional.	Section 9 (4) - An operational creditor may propose a resolution professional to act as an interim resolution professional.
Constitution of Committee of Creditors	Section 21 (2) - The committee of creditors shall consist solely of financial creditors , and all financial creditors of the corporate debtor.	Operational creditors shall not form part of committee.
Submission of financial information	Section 215 (2) - A financial creditor shall submit financial information and information	Section 215 (3) - An operational creditor may submit financial information to the information

³By virtue of the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018, effective from 6th June, 2018, the voting percentage has been reduced from 75% to 66% for substantial decisions like approval of Resolution Plan, replacement or removal of Resolution Professional etc., whereas, the minimum threshold for routine matters has been reduced to 51%.

Difference between Operational & Financial Creditors

relating to assets in relation to utility
which any security interest has
been created.

Table 2: Differences b/w Financial and Operational Creditor

Know More . . .

The difference between financial and operational creditors under the Code is not merely surficial – it is fundamental. If the crux of insolvency regime is priorities, the priorities of the two in the distribution waterfall differ, even if both are unsecured. Is this a differentiation, or discrimination?

The differentiation, alongwith certain other provisions of the Code, was challenged before the Supreme Court in a bunch of petitions. In *Swiss Ribbons Ltd. v. Union of India*, the Supreme Court observed that “A perusal of the definition of ‘financial creditor’ and ‘financial debt’ makes it clear that a financial debt is a debt together with interest, if any, which is disbursed against the consideration for time value of money. It may further be money that is borrowed or raised in any of the manners prescribed in Section 5(8) or otherwise, as Section 5(8) is an inclusive definition. On the other hand, an ‘operational debt’ would include a claim in respect of the provision of goods or services, including employment, or a debt in respect of payment of dues arising under any law and payable to the Government or any local authority.” And, “financial creditors generally lend finance on a term loan or for working capital that enables the corporate debtor to either set up and/or operate its business. On the other hand, contracts with operational creditors are relatable to supply of goods and services in the operation of business. Financial contracts generally involve large sums of money. By way of contrast, operational contracts have dues whose quantum is generally less.” The difference between operational and financial debt/creditors was thus upheld by the Supreme Court.

The most important consideration in determining whether a debt is a financial debt or an operational debt is to “intent of the parties”. Merely because a creditor claims interest for a delayed payment, does not imply that the debt is financial - in such transactions, interest is contemplated as a ‘penalty’ and not ‘returns’. Also, lending for time value of money does not necessarily involve ‘interest’. In order to qualify to be a financial debt, what matters is that the amount was disbursed against time value of money, whether or not expressed in terms of ‘interest’.

Besides financial and operational debts, there can be other types of debts too – however, such other creditors are not entitled to initiate an application under the Code, but can file claims in the specified form.

CLAIM FOR REFUND OF ADVANCE: WHETHER AN OPERATIONAL DEBT

- **Richa Saraf & Shreya Jain**

Editor's Note: *The two basic fountainheads of insolvency proceedings under the Code are default of financial debt and operational debt. Operational debt includes a wide range of claimants for supply of goods and services. However, technical issues arise as to whether customer advances constitute operational debt. When entities go insolvent, not only do they have liabilities for goods and services procured, where payments have not been made, but also advances made by customers have not been appropriated by supply of goods and services by the insolvent entity. The term 'operational debt' however includes an amount due against 'provision' of goods or services. Hence arises the ambiguity as to treatment of such consumer advances – as to whether such amounts can be classified as operational debt or not. As noted, determining nature of debt owed to a creditor is instrumental in determination of rights, entitlements, and limitations of the creditor under IBC. There have been certain judicial interpretations concerning the issue – this piece analyses the same⁴.*

It is not an unusual business practice to collect advance monies from consumers before providing goods/ services to them. In such a scenario, consumers constantly bear the risk of not being able to

“A man who pays his bill on time is soon forgotten”- Oscar Wilde

recover the amount, in the event the provider of goods/ service suddenly ceases operations and as such, also fails to supply the goods/ services. NCLT, Kolkata, in its

recent ruling, in the matter of [SHRM Biotechnologies Private Limited v. VAB Commercial Private Limited](#), determined the issue whether claim towards refund of advance money would fall within the definition of “operational debt”. The NCLT held in negative, stating that the creditor neither did render any service to the corporate debtor nor did provide any goods to the corporate debtor, and thus, such prepayment would not constitute an operational debt.

Though the said issue has been dealt with in numerous cases, however, due to contradictory stands taken by the NCLT benches, the ambiguity continues. In this article, the authors have tried to analyse the judgment.

Facts of the case

SHRM Biotechnologies Pvt. Ltd., Applicant in the instant case, approached VAB Commercials Pvt. Ltd. (“Corporate Debtor”) for arranging for an investor. On the basis of a mandate letter, the Applicant paid certain amount as advance to the Corporate Debtor.

As per the mandate letter, in case the Corporate Debtor is not able to arrange for any investor, the entire advance paid was to be refunded to the Applicant. Despite breach of terms, the Corporate

⁴Contributed on December, 2018.

Claim for Refund of Advance

Debtor did not refund the advance amount. The Applicant contended that the Corporate Debtor has failed to provide requisite services and also, not refunded the advance amount, hence, a demand notice was served on the Corporate Debtor. Further, there was no dispute raised by the Corporate Debtor, and infact, the Corporate Debtor did not turn up before the Adjudicating Authority to contest the application, and therefore, the application should be allowed.

The moot issue for consideration was whether a claim towards repayment of advance, in terms of breach of mandate letter signed and executed by the Applicant and the Corporate Debtor, comes under the ambit of “operational debt”, for the purpose of Section 9 of IBC.

Interpretation of the relevant provisions

To determine whether the application is at all maintainable, the Hon’ble NCLT deliberated on the term “operational debt” as contained in IBC. As per Section 5(21), “operational debt” means:

- a) claim in respect of provision of-
 - i. goods or
 - ii. services, including employment; or
- b) debt in respect of payment of dues arising under any law for the time being in force and payable to-
 - i. the Central Government,
 - ii. any State Government; or
 - iii. any local authority.

The Applicant could definitely not be categorised as Central Government, any State Government or any local authority. The next question for consideration was whether the debt would fall under the ambit of “claim in respect of the provision of goods or services.”

It was observed that the Applicant has not rendered any service, nor provided any goods to the Corporate Debtor. In this regard, the Tribunal also placed reliance on the case of [Sajive Kanwar v. AMR Infrastructure](#), wherein NCLT, Principal Bench analysed the definition of operational debt. The relevant extract is as follows:

“It is doubtful whether it would include all debts other than financial debt because we do not find any such legislative intendment...”

Again, in the case of [Daya Engineering Works Pvt. Ltd. v. UIC Udyog Ltd](#), the applicant made advance payments for certain materials, for which there was a short supply. An application was, therefore, filed under Section 9, but the matter was dismissed on the ground that the amount due to the applicant did not fall under any of the aforementioned elements of the definition of operational debt, and hence, there exists no operational debt at all.

Our Analysis

To emphasize, the term “operational debt” is defined to mean **“claim in respect of provision of goods or services...”** It may be argued that the definition of “operation debt” is ambiguous on two points. First, with regard to the direction of flow of provision of goods or services; the provision does

not stipulate that the provider of goods or services shall be the creditor and the recipient shall be the corporate debtor. An operational debt is only a claim “*in respect of provision of goods or services*”. Hence, there might be instances where the party paying advance may be regarded as a creditor, and the party to provide goods/services is then regarded as debtor against the advance amount. Secondly, the section is not very clear as to whether the provision of goods and services should have already taken place on the date of filing of claim, or on the date of making the application, as the case may be, or whether such provision of goods and services may be for future as well.

Considering the aforementioned, it is quite possible to arrive at alternate interpretations of the definition. In fact, in [M/s Auspice Trading Private Limited v. M/s Global Proserv Limited](#), a creditor, being aggrieved due to non-repayment of advance, approached NCLT, Mumbai under Section 9 of IBC. The application was admitted by NCLT, initiating corporate insolvency resolution process against the debtor.

To further substantiate, there are potentially three types of claims- financial, operational and others. The category of other claims was added mainly for home buyers, pursuant to the Supreme Court ruling in *Jaypee Infratech*.

It is also pertinent to mention that the erstwhile Section 271(1)(a) of the Companies Act, 2013 for failure to pay money has been deleted, leaving no scope for a winding up application by creditors. In essence, the only remedy seems to be IBC. While it is true that IBC is not a proper remedy for commercial claims; underlying a commercial claim, which is otherwise undisputed, there may be a case of inability to pay or discrete insolvency. But the interpretation of the word “claims”, and distinction between financial and operational debt should not be given a narrow interpretation. It is certainly acceptable to construe the term “financial debt” with a precise meaning so as to include financial facilities only, however, the word “operational debt” should be interpreted widely so as to minimise the third category- other claims- which is only a claim without a right. Such a toothless, remediless claim, must be minimised.

DECIPHERING “DISPUTE”

Mobilox Innovations Pvt. Ltd. v. Kirusa Software Pvt. Ltd.

- **Richa Saraf**

Editor’s Note: A default in repaying debt is the fundamental requirement for initiating process under IBC. However, a debt, which itself is ‘disputed’, cannot form the basis of the process. In case of operational creditors, it is mandated that the operational creditor serves a demand notice to the corporate debtor. In response, the corporate debtor may either ‘pay’ the debt, or ‘dispute’ the debt. However, the dispute must be something which was ‘pre-existing’ – that is, the corporate debtor is not entitled to raise frivolous disputes only on receiving the demand notice. Where there exists a dispute, the operational creditor is not entitled to initiate application for corporate insolvency resolution process under IBC.

There had been a lot of ‘dispute’ around the word ‘dispute’ – different benches of NCLTs interpreted the word differently – strictly or liberally. The debate was finally settled by the Apex Court in one of its landmark rulings, Mobilox Innovations Pvt. Ltd. v. Kirusa Software Pvt. Ltd. The article, originally written in 2017, gives a threadbare analysis of the judgment and delves into the definition of ‘dispute’.

The Supreme Court of India has provided a much required clarity on the provisions of IBC vis-à-vis the existence of dispute. In this article, we broadly discuss the various issues that were dealt with in the judgment.

Brief facts of the case

Mobilox Innovations Pvt. Ltd. (hereinafter referred to as “Appellant” or “Corporate Debtor”) was engaged by Star TV for conducting tele-voting for the “Nach Baliye” program on Star TV, who in turn subcontracted the work to the Kirusa Software Pvt. Ltd. (Respondent). A Non-Disclosure Agreement (NDA) was also executed between the parties in this regard.

The Respondent provided the requisite services and raised monthly invoices, which were payable within 30 (Thirty) days of receipt of the invoice. After several follow-ups, the Appellant wrote to the Respondent that the payments are being withheld on account of breach of NDA.

Finally, a demand notice was sent under Section 8 of IBC, to which the Appellant asserted that there exists serious and bona fide disputes between the parties, the notice issued was a pressure tactic and nothing was payable inasmuch as the Respondent had been told way back.

The Respondents then filed an application before the NCLT which was dismissed. Next, an appeal was filed before the National NCLAT, wherein it was held that the Hon’ble NCLT had acted mechanically by rejecting the application, without examining and discussing the issue in context and the case was remitted to AA. It was further held that the Corporate Debtor has failed to fulfil the condition stipulated in Section 8(2) IBC and thus the defence claiming dispute was vague and motivated to evade its liability. Thereafter, the matter came up for final determination by the Apex Court

Question of Admissibility of an Insolvency Application

The Hon'ble Supreme Court has laid down directions to the AA, wherein the NCLT will be required to determine certain questions, while examining the admissibility of an application under Section 9 IBC. The same are as follows-

- (i) Whether there is an "operational debt" exceeding Rs.1 lakh and as defined in IBC?
- (ii) Whether the documentary evidence furnished with the application shows that the aforesaid debt is due and payable and has not yet been paid?
- (iii) Whether there is existence of a dispute between the parties or the record of the pendency of a suit or arbitration proceeding filed before the receipt of the demand notice of the unpaid operational debt in relation to such dispute?

It was held- *"If any one of the aforesaid conditions is lacking, the application would have to be rejected."*

"And" or "Or"-

Samee Khan v. Bindu Khan

"The word 'and' need not necessarily be understood as denoting a conjunctive sense. In Stroud's Judicial Dictionary, it is stated that the word 'and' has generally a cumulative sense, but sometimes it is by force of a context read as 'or'.

Apart from the above, the Adjudicating Authority should consider the factors mentioned in IBC while deciding the admissibility of a case, i.e. the Adjudicating Authority **must follow** the mandate of Section 9 of IBC, more particularly Section 9(5), and only then admit or reject the application.

Conflict between "And" and "Or" resolved

Section 8(2)(a) of IBC provides that the corporate debtor shall, within a period of 10 (Ten) days of the receipt of the demand notice or copy of the invoice bring to the notice of the operational creditor- existence of a dispute, if any, **and** record of the pendency of the suit or arbitration proceedings filed before the receipt of such notice or invoice in relation to such dispute.

The Hon'ble Supreme Court noted that in the Insolvency and Bankruptcy Bill, 2015, only '**existence of dispute**' was mentioned. Elaborating on the intent here, it held-

*"29. ** Even otherwise, the word 'and' occurring in Section 8(2)(a) must be read as 'or' keeping in mind the legislative intent and the fact that an anomalous situation would arise if it is not read as 'or'. If read as 'and', disputes would only stave off the bankruptcy process if they are already pending in a suit or arbitration proceedings and not otherwise. This would lead to great hardship; in that a dispute may arise a few days before triggering of the insolvency process, in which case, though a dispute may exist, there is no time to approach either an arbitral tribunal or a court. Further, given the fact that long limitation periods are allowed, where disputes may arise and do not reach an arbitral tribunal or a court for upto three years, such persons would be outside the purview of Section 8(2) leading to bankruptcy proceedings commencing against them. Such an anomaly cannot possibly have been intended by the legislature nor has it so been intended. We have also seen that one of*

Deciphering Dispute

the objects of the Code qua operational debts is to ensure that the amount of such debts, which is usually smaller than that of financial debts, does not enable operational creditors to put the corporate debtor into the insolvency resolution process prematurely or initiate the process for extraneous considerations. It is for this reason that it is enough that a dispute exists between the parties.

It is settled law that the expression 'and' may be read as 'or' in order to further the object of the statute and/or to avoid an anomalous situation. In this regard, it is quintessential to cite the case of *Samee Khan v. Bindu Khan*⁵, it was held-

"The word 'and' need not necessarily be understood as denoting a conjunctive sense. In Stroud's Judicial Dictionary, it is stated that the word 'and' has generally a cumulative sense, but sometimes it is by force of a context read as 'or'. Maxwell on Interpretation of Statutes has recognised the above use to carry out the interpretation of the legislature. This has been approved by this Court in Ishwar Singh Bindra v. State of U.P. [AIR 1968 SC 1450: 1969 Cri LJ 19]."

The Hon'ble Supreme Court, agreeing with the aforesaid view, also referred to the case of *Maharishi Mahesh Yogi Vedic Vishwavidyalaya v. State of M.P.*⁶ and *Director of Mines Safety v. Tander and Nayandgi Stone Quarries (P) Ltd.*⁷.

A probe into the intricacies of Existence of Dispute

It is pertinent to note that 'dispute' as envisaged by BLRC and as postulated in the Bill meant "**bona fide suit or arbitration proceedings**", contrary to the present version of 'dispute', as retained in Section 5(6) of IBC, which excludes the expression 'bona fide'. The Hon'ble Supreme Court was pleased to construe the purport behind such exclusion and held-

"It is difficult to import the expression "bona fide" into Section 8(2)(a) in order to judge whether a dispute exists or not."

Section 5(6) of IBC which defines the term 'dispute' is reproduced herein below-

*"dispute **includes** a suit or arbitration proceedings relating to-*

- (a) the existence of the amount of debt;*
- (b) the quality of goods or service; or*
- (c) the breach of a representation or warranty."*

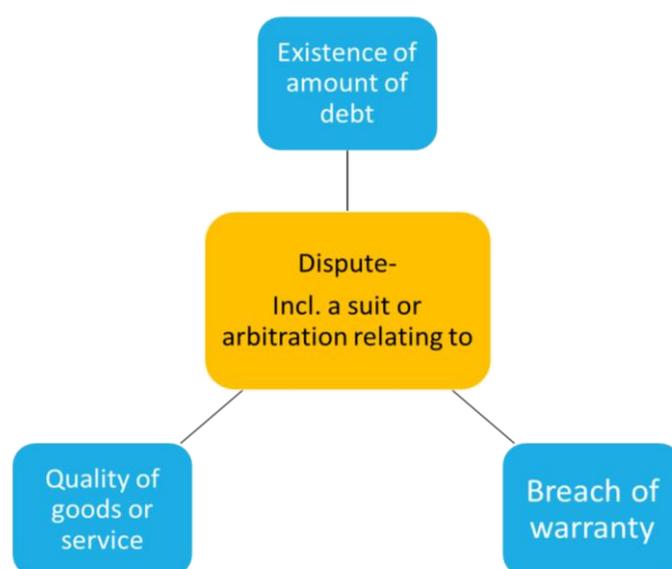


Figure 6: Elements of "Dispute"

⁵(1998) 7 SCC 59

⁶(2013) 15 SCC 677

⁷ [(1987) 3 SCC 208]

Earlier, in the present case, while interpreting the term ‘dispute’, the Hon’ble NCLAT pointed out that the intent of the Legislature, as evident from the definition of the term ‘dispute’, is that it wanted the same to be illustrative and not exhaustive. If the intent was to define ‘dispute’ as only a suit or arbitration proceedings then the word ‘**include**’ would not have been used, it would have simply said ‘dispute **means** a suit or arbitration proceedings’. Agreeing with the aforesaid view, the Hon’ble Supreme Court also held-

“First and foremost, the definition is an inclusive one, and we have seen that the word ‘includes’ substituted the word ‘means’ which occurred in the first Insolvency and Bankruptcy Bill. Secondly, the present is not a case of a suit or arbitration proceeding filed before receipt of notice – Section 5(6) only deals with suits or arbitration proceedings which must ‘relate to’ one of the three sub- clauses, either directly or indirectly. We have seen that a ‘dispute’ is said to exist, so long as there is a real dispute as to payment between the parties that would fall within the inclusive definition contained in Section 5(6).”

Further, the Hon’ble Supreme Court accepted the dictionary meaning of the term ‘**existence**’ and also went on to discuss the judgments of the Australian and UK Courts for the purpose of determining the dispute. The Oxford English Dictionary stipulates the meaning of the word ‘**existence**’ viz., a) reality, as opposed to appearance; b) the fact or state of existing; actual possession of being. Continued being as a living creature, life, especially under adverse conditions; Something that exists; an entity, a being. All that exists.

Further, a ‘**genuine**’ dispute requires that:

- the dispute be bona fide and truly exist in fact;
- the grounds for alleging the existence of a dispute are real and not spurious, hypothetical, illusory or misconceived.

The Australian High Court in *Spencer Constructions Pty Ltd. v. G & M Aldridge Pty Ltd.*⁸ while construing the term ‘genuine dispute’, relied on *Eyota Pty Ltd. v. Hanave Pty Ltd.*⁹, where his Honour said-

“In my opinion [the] expression connotes a plausible contention requiring investigation, and raises much the same sort of considerations as the ‘serious question to be tried’ criterion which arises on an application for an interlocutory injunction or for the extension or removal of a caveat. This does not mean that the court must accept uncritically as giving rise to a genuine dispute, every statement in an affidavit ‘however equivocal, lacking in precision, inconsistent with undisputed contemporary documents or other statements by the same deponent, or inherently and probable in itself, it may be not having ‘sufficient prima facie plausibility to merit further investigation as to [its] truth’ (cf Eng Mee Yong v. Letchumanan [1980] AC 331 at 341), or ‘a patently feeble legal argument or an assertion of facts unsupported by evidence’: cf South Australia v. Wall (1980) 24 SASR 189 at 194.”

⁸ [1997] FCA 681

⁹ (1994) 12 ACSR 785

Deciphering Dispute

It is not expected that the court will embark upon any extended enquiry in order to determine whether there is a genuine dispute between the parties and certainly will not attempt to weigh the merits of that dispute. All that the legislation requires is that the court concludes that there is a dispute and that it is a genuine dispute¹⁰. It is clear that what is required in all cases is something between mere assertion and the proof that would be necessary in a court of law. Something more than mere assertion is required because if that were not so then anyone could merely say it did not owe a debt.¹¹

In the case of *Re Morris Catering (Australia) Pty Ltd.*¹², it was held-

“That is not to say that the court will examine the merits or settle the dispute. The specified limits of the court’s examination are the ascertainment of whether there is a ‘genuine dispute’ and whether there is a ‘genuine claim’.

It is often possible to discern the spurious, and to identify mere bluster or assertion. But beyond a perception of genuineness (or the lack of it) the court has no function. It is not helpful to perceive that one party is more likely than the other to succeed, or that the eventual state of the account between the parties is more likely to be one result than another.

The essential task is relatively simple- to identify the genuine level of a claim (not the likely result of it) and to identify the genuine level of an offsetting claim (not the likely result of it).”

In *Chadwick Industries (South Coast) Pty Ltd. v. Condensing Vaporisers Pty Ltd.*¹³, it was held-

“Certainly the court will not examine the merits of the dispute other than to see if there is in fact a genuine dispute. The notion of a ‘genuine dispute’ in this context suggests to me that the court must be satisfied that there is a dispute that is not plainly vexatious or frivolous. It must be satisfied that there is a claim that may have some substance”.

In *Greenwood Manor Pty Ltd. v. Woodlock*¹⁴ the formulations in *Re Morris Catering (Australia) Pty Ltd.*¹⁵ and *Mibor Investments Pty Ltd. v. Commonwealth Bank of Australia*¹⁶ were referred to, wherein the dictionary definition of ‘genuine’ as being in this context ‘not spurious- real or true’ was noted and the following was concluded:

Chadwick Industries v. Condensing Vaporisers

The notion of a ‘genuine dispute’ in this context suggests to me that the court must be satisfied that there is a dispute that is not plainly vexatious or frivolous. It must be satisfied that there is a claim that may have some substance.

¹⁰ See *Mibor Investments Pty Ltd v Commonwealth Bank of Australia (1993) 11 ACSR 362*; *Moyall Investments Services Pty Ltd v White (1993) 12 ACSR 320*.

¹¹ See *John Holland Construction and Engineering Pty Ltd v Kilpatrick Green Pty Ltd (1994) 12 ACLC 716*; *Aquatown Pty Ltd v Holder Stroud Pty Ltd (Federal Court of Australia, 25 June 1996, unreported)*.

¹²(1993) 11 ACSR 601

¹³(1994) 13 ACSR 37

¹⁴(1994) 48 FCR 229

¹⁵(1993) 11 ACLC 919

¹⁶[1994] 2 VR 290

“Although it is true that the Court, on an application under ss 459G and 459H is not entitled to decide a question as to whether a claim will succeed or not, it must be satisfied that there is a genuine dispute between the company and the respondent about the existence of the debt. If it can be shown that the argument in support of the existence of a genuine dispute can have no possible basis whatsoever, in my view, it cannot be said that there is a genuine dispute. This does not involve, in itself, a determination of whether the claim will succeed or not, but it does go to the reality of the dispute, to show that it is real or true and not merely spurious”.

The Chancery Division in *Hayes v. Hayes*¹⁷ under the U.K. Insolvency Rules held-

“I do not think it necessary, for the purposes of this appeal, to embark on a survey of the authorities as to precisely what is involved in a genuine and substantial cross-claim. It is clear that on the one hand, the court does not need to be satisfied that there is a good claim or even that it is a claim which is prima facie likely to succeed.

On the other hand, the court should be alert to detect wholly spurious claims merely being put forward by an unwilling debtor to raise what has been called ‘a cloud of objections’ as I referred to earlier.”

Similar view was upheld by the Hon’ble Supreme Court in the instant case-

“40. It is clear, therefore, that once the operational creditor has filed an application, which is otherwise complete, the adjudicating authority must reject the application under Section 9(5)(2)(d) if notice of dispute has been received by the operational creditor or there is a record of dispute in the information utility. It is clear that such notice must bring to the notice of the operational creditor the “existence” of a dispute or the fact that a suit or arbitration proceeding relating to a dispute is pending between the parties. Therefore, all that the adjudicating authority is to see at this stage is whether there is a plausible contention which requires further investigation and that the “dispute” is not a patently feeble legal argument or an assertion of fact unsupported by evidence. It is important to separate the grain from the chaff and to reject a spurious defence which is mere bluster. However, in doing so, the Court does not need to be satisfied that the defence is likely to succeed. The Court does not at this stage examine the merits of the dispute except to the extent indicated above. So long as a dispute truly exists in fact and is not spurious, hypothetical or illusory, the adjudicating authority has to reject the application.”

It is relevant to note here, that a confirmation from a financial institution that there is no payment of an unpaid operational debt by the corporate debtor is an important piece of information that needs to be placed before the adjudicating authority.

Concluding Remarks

The judgment in *Mobilox Innovations Pvt. Ltd. v. Kirusa Software Pvt. Ltd* is substantially significant as by providing such a liberal construction of the term ‘dispute’, the Apex Court has provided an end to all the doubts and clarified the scope of dispute, contradictory to the judgment in *Essar*

¹⁷(2014) EWHC 2694 (Ch)

Deciphering Dispute

*ProjectsIndia Ltd. v. MCL Global Steel Pvt. Ltd.*¹⁸, wherein the Mumbai NCLT, while interpreting the definition of dispute under IBC, held that dispute in existence means only when the same is raised before a court or an arbitral tribunal prior to the date of receipt of a demand notice and in several other cases, where a very rigid view was taken.

Know more . . .

The Insolvency and Bankruptcy Code (Second Amendment) Act, 2018 was later enacted, and eliminated the confusion of “and” and “or”. Section 8 was amended to replace “and” by “or”.

The ruling in *Mobilox* was cited in another landmark ruling of the Supreme Court, namely, *K. Kishan v. Vijay Nirman Company Pvt. Ltd.* wherein the Apex Court, in the context of arbitration proceedings, held that a challenge to an arbitral award under section 34 of the Arbitration Act shows a pre-existing dispute and continues ‘*at least till the final adjudicatory process under Sections 34 & 37 has taken place.*’ As such, a debt which is under challenge in arbitral proceedings would be a disputed debt.

The idea behind creating this bar for operational creditors was thus stated in the above case –“*that operational creditors cannot use the Insolvency Code either prematurely or for extraneous considerations or as a substitute for debt enforcement procedures*”.

Notably, there is no provision pertaining to dispute in case of financial debts. BLRC opined that the chances of dispute in operational debts are much higher than those in financial debts. However, it does not imply that financial debts cannot be disputed. As is known, existence of ‘default’ is *sine qua non* for initiation of corporate insolvency resolution process. If prior to admission of application by the adjudicating authority, the corporate debtor can show that no default exists, *in the sense that a debt, which may also include a disputed claim, is not due i.e. it is not payable in law or in fact*, then also application by the financial creditor would not be maintainable. See the ruling in *Mobilox*.

¹⁸2017 (4) TMI 1156

THE CONCEPT OF RELATED PARTY

INTERPRETATION BY LETTER OR SPIRIT OF IBC

- **Richa Saraf**

Editor's Note: As they say, 'eat with relatives, do business with strangers'. In law, though there is no bar on related party transactions, yet such transactions have to pass 'arms' length' test to be considered genuine and within due parameters of law. IBC too, puts certain limitations on related parties – a financial creditor who is a related party is not entitled to participate in the meetings of Committee of Creditors. Also, related parties of ineligible persons are barred from submitting a resolution plan under section 29A.

However, there is no explicit provision under IBC requiring separate treatment of a creditor who is a related party while determining the liquidation value payable to such creditor – section 53 does not provide for any differentiation between a related creditor and an unrelated creditor. For instance, an unsecured financial creditor (whether related/unrelated) is placed above an ordinary operational creditor. This, by itself, becomes a gateway for misuse of law by related parties. So, is it possible to have an equitable remedy against such related parties? According to NCLT Allahabad, dues of related parties can be 'equitably subordinated', such that the provisions are not abused to write-off the dues of operational creditors. The ruling sets an important precedent – however shall be followed on case-to-case basis. This article discusses the perspectives on 'related party' in the light of similar rulings¹⁹.

In the case of [J.R. Agro Industries P. Limited v. Swadisht Oils P. Ltd.](#), NCLT Allahabad (24.07.2018) observed that **"if claim of related party is given priority over operational creditors, it would not be just to operational creditor"**. In the instant matter, the related party and the corporate debtor had common directorship and common promoters, therefore, keeping in view the global practices, especially UNCITRAL legislative guide to insolvency law, NCLT opined that claim of a related party, whether in the nature of loan, should rank subordinate to the claim of operational creditors, and should be treated at par with equity shareholders under Section 53 (1) (h) of the Code.

Who is a Related Party?

The first question for discussion here is who will construe to be a "related party" with reference to the corporate debtor. While Section 5 (24) provides for the definition of related party of the corporate debtor, however, the expression "related party" describes a commutative relationship, i.e. X can be related party of Y, if either X is related to Y, or Y is related to X. It cannot be argued that X is not a related party to corporate debtor, if corporate debtor falls in the definition of "related party" with reference to X.

The definition stipulated in the Code is constructed so as to be limited from the perspective of corporate debtor. Prior to the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018, there was no definition with respect to an individual- this gap has been filled by the Ordinance, 2018, however, there is still nothing in the Code as regards related party of a company or body corporate (other than corporate debtor). In such a scenario, since Section 3(37) of the Code provides

¹⁹Contributed in: August, 2018

The Concept of Related Party

that for words/expressions not defined in the Code, the definitions given in the Companies Act, 2013 will be applicable, the definition under Section 2 (76) of the Companies Act, 2013 becomes relevant.

As per Section 2 (76) (iv) of the Companies Act, 2013, if a director of the company is a member or director of the other company, that other company becomes a related party. Similar clause is reflected in Section 5 (24) (d) of the Code as well, though it is constructed solely from the perspective of the corporate debtor.

It will also be relevant to mention here that Section 5 (24) (m) of the Code is drafted most widely, and indicates that the stance of the draftsman is on the reality of inter-relationships between the two entities. If the two entities are really operating under a common control, the indicia as given in Section 5 (24) (m) will apply. Thus, interchange of personnel, participation in policy-making, or provision of technical information are indicators of association of the two entities. It is not necessary that the company in question must be supplier of technical information, or must be participating in policy-making or would cause inter-change of personnel. If there is a common source of control over both the entities, resulting into these circumstances, it cannot be denied that the two entities become “associated” for that reason.

This discussion is also relevant for the purpose of determining who will constitute a part of committee of creditors, particularly with reference to first proviso to Section 21 (2) of the Code. The intent of Section 21 (2) of the Code in denying voting rights to related parties is to ensure that the corporate insolvency resolution process is driven by external creditors. Even though related parties may have claims, and may even file for the corporate insolvency resolution process, such parties cannot drive the insolvency resolution process, as that would be rife with conflicts of interest. Such a wholesome intent cannot be rendered infructuous by giving a narrow or technical interpretation to the meaning of the term.

Priority of Related Party Claims in the context of *Swadisht Oils*

In the case of *Swadisht Oils (supra)*, the Resolution Professional emphasized that the approval of resolution plan by the Adjudicating Authority is a mere formality because the committee of creditors had already approved the plan, with requisite voting percentage (infact with 100% voting rights), and the resolution plan satisfied all the requirements of Section 30 of the Code, and the regulations thereunder. It was clarified that the related party was not allowed to attend and participate in CoC meetings, hence, there was no occasion to influence the decision of CoC members, yet the resolution plan pays almost nil dues of the operational creditors, and instead prioritises the claim of related party unsecured financial creditor as per waterfall mechanism (Section 53). “Section 53(1)(d) treats all unsecured financial creditors at par so far as priority for their payment is concerned and does not discriminate between unrelated creditors and related creditors”, and accordingly, it was further stated that **express legal provisions cannot be bypassed even on the ground of equity.**

“SECTION 53(1)(D) TREATS ALL UNSECURED FINANCIAL CREDITORS AT PAR SO FAR AS PRIORITY FOR THEIR PAYMENT IS CONCERNED AND DOES NOT DISCRIMINATE BETWEEN UNRELATED CREDITORS AND RELATED CREDITORS”

It was contended that Regulation 38(1)(b) provides that liquidation value due to operational creditors should be paid in priority to any financial creditor, in any event, before the expiry of thirty days after the approval of a resolution plan, and like in most of the cases, in this case as well, the liquidation value for operational creditors, after meeting the claims of financial creditors, was computed to be “nil”, and any payment to be made to such operational creditors, which was over and above such value, should be considered to be a “bonanza” to them.

In the instant case, a related party was getting approximately 62% of its dues back, while the operational creditors were getting almost nil. In such circumstances, it was beyond imagination that, after approval of the plan, the operational creditors will be willing to continue their supplies to the corporate debtor, to keep it as a going concern. Here, it is important to reflect upon foreign Insolvency Laws, wherein priority to secured creditors is given over unsecured creditors, but there is no distinction between financial & operational creditors.

The NCLT relied on the United Nations Commission on International Law, which specifically provides for subordinate ranking of related parties claims as regards ordinary unsecured claims, and pointed out that this particular case, is a glaring example where admittedly a related party, is getting priority over operational creditors, even though the same promoters are considered to be responsible for insolvency and restructuring of the corporate debtor, which appears to be discriminatory.

Under the UNCITRAL Legislative Guide, related persons claim rank inferior to the claims of similar other unsecured creditors, while in IBC, unsecured financial creditors (even if related party), rank higher to the claims of unsecured operational creditors. Under prevailing practices in UK and US also, operational creditors claim rank above the claim of related party claim. It was observed that promoters’ loan to the company is like equity participation, which mostly remains without time value of money, i.e. without any agreement to pay interest and without any time limit for repayment, even if otherwise, the waterfall mechanism under Section 53 should not be merely applied by books, by ignoring the intent, since then, in every case of defaulted/loss-making companies, the liquidation value of operational creditors will always be nil, and they will never get their dues in IBC cases.

The related party of corporate debtor, whether in a familial or business capacity, are such category of creditors that require special consideration. Under some insolvency laws, these claims are always subordinated, and under other laws, they are subordinated only on the basis of inequitable conduct. Other approaches for treatment of these claims do not relate to ranking, but only to restrictions on voting rights. In IBC, an intra-group transactions may be subject to avoidance proceedings, if proved to be fraudulent, preferential or undervalued, and in UNICITRAL legislative guide, such transactions are classified differently from similar transactions conducted between unrelated parties (such a debt may be treated as an equity contribution rather than a loan), with the consequence that the debt obligation will rank lower in priority than the same obligation between unrelated parties.

In this regard, it is relevant to cite Para 55 of UNCITRAL legislative guide of insolvency law, which specifies that when in the natural person or organisation owes debts to more than one creditor, the priority scheme established under applicable law may provide for subordination of certain types of claim, for example, those of related persons, determining the order in which those debts should be paid. Even while a priority scheme is in place, a creditor with a higher priority may be paid after one

The Concept of Related Party

with lower priority because of court order. The Bench contemplated that owners and equity holders may have claim arising from loans extended to the debtor, and regarding claims arising from such equity interests (including claims with respect to their debt, accruing interest), and that many insolvency laws have adopted a general rule that the owners and equity holders of the business are not entitled to a distribution of the proceeds of assets until all other claims that are senior in priority have been fully repaid, passed a similar order.

The NCLT deliberated upon the concept of equitable subordination (subordination by court), wherein a valid and enforceable claim, is paid later in the distribution scheme, than it would otherwise be paid in normal course. The doctrine originally arose to prevent related persons from using legal mechanism to obtain advantages in priority, and is generally applied if any conduct under consideration results in unfair advantage to a creditor or some harm to other creditors. The Bench examined that it may change/ re-arrange the priority of claims, to prevent a creditor who has committed fraud, illegality, or has acted inappropriately to gain advantage over other creditors, from benefiting in any manner, and such that a fair distribution occurs. Accordingly, ordered that the related party claim should be treated in the category of “equity shareholders” as provided in Section 53(1)(h) of the Code, and be considered below the rank of both the unsecured financial creditors and as well as other debts and dues.

Also, in the light of the facts and circumstances of the case, considering the arguments advanced, and to give justice to the operational creditors, the Bench ordered for modification of the resolution plan, and further directed the Registrar to send a copy of this order to IBBI, Secretary, MCA and Central Government through RD, for consideration on the issues which have been pointed out, so that related party of the corporate debtor cannot misuse the provisions of Section 53, to defraud the creditors.



Beyond the Lines . . .

A related party which assigns its debt, assigns no more benefits/entitlements what it had. Therefore, if a related party assigns its debt to an otherwise unrelated party, the latter is subject to the same limitations as the related party would have in relation to the IBC proceedings of the corporate debtor.

In Pankaj Yadav v. State Bank of India, the NCLAT held that “the assignment is the transfer of one’s right to recover the debt of another person as a contractual right. Rights of an ‘assignee’ are no better than those of the ‘assignor’. It can be, therefore, held that ‘assignor’ assigns its debt in favour of the ‘assignee’ and ‘assignee’ steps in the shoes of the ‘assignor’. The ‘assignee’ thereby takes over the right as it actually did and also takes over all the disadvantages by virtue of such assignment.”

Precisely speaking, a related party cannot indirectly achieve, what it could not directly achieve, by recourse to an assignment of debt.

NBFCs AND IBC: THE LOST CONNECTION

- **Sikha Bansal**

Editor's Note: IBC, as expressly stated by BLRC, is not intended for entities having dominantly a 'finance function'. As such, IBC is not applicable to 'financial service providers' as these entities are excluded from the definition of 'corporate person'. Financial service, as defined in section 3(16), includes services as rendered by banks, insurance companies, merchant bankers, investment bankers or alike – the term does not explicitly include a 'non-banking financial company'.

A non-banking financial company can take different forms depending upon the business it undertakes – for instance, a core investment company invests solely in its group companies. Such an NBFC cannot be said to be falling in the category of financial service provider. In order to be classified as financial service provider, the NBFC should undertake an activity which falls in the definition of 'financial service'. However, the adjudicating authorities/appellate authority in multiple cases have held a non-banking financial company to be a financial service provider against which corporate insolvency resolution process cannot be initiated under the Code. This article²⁰ analyses the connect or disconnect between IBC and NBFCs.

The Code seems to have thrown open a host of complicated questions before the stakeholders.

One such incertitude is in the context of applicability of the Code to NBFCs. The Code excludes 'financial service providers' from the definition of 'corporate person'; as such, an entity which is engaged in providing 'financial services' cannot be made to undergo corporate insolvency resolution process under the provisions of the Code. Notably, the Code no-where uses the expression 'non-banking financial company/ies'. As such, the crux would be to identify whether an NBFC can fall within the definition of 'financial service provider'.

Notably, the Code nowhere uses the expression 'non-banking financial company/ies'. As such, the crux would be to identify whether an NBFC can fall within the definition of 'financial service provider'.

In [Randhiraj Thakur, Director Mayfair Capital Private Limited v. Jindal Saxena Financial Services Private Limited](#) [Company Appeal (AT) (Insolvency) Nos. 32 & 50 of 2018], the NCLAT held the NBFC to be a financial service provider and thus exempted from being a debtor under the Code.

The NBFC was being granted a certificate of registration by RBI to commence or carry on the business of non-banking financial institution. The MoA of the company shows the main object of the NBFC includes carrying on the business of an investment company to carry on all types of financial operations and all types of financial services including housing finance, consumer finance and industrial finance etc. The NCLAT noted that the NBFC had entered into "an inter-corporate deposit agreement" with the respondent, which was the financial creditor, and thus, has undertaken a 'financial service' by accepting such deposit. *The amount was thus, not accepted towards public deposit.* Hence, the NBFC, being a financial service provider and thus excluded from the definition of corporate person, an application for initiation of corporate insolvency resolution process under the

²⁰Contributed on: October, 2018

NBFCs and IBC: The Lost Connection

Code was not maintainable against the NBFC. The NCLAT remarked that being a consolidating legislation only those acts are permitted which are mentioned in the Code and it cannot be made applicable to 'financial service providers' including 'non-banking financial institutions' and MFI's banks, which have been kept outside the purview of the Code.

The author would seek humble deviation from the views of Hon'ble NCLAT, attempting to provide explanations for the divergent opinion.

NBFCs: Whether financial service providers

The Code defines a 'financial service provider' as "a person engaged in the business of providing financial services in terms of authorisation issued or registration granted by a financial sector regulator" – section 3 (17). A financial service provider is excluded from the definition of 'corporate person' – section 3(7), and thus cannot be a 'corporate debtor'.

The definition has two necessary ingredients – (i) the entity should be providing 'financial services', and (ii) the entity shall be authorised to do so by a 'financial sector regulator'. These conditions are **cumulative** – where there is a certificate from RBI, to carry on an activity which does not qualify to be a financial service; the entity cannot be called a 'financial service provider'. Such an entity would therefore be appropriately covered under the provisions of the Code.

Scope of Financial Service

What all constitute 'financial services' have been put under section 3(16) of the Code. The definition is *inclusive* and mentions the following categories of services as financial services (for ease of understanding, the respective category of entities providing such service is also mentioned) –

Clause	Particulars	Entities engaged in the activity
(a)	accepting of deposits;	Banks, <u>deposit taking</u> NBFCs/ HFCs
(b)	safeguarding and administering assets consisting of financial products, belonging to another person, or agreeing to do so	Depository
(c)	effecting contracts of insurance;	Insurance Company
(d)	offering, managing or agreeing to manage assets consisting of financial products belonging to another person;	Custodian/ Investment Managers
(e)	rendering or agreeing, for consideration, to render advice on or soliciting for the purposes of—	
	(i) buying, selling, or subscribing to, a financial product;	PMS/ Stock brokers/ Investment advisors
	(ii) availing a financial service	Stock Brokers/ Investment Bankers
	(iii) exercising any right associated with financial product or financial service;	Investment Advisors
(f)	establishing or operating an investment scheme;	Collective Investment Scheme
(g)	maintaining or transferring records of ownership of a financial product	Registrars and Transfer Agents

(h)	underwriting the issuance or subscription of a financial product	Underwriters
(i)	selling, providing, or issuing stored value or payment instruments or providing payment services	Prepaid payment instruments/ Credit Card providers

In clause (a) of section 3(16), the word ‘deposit’ should not be interpreted to refer to all or any kind of deposit. The word ‘deposit’, in view of the intent of the draftsmen, can only refer to deposits taken from public at large.

It may be argued that the definition of ‘financial service’ under section 3(17) is inclusive and thus can be extended to all services being rendered by non-banking financial companies. However, the rule of *ejusdem generis* is to be respected in this case too. On perusal of section 3(17) of the Code, it is well understood that the provision seeks to cover activities which are substantive and crucial to the economy, accepting public deposits being one of them. Behind such backdrop and after applying the rule of *ejusdem generis*, there seems no reason to consider a non-deposit taking NBFC, as to be considered a financial service provider, irrespective of the activity which it carries out.

Financial institutions and FSPs – one and same?

Note that the definition of ‘financial service provider’ has no direct connection with the definition of ‘financial institution’. Safeguarding and administering assets consisting of financial products belonging to other person is a financial service, and financial product includes loans and advances by banks and financial institutions. So, a financial institution is not necessarily a “financial service provider”. Only such financial institutions which are providing “financial services” can be categorised as “financial service providers”. Therefore, only a non-banking institution which carries on a business classifiable in any of the clauses between (a) to (i) of section 3(16) of the Code is eligible to be classified as “financial service provider” and exempted from the definition of corporate debtor under the Code.

For instance, while a deposit taking NBFC can be categorised under clause (a) of section 3(16) of the Code as a financial service provider, a non-deposit taking NBFC cannot be taken in the same category.

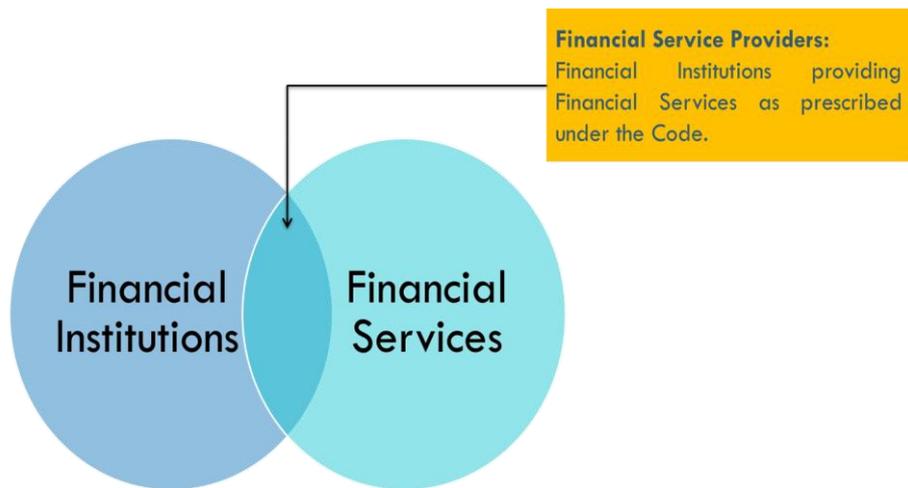


Figure 7: What are FSPs

Intent to exclude FSPs

NBFCs and IBC: The Lost Connection

The Bankruptcy Law Reforms Committee had the mandate of suggesting comprehensive reforms in the area of bankruptcy of individuals and non-financial firms. The exclusion of ‘financial firms’ was in view of the work of the Financial Sector Legislative Reforms Commission (“FSLRC”) which made recommendations for the failure of *financial firms* in the then proposed Indian Financial Code, 2013.

In [Volume – I of its Report](#), while identifying the basic subject matter of regulation (namely, financial products and services), FSLRC opined that particular forms of dealings in financial products, such as securities, insurance contracts, deposits and credit arrangements, constitute the rendering of financial services. This includes services such as, sale of securities, acceptance of public deposits, operating investment schemes and providing credit facilities. The FSLRC, however, recognised that “a principles-based approach to defining financial products and financial services comes with the risk of unintentionally casting the net of regulation too wide. Therefore, it was decided that financial regulation should apply *to only those persons* who are engaged in the business of carrying on financial services.”

FSLRC, at several instances in its Report, emphasises on the systemic importance of such financial entities. The Report says,

“Market discipline does play an important role in ensuring safety and soundness of many financial service providers, but it is often not enough. This inadequacy of self- regulation and market discipline becomes particularly problematic for financial service providers making certain kinds of obligations, and financial service providers of systemic importance.

...

The Commission also notes that for certain kinds of financial service providers, if obligations are not fulfilled, there are adverse consequences for specific consumers. If bank deposits are lost due to a bank failure, the consequences for consumers, whose savings are deposited with the bank, will be quite adverse. If a large financial service provider fails, the entire financial system, and the larger economy, may be adversely affected.

...

For systemically important financial institutions, safety and soundness should be taken to mean reducing the probability of firm failure, and for all other micro-prudentially regulated persons, it should mean *reducing the probability of the event of regulated person failing to meet the obligations made to consumers*”

Failure of financial firms can be highly disruptive for the consumers, the market and the economy as a whole. Therefore, the FSLRC recommended a specialised resolution mechanism and establishment of a ‘resolution corporation’ “that will concern itself with all financial firms that make highly intense promises to consumers, such as banks, insurance companies, defined benefit pension funds, and payment systems. The corporation will also take responsibility for the graceful resolution of systemically important financial firms, even if they have no direct link to consumers.”

In the [Report of Committee to Draft Code on Resolution of Financial Firms](#) (2016), which submitted the draft Financial Resolution and Deposit Insurance Bill, 2016, it was stated that all regulated financial service providers, except individuals, should be covered by insolvency regime proposed

under the Bill. Accordingly, the Financial Resolution and Deposit Insurance Bill, 2016 defined 'financial service provider' as to have the same meaning as assigned to it in section 3(17) of IBC. The Bill was however, withdrawn in August, 2018.

Notably, section 227 of the Code empowers the Central Government to notify financial service providers or categories of financial service providers for the purpose of their insolvency and liquidation proceedings, which may be conducted under this Code. Such power, however, can only be exercised in respect of entities which are 'financial service providers'.

The inter-connectivity argument

It may be argued that NBFCs hold a major chunk of their liabilities in the form of bank loans and advances. As such, initiating processes under the Code in respect of such NBFCs can trigger contagion effect. However, this argument seems to have ignored the fact that the corporate debtors under the Code too, have their liabilities side burdened with bank debts. *Ipsa facto*, there is no difference between the NBFCs and the non-financial companies under the Code.

Concluding Remarks

The discussion above clearly implies that there is no generic exemption for NBFCs from being a 'debtor' under the Code – the applicability/non-applicability has to be decided on case-to-case basis.

STATE OF PERPLEXITY – APPLICABILITY OF IBC ON NBFCs

IBC acts as an invisible shield for NBFCs classified as FSPs

- **Megha Mittal**

Editor's Note: This piece is an extension of the previous article. It analyses the ruling of NCLT in *HDFC Bank Ltd. vs RHC Holding Private Limited* in particular, and takes the discussion further in light of global practices.

Background

In line with the order passed by the National Company Law Appellate Tribunal, (NCLAT) in the matter of [Randhiraj Thakur, Director Mayfair Capital Private Limited v. Jindal Saxena Financial Services Private Limited](#) in September 2018, the Principal Bench of National Company Law Tribunal (NCLT) dismissed an application filed for initiation of Corporate Insolvency Process against a financial services provider.

Vide its order dated 06.12.2018, NCLT in *HDFC Bank Ltd. vs RHC Holding Private Limited*, dismissed the application preferred by HDFC for initiation of Corporate Insolvency Process against RHC Holdings on the ground that the latter, a NBFC is a financial service provider and that the Insolvency and Bankruptcy Code, 2016 (hereinafter referred to as “Code”/ “IBC”) does not cover “financial service providers” in its ambit.

Hence, in light of the recent state of affairs, in this article, we shall analyze the stance/ interpretation of NCLT as well as NCLAT so as to understand the extent of immunity available to FSPs, and whether all NBFCs are FSPs. It must be noted that FSPs, colloquially known as entities that are “too big to fail”, is a significant sector of our economy, where public money is involved. In a situation where

these entities fall into bankruptcy, it will lead to a domino effect. Hence, to avoid failure of the economy which seems very probable if there is an increase in the number of failing FSPs, these entities have been excluded from the ambit of the Code.

Understanding Terminologies

One of the major reasons for which the implementation of the Code was much anticipated was that the Code will emerge as a single-stop solution, consolidating various laws relating to reorganization and insolvency of corporate persons, partnership firms, Limited Liability Partnerships and individuals.

Corporate Persons:

- *Company, under sec 2(20) of the Companies Act, 2013*
- *LLP, under sec 2(1)(n) of the LLP Act, 2008*
- *Any other person incorporated with limited liability*
- *EXCLUDES, any financial service provider*

In such a scenario, it is important to understand the reach of the Code, i.e. the entities to which the Code is applicable.

Section 3(7) of the Code, defines the term “Corporate Person” as

*“a company as defined in clause (20) of section 2 of the Companies Act, 2013 (18 of 2013), a limited liability partnership, as defined in clause (n) of sub-section (1) of section 2 of the Limited Liability Partnership Act, 2008 (6 of 2009), or any other person incorporated with limited liability under any law for the time being in force **but shall not include any financial service provider**”*

The definition being exclusive in nature, very clearly eliminates financial services providers from the purview of the Code.

Now the question arises as to what are “financial service providers?”

Section 3(17) of the Code defines “financial service provider” as a person engaged in the business of providing financial services in terms of authorization issued or registration granted by a financial sector regulator, like the Reserve of bank of India (RBI), Securities & Exchange Board of India (SEBI), the Insurance Regulatory and Development Authority of India (IRDAI) etc. Thus, a financial service provider must be one that provides financial services as defined in the Code **as well as** be regulated by or registered with a financial sector regulator.

Further, section 3(16) of the Code, defining “financial services” is *ad-verbatim* produced as follows:

xxx

*“(16) financial service” **includes** any of the following services, namely:*

- a. accepting of deposits;*
- b. safeguarding and administering assets consisting of financial products, belonging to another person, or agreeing to do so;*
- c. effecting contracts of insurance;*
- d. offering, managing or agreeing to manage assets consisting of financial products belonging to another person;*
- e. rendering or agreeing, for consideration, to render advice on or soliciting for the purposes of*
 - (i) buying, selling, or subscribing to, a financial product;*
 - (ii) availing a financial service; or*
 - (iii) exercising any right associated with financial product or financial service;*
- f. establishing or operating an investment scheme;*
- g. maintaining or transferring records of ownership of a financial product;*
- h. underwriting the issuance or subscription of a financial product; or*
- i. selling, providing, or issuing stored value or payment instruments or providing payment services;”*

(emphasis given)

xxx

State of Perplexity:

Applicability of IBC on NBFCs

The extant definition of “financial services” enlists services which shall tantamount to financial. It is important to note that, the definition being “inclusive” in nature,

- i. is not limited to the activities specified in the Code; and
- ii. is operated by the Rule of “*ejusdem-generis*”, which states that, in construction of laws, wills and other instruments, when certain things are enumerated and then a phrase is used which might be construed to include other things, it is generally confined to things *ejusdem generis*, i.e. of the same kind.

EJUSDEM-GENERIS: of the same kind!

Hence, while determination of a service as “financial service” under the Code, the service must be of the same nature/ kind as those enlisted in the Code.

Interestingly, the Code has refrained from the explicitly using the term NBFCs and as such it is imperative to identify whether NBFCs fall within the purview of Financial Service Providers.

NBFCs are financial institutions that offer various banking services, but do not have a banking license. Generally, these institutions are not allowed to take deposits from the public, which keeps them outside the scope of traditional oversight required under banking regulations.

In furtherance to our earlier articles, it is in light of the recent ruling and scenario that the author humbly attempts to provide a different opinion as outright rejection of NBFCs from the scope of the Code, as a class in entirety, does not seem justified.

Facts of the case

Having understood the connotation of the various terms, let have an insight into the facts of the case in question i.e. HDFC Ltd. vs. RHC Holdings. In the instant case, the financial creditor i.e. HDFC Ltd. preferred an application before NCLT for initiation of corporate insolvency process against RHC Holdings u/s 7 of the Code. However, the application was denied and dismissed by the Hon’ble Bench on the ground that the Respondent i.e. RHC Holdings, an NBFC, is a financial service provider and as such beyond the jurisdiction of the Code.

The Respondent in this matter, is a non-deposit taking NBFC, the main object of which (as stated in para 27 the Order), is “*to lend and finance any persons, companies, corporations, firms or institutions by way of lending*” Therefore, the Respondent, evidently a non-deposit taking NBFC does in no manner involve public money or any such activity which might be substantive or crucial to the economy.

However, placing reliance upon the order of the Hon’ble NCLAT in *Randhiraj Thakur v. Jindal Saxena Financial Services*, NCLT held that the Respondent to be financial services provider and accordingly dismissed the application for initiation of its CIRP on grounds on maintainability.

Rationale

One may argue that the Respondent was engaged in lending and financing companies, corporations, etc. and as such is a financial service provider. However, it is important to note that section 3(16) of the Code enlists those services as financial services which are intricately linked to the money market and/or capital market and might trigger systemic risk in the economy. **And, by the operation of Rule of ejusdem-generis, services like inter-corporate deposits shall not be construed as financial services.**

Inter-corporate deposits are borrowings by one corporate entity registered under the Companies Act from another. The corporate having surplus funds lends it to another corporate which is need of funds. Thus, it is clear that in case of inter corporate deposits, there is very little or no involvement of public's money and hence it does not pose a threat to the economy.

Hence, in the instant case, the Respondent, a non-deposit taking NBFC shall not be classified as a financial service provider and thus be covered under the Code.

It is often said that "finance is the life blood of an economy". FSPs include various entities/ participants, which play a key role in facilitating the smooth functioning of the economy.

The very reason for exclusion of FSPs from the purview of the Code was to avoid failure of the economy which seems very probable if there is an increase in the number of failing FSPs. These institutions are colloquially referred to as "too big to fail".

However, considering that out of the existing NBFCs only a meagre percentage is allowed to accept deposits, exclusion of NBFCs does not seem to be serving the purpose. On the contrary, exclusion of NBFCs that are not FSPs from the Code acts as an invisible shield guarding such entities from the provisions of insolvency law. In absence of an established legal framework, it gives such entities and undue leeway to escape insolvency procedures.

Hence, where on one hand, rationale behind the carve out given to financial service providers seems justified, it is crucial to note that not all NBFCs have the similar impact on the economy. NBFCs that are not financial service providers have the same standing as per the Code, as other non-financial companies, which too are mostly burdened with a pile of bank liabilities.

Owing to this systemic vacuum that exists with regard to bankruptcy situations in financial firms, the Union Cabinet Financial Resolution and Deposit Insurance (FRDI) Bill, 2017 was approved by the Union Cabinet to be introduced in the Parliament. While the Code dealt with companies under insolvency, the FRDI Bill was expected to provide a comprehensive resolution framework to deal with bankruptcy situations in financial sector entities such as banks and insurance companies. However, after over an year of being introduced in the Lok Sabha, followed by the Joint Parliamentary meeting, the FRDI Bill was withdrawn due to apprehensions raised by the stakeholders w.r.t the provisions of the FRDI Bill like the use of bail-in instrument to resolve a failing bank and the adequacy of deposit insurance cover.

"The very reason for exclusion of FSPs from the purview of the Code was to avoid failure of the economy which seems very probable if there is an increase in the number of failing FSPs. These institutions are colloquially referred to as "too big to fail".

State of Perplexity:

Applicability of IBC on NBFCs

Global Scenario

The insolvency Code in India has been drafted placing significant reliance on the UK Insolvency Act and then moulding the same as per the Indian scenario.

Under the UK Insolvency Act, 1986, if an insurance company (a FSP as per the Code), were to fail, procedures that apply to all insolvent companies would apply, subject to certain modifications to ensure protection of the policy-holders. As per the Financial Services and Markets Act 2000 (FSMA) of UK, Insurance companies are not entitled to enter into voluntary liquidation, but can be wound up by the UK Insolvency Act in the event of failure. Section 122 of the UK Insolvency Act sets out the circumstances in which a company may be wound up by the court and carves out no exception for insurance companies or any other systemically important industry, whatsoever. Considering the massive impact on admission of an insurance company for winding up, if the court does decide to wind up the insurer, the Insurers (Reorganisation and Winding Up) Regulations 2004 (the Reorganisation Regulations) of UK will apply.

Hence, despite the probable impact of failure of FSPs in major economies being in multiples as compared to the Indian economy, the insolvency law of other economies have laid down similar procedures to deal with insolvency of financial companies of systemic importance as for other companies.

Thus, where companies of major significance to the economies are also covered under the purview of insolvency law, exclusion of NBFCs from Code does not seem to be justified.

Alternate Remedy

Now that it is established that the doors of the Code are closed for creditors who owe money from FSPs, what is the alternate remedy available to them?

Meanwhile, a separate legal framework is drawn and implemented, it is pertinent to note that section 277 of the Code interestingly bestows upon the Central Government the power to notify, in consultation with the appropriate financial regulators, financial service providers for the limited purpose of insolvency, which may be conducted under this Code. This provision on account of it being overriding in nature gives an extensive power to central government to notify the financial service providers under the Code.

However, despite there being a provision for inclusion of financial service providers in Code, owing to the economy sensitive and complex structure of the extant Financial Service Providers, it shall be best suited to have a separate legal framework dealing with the resolution and insolvency process of Financial Service Providers, especially those which are “systematically critical.”

Conclusion

In light of the facts and circumstances discussed above, it can be construed that:

- a. Not all NBFCs can be classified as financial services providers and as such a deemed carve out of NBFCs from the Code shall not be prudent interpretation; and

- b. as much as exclusion of Financial Service Providers from the Code proves to be appropriate, the need of the hour is to introduce a separate framework dealing with matters of insolvency of financial service providers.



Resolution



III

**SECTION III: CORPORATE
INSOLVENCY RESOLUTION
PROCESS**

Editor’s Note:

Corporate Insolvency Resolution Process is a process laid down in the Code for reviving the company (here: corporate debtor) from its state of insolvency. In colloquial terms, insolvency refers to inability to pay, but the test under the Code has been shifted from “inability” to “failure”, thereby moving from the so-called “balance sheet test” to the “liquidity” or “cashflow test”. CIRP under IBC can be initiated even if default is wilful, i.e. when the corporate debtor has the ability to pay, yet chooses not to pay. Therefore, under IBC, the focal point is “default” of a payment obligation.

The objectives of the Code, as stated in its Preamble include “reorganisation and insolvency resolution” which implies that the idea is to revive and not liquidate. When a company falls into insolvency, the first step is to try and resolve and not liquidate.

An application for CIRP can be filed by a financial creditor, an operational creditor or the corporate debtor itself.

Once an application filed by either of the creditor or the corporate debtor itself is admitted by the Adjudicating Authority, the first and foremost implication is the applicability of moratorium.

“Moratorium”, also referred to as stay or “calm period” is the period during which no creditor, whatsoever can undertake recovery actions against the Corporate Debtor.

During this period, the

corporate debtor too, cannot alienate its assets. However, the umbrella protection of moratorium is not all pervasive – it comes with exceptions as discussed further. This period is exclusively for the Corporate Debtor to revive and reorganize to be fit again. The Code provides a moratorium of 180 days or 270 days as a result of a one-time extension of maximum 90 days.

When the order of commencement of CIRP is passed, the Adjudicating Authority also appoints an insolvency professional to act as the Interim Resolution Professional (IRP). On and from the commencement of CIRP, the control of the corporate debtor is transferred to the hands of the IRP, so appointed. Meanwhile, the board of directors of the corporate debtor remains in animated suspension. It is the duty of the IRP to make public announcement of commencement of CIRP, invite

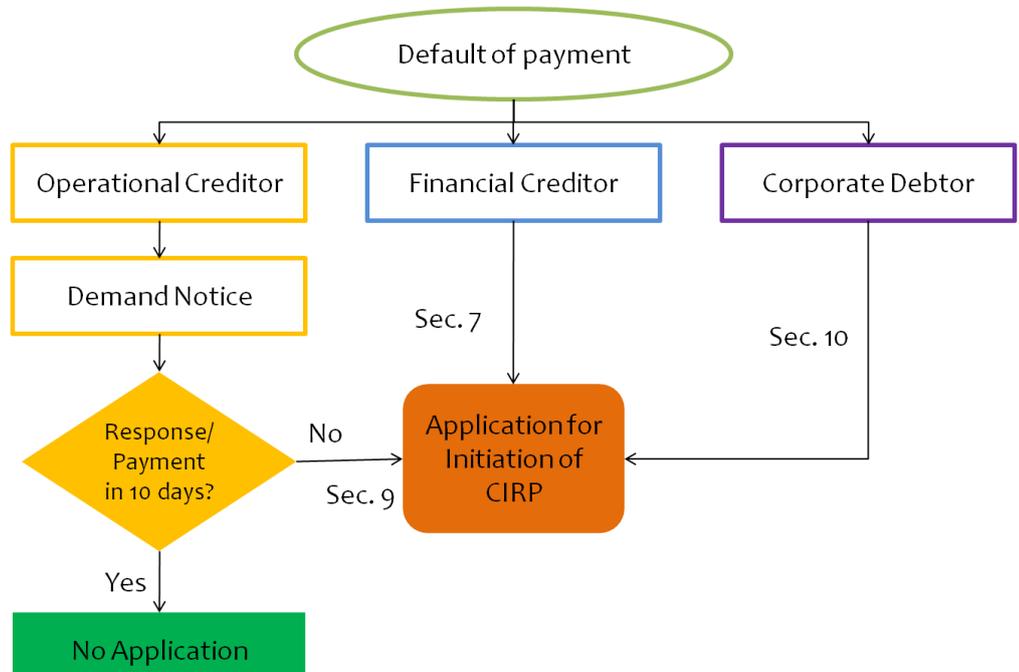


Figure 8: Initiation of CIRP

Corporate Insolvency Resolution Process

claims from creditors, and constitute the committee of creditors. The IRP so appointed may or may not be appointed as the Resolution Professional (RP), and the same is decided upon by the Committee of Creditors in its first meeting.

The most important role of the RP is to invite Resolution Plans. The IRP/RP shall, with co-operation of the board of directors and/ or retained officials of the corporate debtor do or ensure to get done, all such acts as may be necessary to keep the corporate debtor in an operating/ going-concern stage.

Insolvency Professionals are one of the four pillars which uphold the Code. The Code is a car and Insolvency Professional, its driver. Being the executive hand of the entire structure laid down by the Code, the role of Insolvency Professionals becomes crucial to ensure fulfilment of the objectives of the Code.

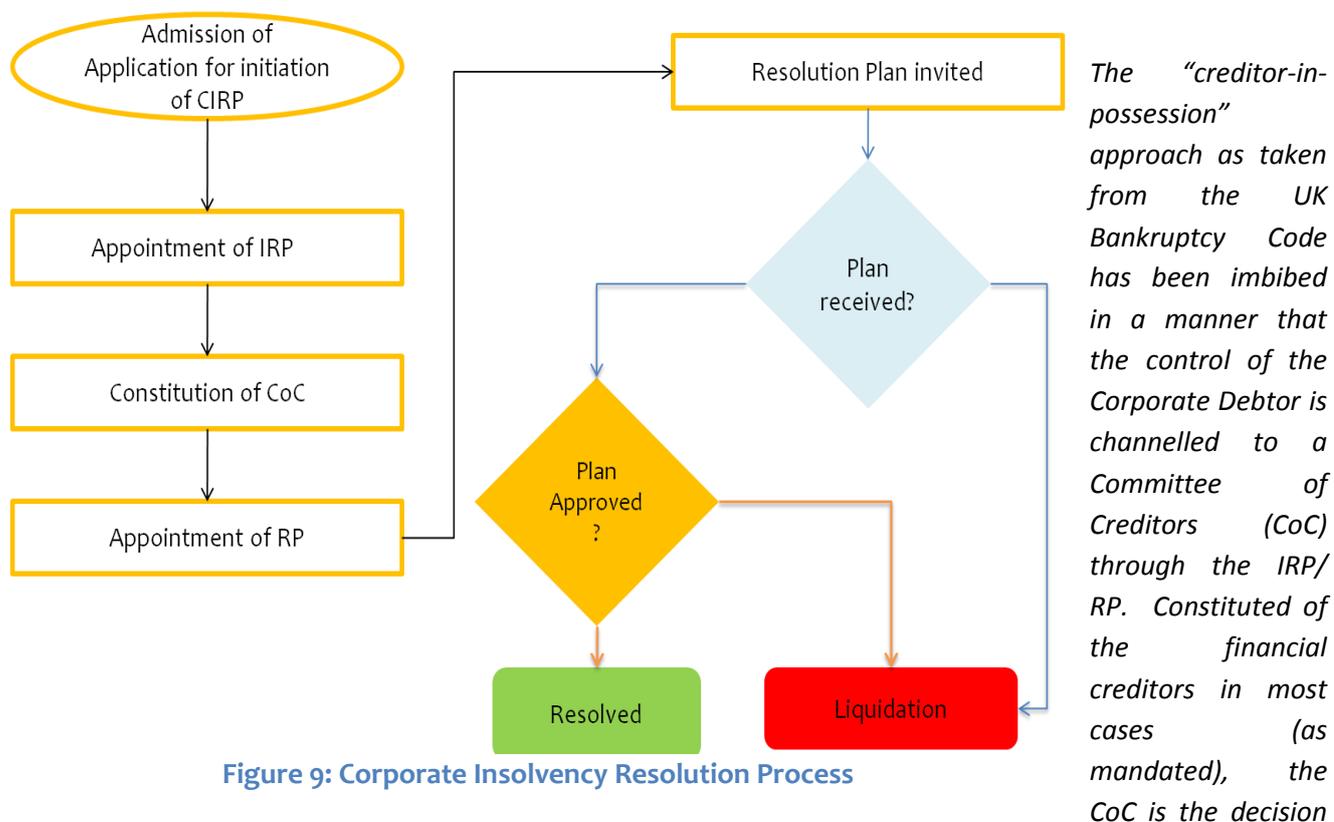


Figure 9: Corporate Insolvency Resolution Process

making body of the Corporate Debtor, for the very reason that it is the investment and interest of these creditors which is at stake. Actions taken by the IRP/ RP are to be ratified by this CoC. The Code has laid down different thresholds for approval of different transactions, viz. substantial matters like approval of resolution plans, removal of RP, require the atleast 66% consent, whereas routine matters like ratification of costs etc. requires atleast 51% consent. This section also covers certain important aspects concerning meetings of the CoC.

The CoC sits together to gauge feasibility and acceptability of resolution plans submitted by various resolution applicants. Resolution Plan perhaps is the most important element of the entire process of resolution. Resolution Plan refers to a plan proposed by a resolution applicant (person/ entity making such proposal) to resolve the insolvency of the corporate debtor. The plan so proposed must compulsorily deal with payment of the CIRP Costs in priority, payment to operational creditors, management of affairs of the corporate debtor on implementation of such plan and other

requirements laid down in section 30 of the Code. It is the duty of the RP to invite resolution plans from prospective applicants.

From the plans so received, the RP shall first ensure that the plan is compliant to the provisions of the Code and then present the plan before the Committee of Creditors, who may accept or reject the same. As such, the RP has a preliminary but crucial role to play. Where the Resolution Plan is accepted, the RP files an application before the Adjudicating Authority for approval of the plan ratified by the Committee, following which, Adjudicating Authority may, upon its discretion accept or reject the same.

When the resolution plan receives a nod from both CoC and Adjudicating authority, the plan operates as a 'statutory magic' and binds all stakeholders involved in the resolution plan. However, where the resolution plan is rejected by the Committee of Creditors itself, or by NCLT, or the RP receives no resolution plans at all, the Corporate Debtor goes into liquidation by a formal order of the NCLT.

It is pertinent to note that Resolution Plans are the way out from insolvency and an escape from liquidation. However, it was noted that Resolution Plans were being proposed by the very promoters, ex-directors and their relatives of the Corporate Debtors, as a result of which, the control of the Corporate Debtor went back to those persons who led it to insolvency, and that too, free from all debt and at 'discounted' prices. The very intent of the Code was frustrated. Hence, to avoid the same, the much-talked about Section 29A of the Code was introduced. With the intent to prohibit all persons with vested interest from proposing plans, section 29A enlists criteria for ineligibility of Resolution Applicants. Hence, those applicants attracting any one or more of the clauses shall be ineligible to propose a resolution plan.

As simple as it may sound, recent developments have clearly indicated that approval of resolution plans is indeed a tedious task. The landmark case of Essar Steel is one such example. In most cases the approval/ rejection of a resolution plan is preceded by applications by aggrieved parties (including unsuccessful resolution applicant) and may also be followed by an appeal by the aggrieved party before the Appellate Tribunal i.e. National Company Law Appellate Tribunal.

Having discussed the basic structure of CIRP, we shall now delve into various loopholes, judicial developments that have come in light whilst practical execution of the provisions of the Code.

CONSTITUTIONAL POWERS IMMUNE FROM MORATORIUM UNDER IBC

- Vallari Dubey

Editor's Note: An order for admission of CIRP is accompanied by orders for causing a public announcement, appointment of an interim resolution professional, and for moratorium. Section 14 of IBC envisages a 'calm period' that is, a time bound moratorium against debt recovery actions and institution of new suits and proceedings during the corporate insolvency resolution process. The calm period is inevitable, as during this period, the creditors and potential resolution applicants negotiate to arrive at a solution to revive the corporate debtor – meanwhile, the assets of the corporate debtor remain in the custody of an insolvency professional, protected against recovery actions.

Section 14 covers an array of actions which cannot be undertaken during corporate insolvency resolution process – institution of suits or continuation of pending suits or proceedings against the corporate debtor; transfer/alienation of assets by the corporate debtor itself; action under SARFAESI Act; and recovery of property by an owner/lessor, where such property is occupied by the corporate debtor. The section also provides for certain exceptions – such transactions as may be notified by the Government (in consultation with any financial sector regulator), and guarantors to the corporate debtor. Besides, though not explicitly stated, the provisions of section 14 cannot curtail the constitutional powers of the Supreme Court and the High Court under Articles 32 and 226 (respectively) of the Constitution of India; however, if the proceeding before the Supreme Court/High Court is not in the nature of those covered under the said Articles, the proceedings will be hit by section 14 of IBC – the same has been upheld by the judiciary. This article discusses one such ruling of NCLAT.

Ever since the Code was enacted, its overriding effect during the moratorium became the talk of the corporate town. It was yet to be tested whether the prohibition of any proceedings against the corporate debtor during the moratorium is a prudent step or not. While the cases started flowing in and came few judgments, it was established that the objective of the Code was to revive the entity at its core and not to be seen as another recovery tool. Under the light of such understanding, it was observed that the moratorium period was very much necessary for the corporate debtor so as to evaluate the possible option and ways for revival of the stressed entity. However, this write-up focuses on the recent judgment pronounced by National Company Law Appellate Tribunal (NCLAT) in the matter of *Canara Bank vs. Deccan Chronicle Holdings Limited*.

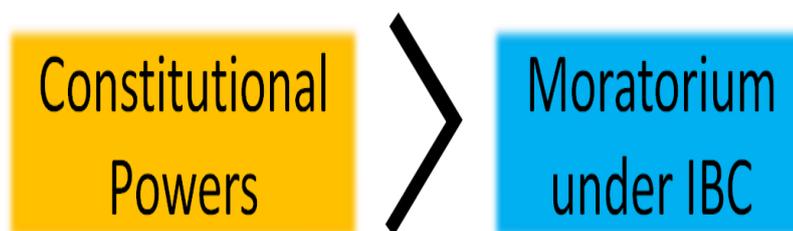


Figure 10: Constitutional Powers override powers under Moratorium

Brief facts of the case

In the present case, an application was filed by Canara Bank (hereinafter known as the 'Appellant') under Section 7 of the Code against Deccan Chronicle Holdings Limited (hereinafter known as "the Corporate Debtor"), which was admitted by the Hon'ble Hyderabad bench of NCLT, declaring Moratorium under Section 14 of the Code on 19th day of July, 2017. However, the Appellant was not content with the order of moratorium pronounced as it specifically excluded proceeding before High Court and Supreme Court from the purview of Moratorium.

Main contentions of the Appellant

The Appellant submitted that the Adjudicating Authority cannot exclude any court from the purview of Moratorium for the purpose of recovery of amount or execution of any judgement or decree, including the proceeding, if any, pending before the Hon'ble High Courts and Hon'ble Supreme Court of India against a 'corporate debtor'.

Relevant extract of Moratorium

Relevant extract of the Moratorium declared by the Hon'ble Bench which is the theme of the matter of discussion is as follows:

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(c) We hereby declared the following Moratorium by prohibiting the following actions: –

*1. The institution of suits or continuation of pending suits or proceedings **except before the Hon'ble High Court (s) and Hon'ble Supreme Court of India**, against the Corporate Debtor including execution of any judgement, decree or order in any court of law, Tribunal, arbitration panel or other authority;*

XXX

Relevant provisions of the Code

Section 14 (1) (a)

XXX

Moratorium – (1) Subject to provisions of sub-sections (2) and (3), on the insolvency commencement date, the 14. Adjudicating Authority shall by order declare moratorium for prohibiting all of the following, namely:—

(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;

XXX

Constitutional Powers Immune From Moratorium under IBC

Findings of the Bench

On Section 14 – Section 14(1)(a) does not exclude any Court, including the Hon’ble High Courts or Hon’ble Supreme Court of India.

Recovery suits in High Courts and Supreme Court – There is no provision to file any money suit or suit for recovery before the Hon’ble Supreme Court except under *Article 131* of the Constitution of India where dispute between Government of India and one or more States or between the Government of India and any State or States on one side and one or two or more States is filed. Some High Courts have original jurisdiction to entertain the suits, which may include money suit or suit for recovery of money.

Certain Powers of High Courts and Supreme Court – The Hon’ble Supreme Court has power under *Article 32* of the Constitution of India and Hon’ble High Court under *Article 226* of Constitution of India which cannot be curtailed by any provision of an Act or a Court.

Judgment passed by the Hon’ble Bench

In view of the above observations, ‘Moratorium’ will not affect any suit or case pending before the Hon’ble Supreme Court under Article 32 of the Constitution of India or where an order is passed under Article 136 of Constitution of India. ‘Moratorium’ will also not affect the power of the High Court under Article 226 of Constitution of India.

However, so far as suit, if filed before any High Court under original jurisdiction which is a money suit or suit for recovery, against the ‘corporate debtor’ such suit cannot proceed after declaration of ‘moratorium, under Section 14 of the I&B Code.

“so far as suit, is filed before any High Court under original jurisdiction which is a money suit or suit for recovery, against the ‘corporate debtor’ such suit cannot proceed after declaration of ‘moratorium, under Section 14 of the I&B Code.”

The Hon’ble Bench of NCLAT disposed of the matter by clarifying the language of Moratorium (supra) as declared in the above case, without suggesting any changes therein and neither rejecting nor accepting the appeal filed by the appellant.

Our Analysis

There are few important points of discussion that can be highlighted by this judgment, discussed briefly below:

- Moratorium declared is within the *constitutional ambit* of the Code. The Code is a Central Act, passed by the parliament by exercising the powers granted under the Constitution of India.
- There are *certain powers* directly bestowed upon the High Courts and the Supreme Court of India by the Constitution of India. Such powers with the respective judiciary bodies are immune of any provision of any law in the Country, be it Central law or State law.

- *Article 32* gives power to Supreme Court to issue directions, writs or orders with respect to right to constitutional remedy.
- *Article 226* gives power to High Courts to issue writs for enforcement of rights given under Part III of the Constitution of India.
- *Article 136* of the Constitution deals with the power to allow a special leave to appeal to person who files an application under this article.
- All the above mentioned powers are exclusive to the two judiciary bodies and therefore Moratorium under the Code shall not affect such powers.
- However, even if the Moratorium as declared in this case excludes suits or proceedings with High Courts, the exclusion does not extend to suits or proceedings with a High Court under original jurisdiction where the suits pertains to recovery of money and therefore will be affected by the period of Moratorium.
- Moratorium is a legal right for the benefit of both the Corporate Debtor and the Creditor and also the judiciary to put a temporary hold/stay on everything else and deal with the case in hand, *ceteris paribus*. The right is however, bestowed by a Central Act; Few powers that are rested upon top two highest judiciary bodies in the country by the supreme law, are untouched of any other right under any other law in the country including the Moratorium period under the Code.

Impact of Judgment and Conclusion

Moratorium is a stay on any action being taken against the Corporate Debtor. On one side, the judgment clarifies the supreme powers of the Supreme Court and High Courts and on the other side, adds more clarity to provisions of Section 14 of the Code. Interestingly, the provisions of Section 14 do not provide any exceptions to Moratorium, as clarified by the judgment in the given case.

NCLT being a quasi-judicial body, formed under an Act of Parliament, cannot override the constitutional powers resting with the Apex judiciary.

Know More . . .

The judiciary has interpreted section 14 as being benevolent to the corporate debtor. For instance, as held by the Delhi High Court in *Power Grid Corporation of India v. Jyoti Structures Limited* section 14 would not apply to the proceedings which are in benefit of the corporate debtor inasmuch the proceedings are not 'debt recovery' actions and its conclusion would not 'endanger, diminish, dissipate or impact the assets of the corporate debtor in any manner whatsoever and hence shall be in sync with the purpose of moratorium'. The interpretation has been broad enough – not only to stop recovery proceedings, but also any proceeding which might have an adverse impact on the assets of the corporate debtor. The Calcutta High Court, in *Unilever Industries Private Limited v. Kwaliti Limited* stayed interlocutory proceedings in relation to intellectual property as continuation of such proceeding might lead to affectation of the intellectual property rights of the debtor.

As to properties of the guarantors of the corporate debtor, initially there was a lot of debate as to whether such properties will be protected by the moratorium. The guarantors (mostly promoters of the corporate debtors) sought refuge under section 14 to protect their personal assets against recovery action of lenders. However, in landmark judgement of *State of Bank of India v. Ramakrishnan & Anr.*, the Supreme Court settled that moratorium provisions cannot apply to personal guarantors of the corporate debtor. Later, section 14 was amended to explicitly provide for the same.

Section 14 also does not impact criminal proceedings, e.g. under section 138 of the Negotiable Instruments Act, 1881.

ROLE OF INSOLVENCY PROFESSIONALS IN CORPORATE INSOLVENCY RESOLUTION PROCESS

- VINOD KOTHARI & SIKHA BANSAL

Editor's Note: *The Code brings, for the first time in India, a regulated profession of insolvency practitioners. Such insolvency practitioner acts as resolution professional (RP) in corporate and non-corporate insolvency resolution, liquidator in case of corporate liquidation, and bankruptcy trustee in case of individual bankruptcy.*

In corporate insolvency, the RP performs various functions, though under the control of the committee of creditors. The RP takes over the management of the business of the company, while the board of directors remains in suspended animation. The RP has to ensure that the business goes uninterrupted. One of the major tasks of the RP is to bring the creditors on table, and have a feasible resolution plan prepared and acceded to by everyone.

The RP acts as a catalyst in the entire negotiation process, even though several tasks are performed by various specialized agencies. The RP has to perform the tough task of balancing several objectives, even though working under very stringent timelines.

This article examines the role of IPs in the process of corporate insolvency resolution. While an insolvent company essentially comes under the creditors' discretion, the IP becomes the nodal agency that brings the creditors together, ensures the going-concern nature of the insolvent during the resolution process, preserves assets and, where needed, enhances the value of assets by challenging questionable transfers of assets or creation of obligations, and above all, plays an enabling role in the framing of the resolution plan. While it may be intuitive to think of the IP as an agency imposed by some or other creditors, and therefore, have the upfront risk of being taken as anti-debtor, it is important to understand that the IP plays the significant role of cementing together the interests of the corporate debtor and the creditors.

Role of IPs: Historical Perspective

Laws pertaining to insolvency have, historically, in India as well as in the UK, been developed in context of individuals, and later extended to companies. US law, which developed largely out of the UK law, took a pro-reorganisation stance, and therefore, are known more because of the so-called Chapter 11 (in lines of which our own Sick Industrial Companies Act was drawn) rather than the liquidation provisions. Irrespective of the jurisdiction or the subject matter of the law, an insolvency resolution process has always needed an agency to execute the process, the primary difference being whether such agency was an officer of the court, or an appointee of the creditors:

1. The Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920 provided for appointment of official assignees/official receivers for the purpose of carrying out relevant procedures under the Acts – see section 17 of the PTIA, 1909 and section 57 of the PIA, 1920.

Role of Resolution Professionals in CIRP

2. In case of companies, section 448 of the Companies Act, 1956 provided for appointment of official liquidators attached to High Court for carrying out liquidation of those companies which are ordered to be wound up by the High Court. The Companies (Second Amendment) Act, 2002 extended the eligibility [which never came into force] to be appointed as official liquidator, by permitting the appointment of a professional, from a panel chartered accountants, advocates, company secretaries, costs and works accountants, or firms, or bodies corporate consisting of such professionals, as empanelled with the Central Government, The Companies Act, 2013, however, brought this change vide section 275. A “company liquidator”, whether in case of winding up by NCLT or voluntary winding up, has to be appointed from a panel of professionals maintained by the Central Government. With the amendments made by the Code, this section will now be relevant only in case of compulsory winding other than on grounds of inability to pay.
3. Under the provisions of the SICA, 1985, an “operating agency” would aid in preparation of scheme for rehabilitation of the sick company. “Operating agency”, as defined under section 2, meant any public financial institution, State level institution, scheduled bank or any other person as may be specified by general or special order as its agency by the BIFR. It may be relevant to mention, inasmuch as the Companies (Second Amendment) Act 2002 sought to merge revival provisions into the Companies Act, the said amending Act defined the term “operating agency” as any group of experts consisting of persons having special knowledge of business or industry in which the sick industrial company is engaged and included public financial institution, State level institution, scheduled bank or any other person as may be specified by the NCLT.
4. The Companies Act, 2013 contained provisions for revival and rehabilitation of sick companies under Chapter XIX. Section 259 provided for appointment of “administrators” by the NCLT from a databank maintained by the Central Government or any institute or agency authorised by the Central Government in a manner as may be prescribed consisting of the names of company secretaries, chartered accountants, cost accountants and such other professionals as may, by notification, be specified by the Central Government. These provisions now stand deleted by the IBC.

The above would make it evident that while a nodal agency has always been present in resolution or liquidation process, there has been a gradual tendency to enhance professional involvement in the corporate insolvency procedures. However, the need of a specialized line of profession focused solely on the areas of insolvency law and practice was always felt, alongwith the necessity of revamping the old laws. The IBC, 2016 addresses this need by introducing IPs in the individual and corporate insolvency resolution processes, individual bankruptcy process and corporate liquidation process as well.

Need for specialized insolvency professionals

The need of specialized professionals to conduct the resolution and liquidation processes has been emphasized unequivocally. The [UNCITRAL Legislative Guide on Insolvency Law](#) recognizes the role of an “insolvency representative” as follows:

“However appointed, the 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.”

In [“Orderly and Effective Insolvency Procedures”](#) by International Monetary Fund, the role of a liquidator or an administrator has been appropriately described, however, with a suitable caution –

“The liquidator and the administrator play a central role in the effective implementation of the law. Although their respective roles differ substantially, they are similar in one important respect. 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. That does not mean, however, that they are a substitute for the court: due process requires that a dispute between the liquidator and an interested party be adjudicated by a court of competent jurisdiction. Even in countries where there are serious problems with the capacity of the judiciary, there is a limit to the amount of authority that the law can confer upon these officers.”

The BLRC, the recommendations of which has led to the enactment of the Code, in its [Final Report](#), emphasises the role of an insolvency professional as follows –

“In an insolvency and bankruptcy resolution process driven by the law there are judicial decisions being taken by the adjudicator. But there are also checks and accounting as well as conduct of due process that are carried out by the IPs. 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.

The role of the IPs is thus vital to the efficient operation of the insolvency and bankruptcy resolution process. A well functioning system of resolution driven by IPs enables the adjudicator to delegate more and more powers and duties to the professionals. This creates

Role of Resolution Professionals in CIRP

the positive externality of better utilisation of judicial time. The worse the performance of IPs, the more the adjudicator may need to personally supervise the process, which in turn may cause inordinate delays. Consumers in a well functioning market for IPs are likely to have greater trust in the overall insolvency resolution system. On the other hand, poor quality services, and recurring instances of malpractice and fraud, erode consumer trust.”

In tune with the proposal of the BLRC, the Code requires an IP to play a catalytic role in corporate insolvency process (as RP), corporate liquidation process (as Liquidator), individual insolvency resolution (as RP) and individual bankruptcy process (as Bankruptcy Trustee). This article focuses solely on the role of an insolvency professional as “resolution professional” in CIRP. However, before getting into the provisions of the Code, 2016, it would be interesting to have a look at the provisions of US and UK laws regarding the roles expected from an insolvency representative; notably, the two laws are different in their approach – the US law follows “debtor-in-possession” approach, while the UK law has creditor-in-possession theme.

Role of an Insolvency Professional – Difference under the UK and the US Insolvency Laws

1. The Insolvency Act, 1986 – UK

In UK, the concept of the licensed insolvency practitioner was first introduced in the mid 1980s and formalised in statutory provisions which now form Part XIII of the [UK Insolvency Act, 1986](#)²¹. The administration (equivalent of insolvency resolution under Indian law) under the UK Insolvency Act, 1986 is conducted by an administrator. The administrator, as Schedule B1 to the Act states, is an officer of the Court, whether or not appointed by the Court. Schedule B1 specifies that the administrator of a company must perform his functions with the objective of “rescuing the company as a going concern”, unless he thinks that it is not reasonably practicable to achieve that objective or that achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up (without first being in administration) would be preferable. Where the administrator thinks that it is not reasonably practicable to achieve either of the objectives, he may proceed to realise property in order to make a distribution to one or more secured or preferential creditors, provided that it does not unnecessarily harm the interests of the creditors of the company as a whole.

Paragraph 49 of Schedule B1 requires that the administrator shall make a statement setting out proposals for achieving the purpose of administration; and the proposal may include a voluntary arrangement (popularly called CVA) under the Act, or a proposal for a compromise or arrangement to be sanctioned under the Companies Act, 2006. The administrator has been vested with the power to do anything necessary or expedient for the management of the affairs, business and property of the company. The administrator of a company may call a meeting of members or creditors of the company. The administrator of a company shall on his appointment take custody or control of all the property to which he thinks the company is entitled.

2. US Code: Title 11 – Bankruptcy

²¹ Technical Manual of Insolvency Service

Chapter 11 of the US Bankruptcy Code deals with reorganization (equivalent to insolvency resolution in India and administration in UK law). The reorganisation framework envisaged under the US Bankruptcy Code follows “debtor-in-possession” approach; hence the nature of duties which a Court-appointed trustee has to perform is different in this case. Section 1106 specifies the duties of a trustee appointed by the Court. He is required to perform the duties of a trustee in a liquidation case specified in section 704 (2), (4), (6), (7), (8), and (9). These include – to be accountable for all property received, to investigate the financial affairs of the debtor, to furnish such information concerning the estate and the estate’s administration as is requested by a party in interest (unless the Court orders otherwise), and to file with the Court periodic reports and summaries of the operation of the business of the debtor. The section also casts certain investigative duties on the trustee – to investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor’s business, and the desirability of the continuance of the business, and any other matter relevant to the case or to the formulation of a plan. Section 1107 places a debtor-in-possession in the shoes of a trustee in every way. The debtor is given the rights and powers of a Chapter 11 trustee. He is required to perform the functions and duties of a Chapter 11 trustee, except the investigative duties.

Role of Insolvency Professional in Corporate Insolvency Resolution Process under the Code, 2016

The corporate insolvency resolution process envisaged under the Code, 2016 is prominently a creditor-driven process, whereby the decision to let the debtor survive or to liquidate the same rests on a collective body of the creditors, i.e. the committee of creditors. Since the RP is an appointee of the creditors, and the IP takes over the management and supervision of the company in insolvency, the business of the company may be said to be in creditors’ possession during the resolution process. While, unlike during the liquidation process, there is no vesting of assets and property in the RP, but the RP takes over the management of the business. Hence, the approach is similar to that under the UK Insolvency Act, 1986. The assets of the corporate debtor are taken into custody by the RP chosen by the committee of creditors and the management of the affairs of the corporate debtor too, vests in the RP. Note that prior to appointment of a RP, an IRP is appointed to perform the aforesaid functions till the committee of creditors is constituted and the RP is appointed. The role played by the RP (including an interim resolution professional) has been explained in the following paragraphs.

3. Management of the affairs of the corporate debtor

Section 17 of the Code, 2016 provides for vesting of the management of the affairs of the corporate debtor in the hands of interim resolution professional, which is natural consequence of a creditor-in-possession regime. The concept of ‘debtor-possession’ implies that the debtor continues to remain in possession of the management of the entity during the resolution process. This was the approach under SICA, as SICA was evidently drawn on the basis of the US Bankruptcy Code. The N L Mitra Committee advocated a deviation from the approach as follows:

“The most critical provision in the SICA is that the promoter/management bringing the entity to the BIFR remains in possession and creates incentives for stripping off assets. Therefore,

Role of Resolution Professionals in CIRP

creditors are against most restructuring proposals. It is therefore recommended that if the owner/promoter/existing management files the petition for the bankruptcy of a company, the possession of the company with its entire assets and liabilities must be vested with the Trustee immediately without any loss of time. That ensures the first principle of maximisation of asset value. If a creditor files the petition the possession of the company's assets and liabilities shall vest on the Trustee as soon as the petition is allowed.”

The Code adopted the theme of “creditor-in-possession”, and therefore, vests the RP with the management of the affairs of the corporate debtor, starting from the date of appointment itself. Further, the powers of the board of the directors of the corporate debtor shall stand suspended, and the same shall be exercised by the interim resolution professional. However, it is important to note that the powers of the interim resolution professional in such capacity is not unfettered – the powers of the interim resolution professional/resolution professional is subject to the authority of the committee of creditors, as discussed in later paragraphs.

The authors, in their “*Law Relating to Insolvency and Bankruptcy Code 2016*”²², discuss that the corporate boards in India are more often supervisory boards while the day-to-day functioning of the entity is the responsibility of the executive management. Section 17 though provides for suspension of the powers of the board of directors, yet clearly says that all officers and employees will report to the interim resolution professional. Hence, the suspension of the powers of the board of directors must have no bearing on the executive machinery. Note that the executive machinery may typically be headed by the managing director. Therefore, the managing director, who works under the supervision of the board of directors, will now work under the supervision of the IRP. Likewise, executive directors will cease to have the powers of “directors” but will continue their respective functional roles, under the supervision of the interim resolution professional.

That it is not the administrator who starts managing the company, but the existing management starts working under the supervision of the administrator, is clear from reading of Item 64 of Schedule B1 to the UK Insolvency Code, reading as follows:

“64. (1) A company in administration or an officer of a company in administration may not exercise a management power without the consent of the administrator.

(2) For the purpose of sub-paragraph (1)—

- (a) “management power” means a power which could be exercised so as to interfere with the exercise of the administrator’s powers,
- (b) it is immaterial whether the power is conferred by an enactment or an instrument, and
- (c) consent may be general or specific.”

It will be impractical for the RP or the administrator to start managing the day-to-day operations of the entity. Neither does the RP have the technical expertise to do so, nor is the replacement of existing management at all conducive to the idea of preserving or maximising the going concern value of the entity. Of course, the RP has wide powers, but the issue is that the power must be exercised in the interest of the entity, and not as a matter of power play. In rulings like *RAB Capital*

²²Vinod Kothari & Sikha Bansal, *Taxmann*, 2016

plc vs Lehman Brothers (International) Europe (2008) EWHC 2335 (Ch), courts have taken very liberal view on the powers of the administrator; however, it is a consistent position in the UK that the administrator does not dismiss the existing management²³.

Sections 18, 20 and 25 of the Code talk about duties and functions of the RP. These may seem to suggest that the actual day-to-day operations of the entity will be carried out by the RP. However, the RP has to preserve the existing management. The RP has powers to appoint agencies to carry out his management function. The idea behind the law is to put the RP effectively in the steering position, so that the going concern is in the creditors' control.

In order to facilitate the IRP/ RP in fulfilling his responsibility of managing the affairs of the corporate debtor, sections 20 and 25 provide authority to interim resolution professional/resolution professional to do necessary acts, including the following –

- (i) to enter into contracts on behalf of the corporate debtor or to amend or modify the contracts or transactions which were entered into before the commencement of corporate insolvency resolution process;
- (ii) to raise interim finance, subject to certain conditions;
- (iii) to issue instructions to personnel of the corporate debtor as may be necessary for keeping the corporate debtor as a “going concern” (see discussion under the next heading);
- (iv) to appoint accountants, legal or other professionals as may be necessary; etc.

However, section 28 acts as a limit to the authority of the interim resolution professional/resolution professional – it lists out certain acts which shall not be undertaken without the prior approval of the committee of creditors. The acts include – raising interim finance in excess of limits approved by the committee of creditors, creating security interest on the assets of the corporate debtor, changing the capital structure of the corporate debtor, undertaking related party transactions, amending constitutional documents of the corporate debtor, amongst others.

4. Management of the entity as “going concern”

The Code emphasises that the interim resolution professional shall manage the operations of the corporate debtor as a “going concern” – section 20. “Going concern” refers to an enterprise continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the

²³ Note the following comment from a Jones Day publication:

“Opinion diverges over who is best placed to run the company (presuming there is not mismanagement or dishonesty). It is arguable that many insolvency cases are caused by some weakness in management. Moreover, the historical link between the insolvency to the displacement of management is very strong. Ironically, the UK has not really had experience with substantive stand alone reorganizations and perhaps the new legislation will highlight whether an insolvency practitioner can manage a business back to health and reorganization. However, the alternative is to identify the management weakness and intervene with expert advisors or help which in many ways mirror the skills of the insolvency practitioner.”

[<http://www.jonesday.com/files/Publication/b0c886bd-6721-4c66-9213db7f01ddb55f/Presentation/PublicationAttachment/96b1ebf1-2203-4577-bff4-8baf89f4e0d1/Comparison%20of%20Chapter%2011.pdf>.]

Role of Resolution Professionals in CIRP

intention nor the necessity of liquidation or of curtailing materially the scale of the operations²⁴. The provision sets out the guiding principle for the interim resolution professional or the resolution professional managing the corporate debtor during the resolution process. The interim resolution professional/resolution professional, therefore, shall administer the company “as is”, without making any material alterations in the scale of operations of the company or selling off material value of its assets which may endanger any possibility of the revival of the corporate debtor.

5. Custody of the assets of the corporate debtor

Section 18 requires the interim resolution professional to take control and custody of any asset over which the corporate debtor has ownership rights and section 20 obliges the interim resolution professional to make every endeavour to protect and preserve the value of the property of the corporate debtor. Again, section 25 states that it shall be the duty of the resolution professional to preserve and protect the assets of the corporate debtor, including the continued business operations of the corporate debtor. The Code has also amended section 429 (1) of the Companies Act, 2013 empowering the NCLT to pass instructions to executory authorities for taking control and custody of assets, in case the RP is facing difficulties in doing so.

Here, the words “take control and custody” shall not be misinterpreted to mean taking control and custody of the assets for the purpose of disposal thereof – the objective of the provision is to move the custody and control of the assets from the directors to the interim resolution professional for the purpose of adequate monitoring and not as a pre-disposal measure. The view transpires from the very fact that the corporate debtor is presently at the stage of “resolution” and not “liquidation” – this also brings out the distinction between the roles played by an administrator and a liquidator.

6. Bringing the creditors together

The interim resolution professional shall constitute the committee of creditors after collation of all claims received against the corporate debtor and determination of the financial position of the corporate debtor – section 21. The committee of creditors is the collective body of financial creditors of the corporate debtor which, by way of majority vote, decides on the ultimate fate of the corporate debtor, i.e. whether to resolve the insolvency or to liquidate the entity. The committee of creditors appoints resolution professional in its first meeting. The resolution professional is then entrusted with the task of convening and conducting the meetings of the committee of creditors during the resolution process – section 24.

7. Conducting the Corporate Insolvency Resolution Process

Section 23 states that 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. During the corporate insolvency resolution process period, the interim resolution professional/resolution professional has to undertake the following activities –

²⁴See Para 10 of the Accounting Standard (AS) 1 (Disclosure of Accounting Policies), issued by the Institute of Chartered Accountants of India.

- (i) making public announcement of the insolvency resolution process in respect of the corporate debtor;
- (ii) collection of all information relating to the assets, finances and operations of the corporate debtor for determining the financial position of the corporate debtor, including information relating to business operations, financial and operational payments, list of assets and liabilities;
- (iii) receipt and collation of claims of creditors submitted pursuant to the public announcement;
- (iv) constitution of the committee of creditors;
- (v) convening and conducting the meetings of the committee of creditors;
- (vi) filing necessary information with information utility;
- (vii) preparation of information memorandum for facilitating the formulation of a resolution plan;
- (viii) inviting prospective resolution applicants to put forward their resolution plans;
- (ix) examining each resolution plan received so as to see whether the resolution plan meets the criteria enlisted under section 30 (2) and presenting the eligible resolution plans at the meetings of the committee of creditors;
- (x) submission of the resolution plan approved by the committee of creditors to the adjudicating authority for approval of the latter;
- (xi) making applications for avoidance of preference, undervalued, fraudulent transactions; etc.

8. Preparation of Information Memorandum

Section 29 requires that the resolution professional shall prepare an information memorandum in such form and manner containing such relevant information as may be specified by the Board for formulating a resolution plan. The CIRP Regulations, however, require that certain minimum information shall be provided to each member of the committee of creditors and any potential resolution application before the first meeting of the committee of creditors. This calls for preliminary preparation of information memorandum by the IRP. The information memorandum shall contain details on the basis of which a resolution plan may be formulated. Regulation 36 (2) of the CIRP Regulations lists out the contents of the information memorandum.

9. Facilitating Resolution Plan

As mentioned in the preceding paragraph, the resolution professional prepares the information memorandum which serves as an input for the formulation of the resolution plan. The task of the RP in respect of the resolution plan does not end here – section 30 of the Code, 2016 read with regulation 38 of the CIRP Regulations mandates that a resolution plan must confirm to certain minimum requirements. The resolution professional must examine each resolution plan received by him to confirm that each resolution plan –

- (i) provides for the payment of insolvency resolution process costs in priority to the repayment of other debts of the corporate debtor and identifies specific sources of funds to pay the same;
- (ii) provides for the repayment of the debts of operational creditors which shall not be less than the liquidation value due to operational creditors in priority to any financial creditor and

Role of Resolution Professionals in CIRP

before the expiry of thirty days after the approval of a resolution plan by the adjudicating authority;

- (iii) provides for the repayment of the liquidation value due to dissenting financial creditors before any recoveries are made by the financial creditors who voted in favour of the resolution plan.²⁵
- (iv) provides for the management and control of the affairs of the corporate debtor after approval of the resolution plan;
- (v) the implementation and supervision of the resolution plan;
- (vi) does not contravene any of the provisions of the law for the time being in force.

The RP shall present to the committee of creditors for its approval such resolution plans which confirm the conditions as referred hereinabove. The resolution plan which is approved by the committee of creditors shall then be submitted by the resolution professional to the adjudicating authority. Where the resolution plan is approved by the adjudicating authority, the resolution professional shall forward all records relating to the conduct of the corporate insolvency resolution process and the resolution plan to the Insolvency and Bankruptcy Board of India to be recorded on its database.

The assessment of the fair values of assets, and a preparation of the liquidation value assessment is one of the key tasks at this stage. Resolution is the preferred alternative; liquidation is the ultimate. Therefore, a resolution plan has to offer to the stakeholders something better than what they would get in liquidation. There is a well-known “vertical test” used by UK Courts [for example, see *T & N Limited*, (2005) 2 BCLC 488] that in a resolution, a stakeholder cannot be put to prejudice *apropos* what he would get in liquidation. So, a creditor either votes on the resolution plan, and therefore, hopes to get a better deal out of a healthier borrower, or votes against (which includes not voting) the resolution plan, in which case, he gets an exit based on what would have been liquidation value of his claim, going by the priority order of distribution and the estimated fair value of the assets.

While the RP acts as the catalyst of the entire process, he is not the one who actually prepares the resolution plan. The plan is prepared by a “resolution applicant”, who may either one of the lenders themselves, or an external consultant. A resolution plan is a rescue strategy. Turnaround strategy is always a bespoke solution to the case; it involves close scrutiny of assets, liabilities, incomes and expenses. In terms of assets, the plan may provide for sale of non-core assets, or replacing owned assets by leased assets. In respect of liabilities, the plan may provide for conversion of the unsustainable debt into equity, or sacrifice of interest. The plan may involve curtailing expenditure, redirecting operations, etc. Very often, a restructuring plan may also involve alteration of product mix, product markets, etc.

²⁵*A dissenting financial creditor meant a financial creditor who voted against the resolution plan or abstained from voting for the resolution plan, approved by the committee; and Regulation 38(1) of the CIRP Regulations required all resolution applicants to provide liquidation value to dissenting financial creditors in priority. The Hon’ble National Company Law Tribunal, in the matter of [Central Bank of India vs. Resolution Professional of Sirpur Paper Mills Limited & Ors](#), observed that Regulation 38 (1) of the CIRP Regulations was inconsistent with the Code and ought to be removed and as such the instant ruling set the ball rolling for the amendment dated 5th October, 2018, by virtue of which the concept of dissenting financial creditors was done away with.*

Preparation of rescue plan may include rescue financing as well. Note that the Code gives uppermost priority in the liquidation waterfall to interest and principal on rescue financing. However, it is hoped that resolution applicants do not go ambitiously in restructuring plans for further capital infusion. This strategy has not worked in past SICA revivals or CDR cases. Instead, resolution applicants may provide for interim financing largely for paying off dissenting creditors, and therefore, reducing the burden of liability on the entity.

Conclusion

The following statement²⁶ sums up the importance of the role with insolvency professionals play in reorganisation or resolution of an entity:

“It is conceivable for an insolvency system to function with minimal interventions by courts or government agencies. It is not conceivable for such a system to function effectively without specialists, especially for reorganization. “The probability of effective reorganization increases when agents of reorganization have the capacity to (a) decide whether rescuing business is feasible and to advise on alternative courses of action (liquidation, reorganization, creative combinations of these); and (b) to reorganize the company itself” Such capacities depend on a sufficient supply of expert labor. Public policy must therefore (a) find means to bring the best and brightest into the debt restructuring area, (b) regulate competition to constrain costs and reduce conflicts of interest, (c) remove financial and reputational barriers to insolvency professions, and (d) develop a regulatory system that delivers competency and integrity.”

Beyond the Lines . . .

Recently, NCLT, Mumbai in an application filed by [RP of Bharati Defence, in the matter of Edelweiss Asset Reconstruction Company Limited v. Bharati Defence and Infrastructure Limited](#), made adverse observations against the RP and thereby removed him from the role and appointed another person as the liquidator, citing conflict of interest of the RP.

Consequently, in an appeal filed by the RP against the adverse observations placed by the AA, the [Hon'ble NCLAT in its order dated 29.03.2019](#), set aside the observations made by the AA against Mr. Dhinal Shah and held that, no individual notice was served to him. It was further stated that any misconduct on the part of the RP shall be reported to IBBI, the appropriate authority in such circumstances.

²⁶ Institutional Lessons from Insolvency Reforms in East Asia, Terence C. Halliday and Bruce G. Carruthers, available here: <http://siteresources.worldbank.org/GILD/Resources/Halliday4.pdf>;

RESOLUTION PROFESSIONAL VIS-A-VIS BOARD OF DIRECTORS: GOVERNANCE OF INSOLVENT COMPANIES

- **Sikha Bansal**

Editor's Note: As discussed in the earlier article, RP acts as a driver of the corporate insolvency resolution process, balancing the interests of concerned stakeholders, simultaneously acting as an officer of the court. RP's functions are multi-faceted – besides taking care of the resolution process, the RP has to ensure that the company is being preserved as a going concern. As such, the RP steps into the shoes of the board of directors of the company.

IBC contemplates that as soon as interim resolution professional assumes office, the management of the affairs of the corporate debtor shall vest with the interim resolution professional (and consequentially, the resolution professional), and the powers of the board of directors of the insolvent company shall stand suspended and be exercised by the interim resolution professional (and then, by the resolution professional).

There are views which hold that the board of directors lose their powers and as well as are relieved of their duties to perform functions which they are otherwise required to perform. This, however, does not seem to be going the right way – as the provisions are clear – initiation of corporate insolvency resolution process blocks the board of directors to do anything on their own will or even at the will of equity holders. The idea is to take away the “power” – that too, temporarily. The board, precisely, remains in animated suspension. This article visits various provisions as well as rulings to analyse the position of the board of directors in corporate insolvency resolution process s.

S EBI has issued a [“Discussion Paper on Compliance with SEBI Regulations by Listed Entities undergoing Corporate Insolvency Resolution Process under the Insolvency and Bankruptcy](#)

[Code, 2016”](#) on 28th March, 2018. The Discussion Paper proposes certain modifications in the applicable regulatory framework to facilitate insolvency resolution of listed corporate debtors while at the same time ensuring that the interests of investors in securities of such corporate debtors are protected.

IBBI in its [Circular No. No. IP/002/2018](#) dated 3rd January, 2018 has emphasised that a corporate person undergoing insolvency resolution process, fast track insolvency resolution process, liquidation



process or voluntary liquidation process under the Code needs to comply with provisions of the applicable laws (Acts, Rules and Regulations, Circulars, Guidelines, Orders, Directions, etc.) during such process. For example, a corporate person undergoing insolvency resolution process, if listed on a stock exchange, needs to comply with every provision of the LODR Regulations, unless the provision is specifically exempted by the competent authority or becomes inapplicable by operation of law for the corporate person. The Circular directed that while acting as an interim resolution professional, resolution professional or a liquidator for a corporate person under the Code, an insolvency professional shall exercise reasonable care and diligence and take all necessary steps to ensure that the corporate person undergoing any process under the Code complies with the applicable laws. Further, it was clarified that if a corporate person during any of the aforesaid processes under the Code suffers any loss, including penalty, if any, on account of non-compliance of any provision of the applicable laws, such loss shall not form part of insolvency resolution process cost or liquidation process cost under the Code. It is also clarified that the insolvency professional will be responsible for the non-compliance of the provisions of the applicable laws if it is on account of his conduct.

Thus, the aforesaid Circular, in effect, puts the resolution professional entirely into the shoes of the board of directors of the corporate debtor. The Discussion Paper too, makes references to the Circular. Therefore, the belief which seems to be building around is that the resolution professional completely replaces the board of directors and the executive machinery of the corporate debtor has to be operated by the resolution professional alone. This, however, seems to be a misplaced view, in light of the discussion made below.

Introduction

A corporate set-up is governed by the board of directors vested with general powers to manage the operations of the corporate entity; however, their powers are subject to the limitations set by the equity owners, the constitutional documents of the entity, and the laws governing the entity. As long as the company sails unruffled, the governance of the entity rests in the hands of the board of directors. However, as things go topsy-turvy, as the company starts defaulting on dues and fails to meet continuing obligations, the control goes for a change as per the scheme of the Code. When a company is sound, corporate governance ensures maximisation of benefits to each stakeholder. But when a company approaches default, the persons at the helm of affairs of the company, in anticipation of such default, may engage in customised and illicit transactions thereby depleting the wealth of the company and disregarding the legitimate rights of credit-providers. Therefore, in order to intercept such a behaviour, the Code envisages the design of 'creditor-in-possession'. BLRC thus observes:

“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.”

The Code provides for suspension of the powers of the board of directors of the corporate debtor and appointment of a resolution professional to manage the affairs of the corporate debtor. Such resolution professional is selected by a committee of creditors.

Resolution Professional vis-a-vis Board of Directors

The Conundrum

As discussed in the *UNCITRAL Legislative Guide on Insolvency Law*, the insolvency laws tend to follow one of these approaches as regards continuing role of a debtor in reorganisation proceedings – (i) total displacement of the debtor, (ii) supervision of the debtor by the insolvency representative, and (iii) full control by the debtor.

In case of total displacement of the debtor, the procedure is the same as in liquidation, *removing all control of the business* from the debtor and appointing an insolvency representative to undertake the debtor's functions with respect to management of the business. While under the debtor-in-possession approach, the debtor retains full control over the operation of the business, with the consequence that the court does not appoint an independent representative once the proceedings commence. However, to mitigate the difficulties associated with this approach, certain protections may be adopted. Between these two extremes, intermediate approaches establish different levels of control between the debtor and the insolvency representative. *These generally involve some level of supervision of the debtor by the insolvency representative, such as where the latter broadly supervises the activities of the debtor and approves significant transactions, while the debtor continues to operate the business and take decisions on a day-to-day basis.*

In the context of our discussion, the moot question is – to what extent will the resolution professional replace the board of directors? The language of the Code coupled with remarks made by the courts is apparently puzzling the authorities, corporate boards, and the professionals too. Seemingly, there is a consensus building on the point that once an insolvency professional takes over the corporate debtor for taking it through the resolution process, the directors and other officers become entirely non-functional and it is the resolution professional who has to do anything and everything which a director has to do in respect of the company.

The above, however, does not seem to reflect the true intent of the Code. The resolution professional leads the resolution process so as to ensure that there is no malfeasance on the part of the board of directors, that those in control of the entity do not deplete the entity's wealth so much so that the creditors have to go empty-handed. However, appointment of a resolution professional is not intended to be an intrusive move – a professional coming in for some months is neither equipped nor should be expected to run a business established and being run for decades by those who are better placed to do so.

Before we proceed further, it would be relevant to note the relevant provisions of the Code and the observations made by the Supreme Court which has become more of a conundrum for the experts.

Stipulations in the Code

Section 17 of the Code, *inter-alia*, states,

“17. (1) From the date of appointment of the interim resolution professional,—

...

(b) the powers of the board of directors or the partners of the corporate debtor, as the case may be, shall stand suspended and be exercised by the interim resolution professional;

(c) the officers and managers of the corporate debtor shall report to the interim resolution professional and provide access to such documents and records of the corporate debtor as may be required by the interim resolution professional;

...”

Sub-section (2) goes on to state that the interim resolution professional, vested with the management of the corporate debtor, shall act and execute in the name and on behalf of the corporate debtor all deeds, receipts, and other documents and shall have the authority to access the electronic records, books of accounts, records and other relevant records of the corporate debtor.

Section 19 of the Code runs as under:

“(1) The personnel of the corporate debtor, its promoters or any other person associated with the management of the corporate debtor shall extend all assistance and cooperation to the interim resolution professional as may be required by him in managing the affairs of the corporate debtor.”

Note that the word “personnel” includes the directors, managers, key managerial personnel, designated partners and employees, if any, of the corporate debtor (as defined under section 5 (23)).

Section 24 (3) perpetuates confusion when it says the resolution professional shall give notice of each meeting of the committee of creditors to the members of the “*suspended* board of directors or partners of the corporate debtor”.

Section 25 (1) of the Code enunciates that it shall be the duty of the resolution professional “to preserve and protect the assets of the corporate debtor, including the continued business operations of the corporate debtor”. Sub-section (2) then lists down the actions to be undertaken for fulfilment of the duty stipulated under sub-section (1).

In *Para 11* of the judgment delivered in [Innoventive Industries Ltd v. ICICI Bank and Another \[Civil Appeal Nos. 8337-8338 OF 2017\]](#), the Supreme Court says, “According to us, once an insolvency professional is appointed to manage the company, the *erstwhile* directors who are no longer in management, obviously cannot maintain an appeal on behalf of the company . . . Entrenched managements are *no longer allowed to continue in management* if they cannot pay their debts.”

The *obiter dicta* suddenly became a precedent in concluding that the Code is a confiscatory legislation by which the directors become “*erstwhile* directors” and the management is “no longer allowed to continue in management” once an insolvency professional is appointed.

We humbly diverge – reasons being deliberated as follows.

Suspension of powers of board vs. Suspension of board

Resolution Professional vis-a-vis Board of Directors

Section 17 (1) talks about suspension of “powers” of the board of directors and partners of the corporate debtor, and exercise of those powers by the interim resolution professional/resolution professional. Therefore, the expression “suspended board of directors” as used in section 24 is misguided. In section 17, the word “suspended” qualifies “powers of the board”, and not “board of directors” itself.

Cessation of powers must be distinguished from cessation of directorship. In [Rangai Goundan \(M.K.\), Re, \(1942\) 12 Com Cases 198, 201 : AIR 1942 Mad 702](#), the Madras High Court held interpreting section 208A of the Companies Act, 1913 that the wording of the section suggests that the directors will lose their powers, but they will not cease to be directors. See also, [Steel Konnect \(India\) Pvt. Ltd. v. M/s. Hero Fincorp Ltd. \[Company Appeal \(AT\) \(Insolvency\) No. 51 of 2017\]](#) where the NCLAT clearly noticed that directors of the company do not cease to be directors, as they are not suspended but their function as “board of directors” is suspended [para 18].

See also, [M/s. Subasri Realty Private Limited v. Mr. N. Subramanian & Anr. \[Company Appeal \(AT\) \(Insolvency\) No. 290 of 2017\]](#), in which the NCLAT, Delhi in clear words, stated:

“ . . . we may clarify that after appointment of the Resolution Professional and declaration of moratorium, the Board of Director stands suspended, but that **does not amount to suspension of Managing Director or any of the Director or officer or employee of the Corporate Debtor**. To ensure that the Corporate Debtor remains on going concern, all the Director/ employees **are required to function and to assist** the Resolution Professional who manages the affairs of the Corporate Debtor during the period of moratorium. If one or other officer or employee had the power to sign a cheque on behalf of the Corporate Debtor prior to the order of moratorium, such power does not stand suspended on suspension of the Board of Directors nor can be taken away by the Resolution Professional. If, the person empowered to sign cheque refuse to function on the direction of the Resolution Professional or misuse the power, in such case it is always open to the Resolution Professional to take away such power after notice to the person concerned.”

Board of directors vs. Individual directors

The board of directors works as a collective body, and the directors, in their individual capacity, are not empowered to exercise the powers which the board is entitled to exercise. There is nothing which stipulates that the directors in the board of directors of the corporate debtor shall be suspended or shall vacate their offices. It precludes them from *working as a “board”*. The board of directors is still there, but is powerless in doing acts which they have been empowered to do under the law. However, the directors who constitute the board are there and are NOT relieved from their duties and functions. This is evident from section 19 which mandates the personnel of the corporate debtor to assist the resolution professional in managing the affairs of the corporate debtor.

“Officers” to report to the Resolution Professional

The point presented above gets substantiated by what has been stated in clause (c) of section 17 (1) of the Code that the officers and managers of the corporate debtor shall report to the interim resolution professional. The expression “officer” has not been defined under the Code, hence reference shall be drawn to the Companies Act, 2013.

Section 2 (59) of the Companies Act, 2013 defines “officer” so as to include “any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the board of directors or any one or more of the directors is or are accustomed to act”. Therefore, the officers of the corporate debtor, whether or not in the board of directors, are not suspended; they merely start functioning under the overall control and supervision of the resolution professional.

As defined under section 2 (53) of the Companies Act, 2013, “manager” means “an individual who, subject to the superintendence, control and direction of the Board of Directors, has the management of the whole, or substantially the whole, of the affairs of a company, and includes a director or any other person occupying the position of a manager, by whatever name called, whether under a contract of service or not”. A manager is thus a part of the executive management – day-to-day affairs of the company are managed by the executive management under the superintendence, control and direction of the board of directors. Once the resolution proceedings commence, the manager (whether he is a director or not), becomes accountable to the resolution professional. He will continue performing his activities subject to the directions and instructions of the resolution professional. *The resolution professional taking over the management of the corporate debtor does not imply that he has to perform day-to-day acts in relation to the company.*

The Role of Chief Executive Officer or Managing Director

Section 2 (54) of the Companies Act, 2013 defines “managing director”, as a director who, by virtue of the articles of a company or an agreement with the company or a resolution passed in its general meeting, or by its board of directors, is entrusted with substantial powers of management of the affairs of the company and includes a director occupying the position of managing director, by whatever name called.

The managing director of the company wears two hats – that of a director, and that of a chief managerial person or employee of the company. *Apropos* to his role of being the chief managerial person of the company, he knows the company’s affairs, its business, its markets, and its resources in and out. As such, he is “entrusted” with substantial powers of managing the company. The acumen of the think-tank of a business and the expertise of a specialized professional like insolvency professional operate in two different domains and cannot be used as substitutes for each other.

The managing director cannot be uprooted from his position until he acts *malafide*. His powers remain dormant till the continuation of the resolution period. Any act proposed to be done by the managing director shall be subject to concurrence of the resolution professional.

“Preserve and Protect” Continued Business Operations of the Corporate Debtor

It is the duty of the resolution professional, as stipulated under section 25 (1), to *preserve and protect* the continued business operations of the corporate debtor. The provision does not ask the resolution professional to look into the business operations of the corporate debtor. For the purpose of protecting and preserving the continued business operations of the corporate debtor, the resolution professional shall undertake the tasks listed under sub-section (2) of section 25. A bare perusal of the list shows that most of the tasks are related to the conduct of the resolution process and those related to the corporate debtor directly are either custodial or supervisory or

Resolution Professional vis-a-vis Board of Directors

representative in nature. The resolution professional has to step in where there are difficulties in continued business operations of the corporate debtor.

Conflict of Interests of Resolution Professional

In [Steel Konnect \(India\) Pvt. Ltd. v. M/s. Hero Fincorp Ltd. \[Company Appeal \(AT\) \(Insolvency\) No. 51 of 2017\]](#) it was held that the board of directors or partners of the corporate debtor, as the case may be is suspended and their power can be exercised by the interim resolution professional, but such

exercise of power is limited to the extent to sub-section (2) of section 17 of the Code and not for any other purpose. It is desirable to notice that though pursuant to section 17, the board of directors of a corporate debtor stands suspended (for a limited period of corporate insolvency resolution process – maximum 180 days or extended period of 90 days i.e. 270 days), *but they continue to remain as directors and members of the board of directors for all purpose in the records of Registrar of Companies under the Companies Act, 2013.* Therefore, the corporate debtor has the right to prefer appeal under sub-section (1) of section 61 through its board of directors or authorise person or its officers.

Steel Konnect vs. Hero Fincorp:

“the board of directors or partners of the corporate debtor, as the case may be is suspended and their power can be exercised by the interim resolution professional, but such exercise of power is limited to the extent to sub-section (2) of section 17 of the Code and not for any other purpose”

Hence, where there are matters evidencing conflict of interests of the resolution professional with the interest of the corporate debtor, the directors shall be free to represent the corporate debtor before the courts. If the corporate debtor is left in the hands of the resolution professional to raise its grievance by filing an appeal under section 61 of the Code, it will be futile, as no resolution professional will challenge the initiation of corporate insolvency resolution process which ultimately will challenge his appointment.

Though the order of the NCLAT in *Steel Konnect (supra)* is juxtaposed to the observation made by the Hon’ble Supreme Court in *Innoventive Industries (supra)*, yet the assertions made by the former also deserve commendation.

Resolution vs. Liquidation

It might be relevant to note sub-section (7) of section 33 of the Code. It stipulates that “the order for liquidation under this section shall be deemed to be a *notice of discharge* to the officers, employees and workmen of the corporate debtor, *except* when the business of the corporate debtor is continued during the liquidation process by the liquidator”.

Two important points may be noted here –

When an entity goes into liquidation, the order of liquidation is deemed to be a notice of discharge to the officers, employees and workmen. As such, these persons vacate their respective offices. The law explicitly provides for vacation of their offices. Such a provision cannot be said to the same as that contained under section 17. “Suspension” should be differentiated from “discharge”.

Where the business of the corporate debtor is continued during the liquidation process by the liquidator, the order *shall not be taken* to be a notice of discharge to officers and employees of the corporate debtor. This exception leads to the corollary that in case the entity is allowed to continue its operations, the officers shall continue serving their respective functions, which is the case during resolution.

Besides, the revival provisions contained in the Companies Act, 1956/2013 could never be implemented, certain provisions relating to winding up or liquidation might be relevant. Section 491 of the Companies Act, 1956 stated,

“On the appointment of a liquidator, all the powers of the Board of directors and of the managing or whole-time directors and manager, if there be any of these, shall cease, except for the purpose of giving notice of such appointment to the Registrar in pursuance of section 493 or insofar as the company in general meeting or the liquidator may sanction the continuance thereof.”

Section 313 of the Companies Act, 2013 (the provision has now been omitted by virtue of amendments made by the Code) corresponds to section 491 of the Companies Act, 1956. It is notable that the above provision explicitly provided for cessation of the powers of the managing and whole time directors. However, the Code preserves (i.e. suspends and does not cease), and thoughtfully so, the powers of the employees of the company, which must be deemed to preserve the powers of the key managerial personnel of the company.

Closure of resolution process

What happens to the powers of the board of directors once the insolvency resolution process period is over? Where the resolution proceedings conclude a resolution plan for implementation, the board comes back to power subject to the provisions of the resolution plan. Where the resolution proceedings fail and the entity is taken into liquidation stage, the officers and employees are automatically discharged.

The Concern

The views that are currently prevailing that once the insolvency resolution period commences, there would be no board meetings, there would be no audit committee meetings, that the resolution professional will sign each and every document relating to the corporate debtor, that the resolution professional shall be do all the filings are completely misguided.

A resolution professional takes over the management of the corporate debtor on “*as is*” basis – just that the management comes under the powers of the resolution professional conferred on him under the law. The officers continue functioning as they used to. The meetings of the board and that of the committees of the board will continue to be conducted in accordance with the applicable laws. The concerned officials will continue filing and maintaining records and documents as required under various laws. However, the overall governance of the corporate debtor will go in the hands of the resolution professional so as to ensure that the corporate debtor goes through the resolution process *sans* hindrances. The functional machinery of the corporate debtor remains intact under the controlled supervision of the resolution professional.

Resolution Professional vis-a-vis Board of Directors

The BLRC defined the boundaries of the functions performed by an insolvency professional –

“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. . . . 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.

“THE RESOLUTION PROFESSIONAL IS RATHER AN AGENT OF THE ADJUDICATING AUTHORITY AND NOT OF THE COMPANY OR ANY OF ITS STAKEHOLDERS. A RESOLUTION PROFESSIONAL IS A SPECIALISED PROFESSIONAL AND NOT AN EMPLOYEE OF THE CORPORATE DEBTOR OR A BUSINESSMAN”

The role of the IPs is thus vital to the efficient operation of the insolvency and bankruptcy resolution process. A well-functioning system of resolution driven by IPs enables the adjudicator to delegate more and more powers and duties to the professionals. This creates the positive externality of better utilisation of judicial time.”

Thus, the resolution professional is rather an agent of the adjudicating authority and not of the company or any of its stakeholders. A resolution professional is a specialised professional and not an employee of the corporate debtor or a businessman – his task is to facilitate and catalyse the resolution of the corporate debtor and not get entangled in daily affairs of the company unless that comes as an obstacle to continued business operations of the corporate debtor. *The business of a resolution professional is not to do business but to facilitate survival of business*. The resolution professional, in the short span of time allowed to him and given the object with which he has been appointed, cannot be put into multiple shoes. Any other interpretation of the provisions may lead to grave consequences and may actually result in ill-governance.

If the resolution professional replaces the board completely, there may be serious lapses in corporate governance:

- (i) All matters which require decision-making by the board of directors [sec 179 (3) of the Companies Act and several other sections] will become meaningless;
- (ii) Audit committee and other board committees will become meaningless;
- (iii) Board responsibilities come on the IRP/RP who has a very narrow mandate in terms of time, and therefore, cannot be effectively replacing the long term functions of the board.

The right approach to adopt will be a temporary cessation of board powers, and placing the board under the control and supervision of the interim resolution professional/resolution professional.

The MCA as well as SEBI may consider issuing the following clarifications –

- (i) During the insolvency resolution phase, the board/board committees shall function under the supervision and control of the resolution professional;

(ii) In terms of regulatory filings and authentication [for example, authentication of financial statements, quarterly financial statements, etc.], where authentication by the board is required, the same may be countersigned by the resolution professional as well;

(iii) All statutory duties and functions of whole time directors and managing director will continue to be discharged subject to the supervision of the resolution professional.

Therefore, the IBBI Circular that directs an insolvency professional to ensure corporate person undergoing any process under the Code complies with the applicable laws shall be read accordingly. It should be the responsibility of the KMPs and SMPs to continue to comply with the applicable laws and report periodically to the insolvency professional. The order passed in *M/s. Subasri Realty Private Limited (supra)* strengthens the view as stated above.

MEETINGS OF COMMITTEE OF CREDITORS UNDER INSOLVENCY CODE

- Nitu Poddar

Editor's Note: As BLRC writes, "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." Equity owners exercise control through a board of directors appointed by them. The board is responsible for overall direction and governance of the company. However, when the company slips into insolvency, the equity owners should take a backseat and the creditors shall take charge and decide the fate of the entity – this is what the idea of IBC is.

Therefore, all major decisions pertaining to the company are taken with the approval of a duly constituted CoC. Section 28 of IBC lists out the acts which can be undertaken by the RP only with the prior approval of the CoC. The CoC is a collective body consisting solely of financial creditors of the corporate debtor. The committee is constituted by the interim resolution professional after collation and verification of claims.

The first meeting of CoC shall be held within 7 days of the constitution of the CoC. IBC read with the CIRP Regulations, 2016 lays down detailed provisions relating to the meetings of CoC. This note briefly captures the same.

Practice makes a man perfect and the same practice (read: implementation) makes a law seamless. IBC along with its allied rules and regulation is just a year old technically (and around 5 months old effectively) and surely there are gaps which are being detected during implementation.

One such gap is in the provisions laid down for convening the meeting of the CoC

Quorum for the meeting

As per Regulation 22 of the CIRP, 2016, minimum 33% of voting rights is required to be present for any meeting to hold good. Such members may be present either in person or by video conferencing or by any audio-visual means.



Figure 12: Requirements to quorate the CoC Meeting

However, as per Regulation 21 (3) (b) read with 25 (5) of the CIRP, 2016, no voting can take place at the meeting in case even a single member of the CoC is absent. The Resolution Professional conducting the meeting has to provide for e-voting facility in case any (even single) member of the CoC is absent from the meeting.

On reading of the two Regulations referred above, it seems that in IBC – there are effectively two quorum – (a) 33 % of the total voting rights of the CoC – for the meeting to hold good for discussion; (b) 100 % of the total members of the CoC – for allowing voting at the meeting.

This is unlike the age old practice being followed for Companies Act purposes where once quorum is present, deliberation can be done and voting can be sought.

Participation by video-conferencing and e-voting

As per Regulation 21 (1) read with Regulation 23 (1) of the CIRP, the notice of the meeting “shall inform” of the option available to the members to participate through video conferencing or other audio and visual means.

Also, as said above, in case any member of the CoC is not present at the meeting, votes with respect to such meetings have to be sought via e-voting.



In its intent to make use of technology, it seems that the provisions of the law have missed on the practical difficulty and cost burden on the corporate debtor (which is anyway financial unhealthy). E-voting is surely a costly and time consuming affair as one needs to develop model with respect to assigning voting percentage to each of the member of the CoC. This should be noted that for general meetings of members in corporate – the voting rights are aligned to the shareholding and the same is always updated on real time basis with the RTA. Therefore no extra calculation / programming needs to be done for conducting a voting by electronic means. However, since in IBC, the votes are aligned with the individual claim amount vs the total claim amount of all the financial creditors put together – the same has to be set in the system of the service providers to enable e-voting.

Also, as a matter of fact, unlike in case of corporate e-voting, in IBC e-voting is after the meeting. In corporate e-voting, the voting happens before the meeting.

The concept of e-voting is to allow such members to vote who are unable to attend the meeting in person. Accordingly, where all the members of the CoC are present at the meeting and ready to vote at the meeting, the requirement of providing video conferencing facility and voting by electronic means may be done away with.

However, where some members are not present, or where members want to take time (for example, consultations at their respective offices / heads), members may vote electronically.

Voting by circulation

Meetings are meant for decision making. Unlike Companies Act, while there is not explicit provision for voting remotely (by circulation or through e-voting only), however at the same time, the law has not expressly ruled out the same.

Meetings of the CoC under Insolvency Code

In fact, section 24(1) of the IBC, 2016 provides that voting can be conducted either at the meeting or by such electronic means as may be prescribed

The extract of the relevant section is reproduced -

“24.(1) The members of the committee of creditors may meet in person or by such electronic means as may be specified”

As such, participation by audio visual means is permitted and also encouraged. Meeting by circulation and voting remotely is a convenient mode for fast decision making and particularly for such a time bound process as resolution; therefore, there is nothing wrong in the COC deciding to adopt a resolution by circulation, particularly for matters which are not covered by the statute (that is a non-section 28(1) matter).

The same is also hinted in Regulation 25 (1) and 25 (2) of the CIRP. Where clause (1) for section 28 items mentions that the same “shall” be considered at the meeting; clause (2) for non-section 28 items mentions that such items “may” be considered at the meeting. To infer, a non-section 28 item may be considered through voting by circulation.

Voting percentage required²⁷

For any resolution to sail through, minimum 75% of votes in favour is required. Practically, there can be three situation – (a) assent; (b) dissent; and (d) present but did not vote i.e abstained from voting. The age old practice for corporate meetings have been that only “present and voted” is counted for the purpose of drawing conclusion for any agenda item. The reason for the same is that the ones who were present and still chose to abstain from voting were unable to make up their mind to either go for the resolution or against- hence they choose to remain with the majority.

The same is hinted in section 21(8) of the Code.

“(8) All decisions of the committee of creditors shall be taken by a vote of not less than seventy-five per cent of voting share of the financial creditors:”

Accordingly, the 75% votes required for a resolution to sail through is 75% of those who casted their votes.

For example, at e-voting or voting at the meeting, a particular creditor may not vote at all (within the time allowed for e-voting), or may refrain from voting. Such creditors’ vote is not counted at all (the same is disregarded in both the denominator and the numerator).

²⁷The article was contributed on 1st June, 2017. Readers are requested to peruse the article in line with the following:

By virtue of the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018, effective from 6th June, 2018, the minimum voting percentage required by CoC has been reduced from 75% to 66% for substantial decisions like approval of Resolution Plan, replacement or removal of Resolution Professional etc., whereas, the minimum threshold for routine matters has been reduced to 51%.

ABSENTEEISM IN VOTING: AN OXYMORON

- Nitu Poddar

Editor's Note: Resolution plans are to be approved by CoC by a requisite majority. Now, a creditor who is a member of CoC may or may not be present in the meeting. Even if present, the creditor may simply 'abstain' from voting on the resolution. Given such practical scenarios, the manner in which the percentage of votes in favour of a particular resolution is calculated and more importantly, treatment of those creditors, who abstain from voting, do not vote at all, and its impact on the insolvency process and steps to be taken by the Resolution Professional have been discussed in the note below:

This note deals with the question whether, in determination of the assent at a Committee of Creditors in resolution proceedings, the votes of such creditors who (a) do not vote at all, at an electronic voting; or (b) abstain from voting at the meeting itself [collectively referred to as "abstaining creditors"] will be considered while computing the voting strength of 75%²⁸ required. The relevant provision of law for this purpose is sec. 21 (8) of the Code which provides as follows:

All decisions of the committee of creditors shall be taken by a **vote of not less than seventy-five per cent** of voting share of the financial creditors: "voting share" has been defined in sec. 5 (28) as follows: (28) "voting share" means the share of the voting rights of a single financial creditor in the committee of creditors which is based on the proportion of the financial debt owed to such financial creditor in relation to the financial debt owed by the corporate debtor.

Assuming that the total number of voting shares, based on financial debt availed by the corporate debtor is Rs 100, and at a meeting, creditors holding financial debt of Rs 20 decides to abstain from voting, and out of the remaining Rs 80, creditors holding financial debt worth Rs 70 assent, whereas those holding financial debt worth Rs 10 oppose, is the decision passed with not less than 75% voting share? The answer will be affirmative, if we consider total voting share of Rs 80 who decided to cast votes, and the answer will be negative if we consider the total number of votes, including those who were undecided, or decided to remain undecided, that is, Rs 100.

The situation of abstaining financial creditors forms a substantial reality in CoC meetings. Very often, an officer of a bank or financial creditor comes to the meeting, and decides to abstain from voting, and commonly specifically writes on the ballot paper: "Abstain from voting since HO instructions not received", or the like. It is quite commonplace practice that no matter which officer comes to the meeting, the voting at the meeting is often at the directives of "senior management" or "HO", and if the officer attending the meeting has not got his HO consent, we will mostly abstain.

²⁸The article has been contributed prior to the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018, effective from 6th June, 2018, and as such, readers are requested to read the same in line with the following amendment:

The minimum voting percentage required by CoC has been reduced from 75% to 66% for substantial decisions like approval of Resolution Plan, replacement or removal of Resolution Professional etc., whereas, the minimum threshold for routine matters has been reduced to 51%.

Absenteeism in Voting: An Oxymoron

The process of decision-making at CoCs very often involves existential question – the very survival of the corporate debtor depends on whether the CoC has decided to pass a resolution plan, or has failed to do so. Hence, the question becomes critical – can a member, who decides not to vote at all, and therefore, have no view on a matter whatsoever, may be counted at par with a person who has explicitly expressed a negative view?

There are 5 perspectives from which we will try to attempt this critical question:

- General rationale of collective decision-making
- Law of meetings, as settled over decades of authorities and rulings
- Notes of the BLRC
- Amendments to CIRP Regulations
- Decisions, or indecision, as available from NCLT rulings

General rationale of collective decision-making

After all, the CoC is a collective decision-making forum. The law insists on a super-majority for decision-making. A decision has two takes – a positive take, and a negative take. No collective decision-making process may force a person to decide. A person may not want to decide, or may remain indecisive. A person may simply absent from the decision-making process.

The process of counting majority or supermajority is a process of assimilating views expressed on a matter. If there is no view expressed, or a member does not come forward to vote at all, the same cannot be equated with a negative view. Therefore, the required super-majority has to be computed based on votes cast. This seems to be the intuitive rationale of collective decision-making.

General Law of voting

Over several years now the general law of voting is that members express their views by either voting in favour of a resolution or against the resolution. There can also be members who do not express their views at all; either by a) not attending the meeting, or b) by attending but not voting or abstaining to vote at the meeting.

The members who do not express their views are considered to be indecisive, and, therefore, by implication, have decided to follow the decision of the majority.

So, to count votes and to arrive at a conclusion on whether or not an agenda is resolved at the meeting, the votes in favour and the votes against are weighed and the majority is counted by finding the proportion of the votes cast in favour to the votes cast against. In no circumstance, the invalid votes or votes not cast at all are counted to calculate the majority.

According to ***Black's Law Dictionary (8th edition)***, “simple majority” means “a majority of the members who vote, a quorum being present, disregarding absent members, members who are present but do not vote, blanks, and abstentions”. “Majority rule” means, among others, “governance by the majority of those who actually participate, regardless of the number entitled to participate”. According to the same dictionary, “abstention” means “the act of withholding or keeping back (something or oneself); especially the withholding of a vote”.

According to ***Guide for Meetings and Organisations, N E Renton, 7th ed. volume 2, para. 12.101***, “Unless otherwise stated, “majority” means a majority of those actually voting either “yes” or “no” (a phrase sometimes need in this context is “present and voting”). The term does not refer to: (1) a majority of the quorum (provided that, in the case of a meeting, a quorum is present); (2) a majority of those present (which might include abstainers); (3) a majority of the total membership. If concepts such as these are desired, then they must be explicitly spelt out in the organisation’s constitution.”

In ***Shackleton on the Law and Practice of Meetings***, Chapter 15 deals with the Members' Meetings and Resolutions. The commentary observes that “*abstainers will not count; in other words, if an ordinary resolution is put to the vote and six vote in favour, five vote against, and 12 abstain, the resolution is carried.*”

On reading of section 189 of Companies Act, 1956 and section 114 of Companies Act, 2013, it is clear that the same law has also been part of Corporate Laws over decades now.

The ones present and abstaining from voting are surely counted towards quorum for the meeting but not added in the denominator to count the percentage of “yes” votes as against the “no” votes. Mere presence in the meeting does not amount to participation and taking decision unless the same is done by exercising the voting rights.

The [High Court of Gujarat in In re: Arvind Mills Ltd.](#)²⁷, has held that a bare attempt to vote by depositing blank ballot containing any writing is not effective and cannot be included in the total count. Only those ballots that express voters preference can be counted. The requirement contemplates only two preferences: one affirmative and the other negative. To adopt any other rule would be to say that three ballots were contemplated-- one affirmative, one negative, and another neither affirmative nor negative but forming a new class into which all ballots void for any reason must go.

In the matter of [Kirloskar Electric Co. Ltd., High Court of Karnataka](#), held that a member present and voting may remain neutral, indifferent, unbiased, or impartial- not engaged on either side. One is not supposed to write anything except putting 'yes' or 'no' either in favour of or against the proposition. A vote cast without indicating the mind of the voter either for or against the resolution is no voting at all. So, in construing whether a resolution is passed by three- fourths majority present and voting, what is to be considered in calculating the majority is not the number of persons present and voting, but the number of valid votes polled in such meeting. The number of valid votes includes only votes indicating the mind of the voter for or against the resolution.

The aforesaid Order of Karnataka HC was for a section 391 matter of Companies Act, 1956. It may be noted that the proceedings under sec. 391 also involve compromises or arrangement, akin to resolution proceedings under the Code. This ruling was reiterated and referred in further matters as well.

Accordingly, the member who abstains from voting has neither decides to cast his vote in favour of the motion nor against the resolution and therefore one cannot invoke the principle that silence amounts to acquiescence in favour of the motion. Such abstaining member is not counted for voting at all – neither in the numerator nor in the denominator.

Absenteeism in Voting: An Oxymoron

Voting in context of IBC

Voting in IBC is no different and the above rule also applies in calculating the voting of the CoC. There are instances of indecisiveness in CoC Meetings also more so when bankers are generally the majority members in the CoC. In the absence of requisite approval / mandate from their seniors / heads, bankers abstain from voting quite often. In such a scenario, to decide whether the resolution is through or not by requisite votes in favour, the members who abstain from voting are excluded from the count and consequently, the votes are counted out of the total no of votes received, i.e to say the votes cast in favour or against.

A careful reading of sec. 5 (28) of IBC will reveal that the definition is using two terms – voting share, and voting right. It defines a voting share to mean a voting right, based on financial debt, etc. As evident, a financial creditor gets the right to vote based on the financial debt. That voting right is converted into a vote by actual exercise of the voting rights. The voting rights of the votes cast are pooled together, and then, one determines the voting shares that have approved the proposal, versus those who rejected. A “right” has to be exercised to become a voting share. One cannot, without exercising the right, exercise it by implication. Where a member abstains from voting, such member is in a state of indecisiveness and therefore choose not to exercise his right to vote. His voting right is neither here nor there. As a result, since he cannot decide for himself, he chooses to go ahead with the required majority.

It is pertinent to note that pursuant to the IBBI (IRP-CP) Fourth Amendment Regulations, 2017 notified on 31.12.2017, the definition of dissenting shareholders was amended to include a financial creditors who abstained from voting for a resolution plan, approved by the committee.

The amended text is reproduced for easy reference:

Regulation 2(1)(f) “dissenting financial creditor” means a financial creditor who voted against the resolution plan or abstained from voting for the resolution plan, approved by the committee;”²⁹

Post this amendment, there remains no doubt in the matter. Notably, the term “dissenting financial creditors” is used only once in the entire Regulations (in Reg no 38(1)(c)) wherein it is mentioned to provide the liquidation value due to the dissenting financial creditors.

Had it been intended by the lawmakers to consider the members abstained from voting equal to the ones who voted against the resolution, the same would have been done by them. Noting stopped the legislature to make such amendment in the Code itself so as to make such definition universal Code-wide. The lawmakers have conspicuously amended the definition only in the IRP-CP Regulations to add such intent only in case of allocating liquidation value.

²⁹*The article has been contributed prior to the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018, effective from 6th June, 2018, and as such, readers are requested to read the same in line with the following amendment:*

The minimum voting percentage required by CoC has been reduced from 75% to 66% for substantial decisions like approval of Resolution Plan, replacement or removal of Resolution Professional etc., whereas, the minimum threshold for routine matters has been reduced to 51%.

Until the aforesaid amendment was rolled out, the abstaining members were not included in the ones dissenting and therefore this explicit addition was done in the definition of dissenting financial creditors.

Know More . . .

The Hon'ble Supreme Court in the matter of K. Sashidhar v. Indian Overseas Bank held that where the dissenting financial creditors have not voted in favour of the resolution plan, solely for commercial reasons, there arose no need to record reasons for such disapproval. It was further observed that the Code does not empower the AA to judge the commercial decisions of the CoC, be it approving or dissenting the resolution plan or abstaining to vote at all. Even inquiry before the Appellate Authority is limited to the grounds under Section 61(3) of the Code.

Dictated Decision-Making

IBBI Expects To Usher Effective Decision-Making in Creditors' Committee Meetings

- Vinod Kothari

Editor's Note: *The one who has been created and exists "to decide" cannot "not decide" or remain indecisive. CoC, being now in charge of steering wheel, has to decide on several matters pertaining to the corporate debtor under corporate insolvency resolution process. And given the strict timelines, there cannot be any scope for procrastination or delaying/deferring the decision-making process.*

The CoC mostly consists of banks and financial institutions, which send their representatives to attend the meetings held by the RP. The objectives of constitution of CoC being very clear, one cannot afford the representatives to be merely note-makers or listeners – for effective deliberations in the meetings, the representatives ought to have full authority to deliberate as well as decide and vote on the concerned matters. Or else, the entire objective of calling a meeting stands defeated.

There is no specific stipulation under the Code as to the above; however, IBBI, in view of practical experiences faced by RPs and stringent observations made by NCLTs in certain rulings, came up with a Circular requiring that CoC members shall be represented by such persons who are competent and are authorised to take decisions on the spot and without deferring decisions for want of internal approvals.

This piece is a quick observation on why this Circular was badly needed.

The recent [IBBI circular](#) dated 10-08-2018 makes an interesting reading. While it is lamenting the fact that the hard timeline-bound regime of the insolvency process will lead to unintended corporate mortality if the bank representatives attending the CoC meetings are not empowered to decide, the amusing undertone is that it has directed the resolution professionals to ensure the attendees in CoC meetings are decision-makers themselves.

The IBBI circular comes in the wake of order by NCLT, Principal Bench dated 7.6.2018, in the matter of [SBJ Exports & Mfg. Pvt. Ltd. v. BCC Fuba India Ltd](#) and order dated 4.7.2018 in the matter of [Jindal Saxena Financial Services Pvt. Ltd. v. Mayfair Capital Private Limited](#) (C.P. No. (IB)-84(PB)/2017). Earlier, the Hyderabad Bench had, vide order dated 27-11-2017, in the matter of [Kamineni Steel & Power India Private Limited](#) criticized the members of CoC meeting on making attendance without full mandate from their competent authorities to take final call at the meeting itself instead of falling back on their seniors' approval and delaying the time-bound procedure.

It is a matter of common knowledge that India is one of the few insolvency frameworks in the world which comes with hard timelines. If insolvency is not resolved within 180 (or, on extension, 270) days, the company will be mandatorily moved to liquidation path. Since the resolution process is entirely based on decisions at the CoCs, the CoC may arrive at some conclusive resolution only if the CoC members are empowered to decide and vote at the meetings. The ironic reality is that the attendees at the CoC meetings are rarely decision-makers themselves. They come to discuss the matter at the



meeting, but would mostly take the matter to their respective offices to get the view of their seniors, very often, committee in their respective offices too. The indecision of the CoC itself may be the reason for corporate mortality.

As a resolution professional, one would very often experience this situation: there is a patient on the operation table, and a panel of doctors would decide how to treat and operate upon the patient. Assume the doctors have to decide by a certain majority, and they themselves in turn have to depend on their seniors to give their views. The patient will be surely killed by indecision.

No matter what the IBBI has to say or what NCLT/NCLAT might have ruled, the irony is that the CoC attendees barely are able to decide. There are several reasons for their indecisiveness. The reasons may include mundane, such as the seniority of the person attending, the recent transfer of the attendee into the resolution matters, or the internal hierarchy of the bank itself. However, the most important issue that affects decision-making is the fear of persecution that the banker carries if he has hard decisions to make. And surely, the most important decision in insolvency process is the decision about the haircut. Bankers have a natural fear, born out of years of experience, that if the one who decides has to face the so-called 3 Cs – CBI, CAG and CVC. There is no pursuit against indecision. No one is punished for not deciding. However, decision-making invites internal and external action. Therefore, banks just don't decide on matters like haircuts. Practically, one would have seen several situations where the attendee at CoC would have confessed that he knows that the value he will get in liquidation will be far lower than the haircut put for approval, but he would rather let the haircut be faced as a *fait accompli* in liquidation rather than decide upon much lower haircut in resolution.

Added to the problem of indecision is the prevailing notion, incorrect in the view of the author, that the abstinence of a creditor from voting amounts to disapproval. That is, if a certain creditor at a CoC meeting decides not to vote at all, his vote will be counted as a negative vote, as the required decision-making should be positive votes out of total votes, and not out of those voting. The author strongly argues that this is a wrong view; however, this view is being espoused by several people. This exacerbates the issue of decision-making at CoCs.

Undoubtedly, the intent of the Code as well as the IBBI is absolutely clear. It is resolution before liquidation. In this wake, the voting percentage required for approval by CoC has also been reduced, by way of an Ordinance, from flat 75% to 66% for substantial decisions and 51% for routine matters.

So, will the scenario be better after this IBBI circular? Surely, one may ensure compliance by writing, perhaps as a part of the notice calling the CoC meetings, that only those empowered to decide should be attending, but practically, no resolution professional may reasonably expect there would be much change. Unless, of course, the RBI sends out a directive – that the member attending the CoC should be sent with a pre-approval of the relevant hierarchy so that the attendee may take a decision at the meeting or the banks become proactive enough to prepare their own evaluation matrices, approved by the senior-most personnel, which can serve as basis to take decision for the attendees at CoC.

INELIGIBILITY CRITERIA U/S 29A OF IBC: A NET TOO WIDE?

- **Sikha Bansal & Richa Saraf**

Editor's Note: IBC has been designed to explore revival opportunities for an ailing corporate entity. Thus, it invites potential resolution applicants to come forward and submit resolution plans. The approach, initially, was all inclusive and any person could come as resolution applicant. However, this became a second chance for defaulting promoters, who either directly or through related entities, were able to buy back their companies at hugely discounted prices. Therefore, a need arose to restrict such defaulting promoters to come back to power, and repeat the history. Section 29A, often quoted as the most controversial provision of IBC, was thus enacted by way of an amendment. Section 29A is a negatively prescribed list, and enumerates person who cannot be a resolution applicant.

Originally drafted section 29A was rigid to the extent that it closed too many doors – thus, reducing the possibilities of receiving resolution plan with each restrictive layer it created. Also, some of the clauses of section 29A were expansive to the point of being unreasonable. This analysis goes through the section and discusses some relevant points.

The section was later fine-tuned – please refer to our next article for the amendments which were later introduced in the section.

Resolution plan is designated to be the “way-out” for insolvent entities coming under the Insolvency and Bankruptcy Code, 2016. The resolution professional appointed by the adjudicating authority constitutes a committee of creditors, invites resolution plans from prospective resolution applicants, and places the resolution plans before the committee of creditors. The resolution plan which is approved by the committee of creditors is submitted to the adjudicating

authority for sanction. A resolution applicant, as defined under section 5(25) of the Code, earlier referred to mean **any person** who submits a resolution plan to the resolution professional. Hence, a resolution applicant might have been any person- a creditor, a promoter, a prospective investor, an employee, or any other person. The Code had not gone into the basis and criteria for selection of the resolution applicant. This became a fatal loophole in the law which allowed back-door entry to defaulting promoters at substantially discounted rates for the assets of the corporate debtor.

A resolution applicant, as defined under section 5(25) of the Code, means any person who submits a resolution plan to the resolution professional.

To curb the illicit ways, several amendments were made in the Code, first by way of [Insolvency and Bankruptcy Code \(Amendment\) Ordinance, 2017](#) dated 23rd November, 2017, then by [Insolvency and Bankruptcy Code \(Amendment\) Act, 2018](#) dated 19th January, 2018 (“**Amendment Act**”). Of all the amendments, the one which has become a riddle for all is section 29A. The section specifies persons not eligible to be resolution applicant, and has ten parts (i.e. clauses), the tenth part is further

divided into three sub-parts, of which the third part has its own descendants. These layers of section 29A are more in the nature of elimination rounds. The write-up below digs deeper into the section.

Resolution Applicant – Who and Who Not?

Vide the Amendment Act, the definition of “resolution applicant” was amended so as to mean a person, who individually or jointly, submits a resolution plan to the resolution professional pursuant to the invitation made under section 25(2)(h).

Section 25(2)(h) requires the resolution professional to invite resolution plans from prospective resolution applicants who fulfill criteria as laid down by the resolution professional with the approval of committee of creditors, having regard to the complexity and scale of operations of the business of the corporate debtor and such other conditions as may be specified by the Board.

Section 29A is a restrictive provision- any person falling in the negative list is not eligible to submit a resolution plan.

Therefore, a person in order to be eligible to submit a resolution plan –

- **shall** fulfill the criteria laid down by the resolution professional with the approval of the committee of creditors; and
- **shall not** suffer from any disqualification mentioned under section 29A.

Section 29A – A Pandora’s Box

According to Section 29A, a person suffering from the disqualifications as mentioned hereunder shall not be eligible to submit a resolution plan. Further, any other person acting jointly or in concert with the prospective resolution applicant shall not be covered under the following disqualifications –

- (i) the person is an undischarged insolvent;
- (ii) the person is a wilful defaulter in terms of the RBI Guidelines issued under the Banking Regulation Act, 1949;
- (iii) the person has an account, or an account of a corporate debtor under the management or control of such person or of whom such person is a promoter, classified as non-performing asset in accordance with RBI Guidelines issued under the Banking Regulation Act, 1949 and at least a period of 1 (One) year has lapsed from the date of such classification till the date of commencement of the corporate insolvency resolution process of the corporate debtor: Provided that the person shall be eligible to submit a resolution plan if such person makes payment of all overdue amounts with interest thereon and charges relating to non-performing asset accounts before submission of resolution plan;
- (iv) the person has been convicted for any offence punishable with imprisonment for 2 (Two) years or more;
- (v) the person is disqualified to act as a director under the Companies Act, 2013;

Ineligibility Criteria u/s 29A of IBC:

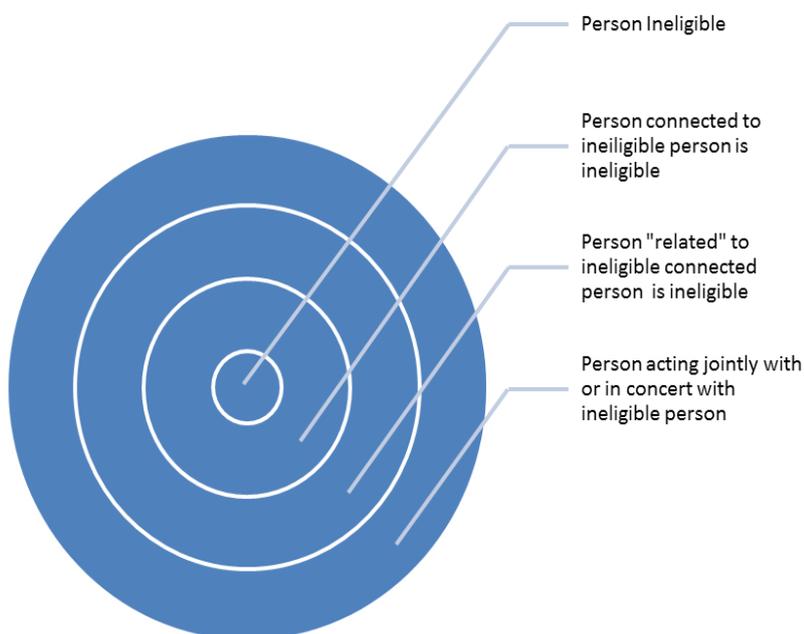
A Net too wide?

- (vi) the person is prohibited by SEBI from trading in securities or accessing the securities markets;
- (vii) the person has been a promoter or in the management or control of a corporate debtor in which a preferential transaction, undervalued transaction, extortionate credit transaction or fraudulent transaction has taken place and an order has been made by the adjudicating authority under the provisions of the Code;
- (viii) a person who has executed an enforceable guarantee in favour of a creditor, in respect of a corporate debtor against which an application for insolvency resolution made by such creditor has been admitted under the Code;
- (ix) a person who has been subject to the above listed disabilities under any law in a jurisdiction outside India;
- (x) connected persons, i.e. persons connected to the person disqualified under any of the aforementioned points, such as those who are promoters or in management or control of the resolution applicant, or will be promoters or in management or control of the business of the corporate debtor during the implementation of the resolution plan, the holding company, subsidiary company, associate company or related party of the above referred persons – exception has been carved out for scheduled banks, asset reconstruction companies registered with RBI under Section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, and alternative investment funds registered with SEBI.

Major aspects of the provision have been analysed as below-

Layers of Ineligibility

An assiduous analysis of Section 29A reveals that the section imposes four layers of ineligibility, as mentioned below-



– First layer ineligibility, where the person itself is ineligible;

– Second layer ineligibility, i.e. where a “connected person” is ineligible;

– Third layer ineligibility, i.e. being a “related party” of connected persons; and

– Fourth layer ineligibility, where a person acting jointly/in concert with a person suffering from first layer/second layer/third layer ineligibility, becomes ineligible.

Figure 13: The four layers of ineligibility u/s 29A

Clause (c): The NPA Criterion

Clause (c) of Section 29A debars a person or a person acting jointly or in concert with such person who-

- (i) has an account classified as NPA;
- (ii) is a promoter of a corporate debtor the account of which has been classified as NPA;
- (iii) is in the management of a corporate debtor the account of which has been classified as NPA;
- (iv) is in control of a corporate debtor the account of which has been classified as NPA.

At least a period of 1 (One) year should have elapsed from the date of classification till the insolvency commencement date. Therefore, any company (including the promoters/persons in the management of or control of such company) which has its account classified as NPA for last 1 (One) year will not be able to file a resolution plan however, the Code provides for a carve out that such person shall be eligible to submit the resolution plan if such person makes payment of all overdue amounts with interest thereon and charges relating to non-performing asset accounts before submission of resolution plan. See also, clause (j) of Section 29A.

Clause (g): Vulnerable Transactions

According to clause (g) of Section 29A, a promoter/person in the management of or control of a corporate debtor in which a preferential transaction (Section 43), undervalued transaction (Section 45), extortionate credit transaction (Section 50), or fraudulent transaction (Section 49) have taken place and the adjudicating authority has passed an order under the Code. The provision is qualified to the extent it uses the term “corporate debtor”, and that the adjudicating authority should have passed an order under the Code itself.

Clause (h): Guarantor executing guarantee in favour of the applicant creditor

The negative list includes persons who might have guaranteed the obligations of the corporate debtor which is currently in insolvency. As the provision goes, a person who has executed enforceable guarantee in favour of a creditor in respect of a corporate debtor against which an application for insolvency resolution made by such creditor has been admitted under the Code. Going by the construction of the clause, it appears that the guarantee should be in favour of that creditor who has applied for insolvency resolution of the corporate debtor.

The provision came up for discussion in *RBL Bank Ltd. v. MBL Infrastructures Ltd.* [CA(IB) No. 543/KB/2017; order dated 18.12.2017], where NCLT took a view that there was no intent of the Government to debar all the promoters, only for the reason for issuing a guarantee which is enforceable, unless such guarantee has been invoked and not paid for, or the guarantor suffers from any other antecedent listed in section 29A. The resolution applicants stated that by

RBL Bank Ltd. v. MBL Infrastructures Ltd.:

NCLT took a view that there was no intent of the Government to debar all the promoters, only for the reason for issuing a guarantee which is enforceable, unless such guarantee has been invoked and not paid for, or the guarantor suffers from any other antecedent listed in section 29A.

Ineligibility Criteria u/s 29A of IBC:

A Net too wide?

purporting to disqualify the entire class of guarantors under the said clause would be violative of the valuable rights of the applicant. If the guarantee is not invoked and demand is not made on the guarantor, the debt payable by him is not crystallized and the guarantor cannot be therefore said to be in default for breach of the guarantee and be penalized merely because a legal and binding contract of guarantee exists, which is otherwise impossible but is subject to its invocation in accordance with the terms of the guarantee. The NCLT agreed to the view observing that the guarantors in respect of whom, a creditor has not invoked the guarantee or made a demand under guarantee should not be prohibited. Therefore, no default in the payment of dues by the guarantor has occurred, cannot be covered under clause (h) of Section 29(A). It cannot be the intent of clause (h) to penalize those guarantors who have not been offered an opportunity to pay by calling upon them to pay the dues, by invoking the guarantee. Therefore, the words “enforceable guarantee” appearing in clause (h) are not to be understood by their ordinary meaning or in the context of enforceability of the guarantee as a legal and binding contract, but in the context of the objectives of the Code and Ordinance in general and clause (h) in particular.

Clause (j): Connected persons

The word “connected persons” appear in clause (j) of section 29A. A person who is connected to the persons as defined under the Explanation, shall be disqualified if the other person suffers disability under clause (a) to (i) of section 29A.

“Connected persons” have been defined so as to include three categories –

Explanation.— For the purposes of this clause, the expression "connected person" means-

- (i) any person who is the promoter or in the management or control of the resolution applicant;
or
- (ii) any person who shall be the promoter or in management or control of the business of the corporate debtor during the implementation of the resolution plan; or
- (iii) the holding company, subsidiary company, associate company or related party of a person referred to in clauses (i) and (ii):

The definition can be analysed as follows-

1. Clause (i) includes:
 - a. promoter;
 - b. person in the management; and
 - c. person in control

of an ineligible resolution applicant.

Further, in accordance with clause (iii),

- where (a) or (b) or (c) is a company, the holding, the subsidiary, and the associate companies or “related party” of (a), (b), (c) (as the case may be), shall also be disqualified.
 - where (a) or (b) or (c) is a natural person, any “related party” of such person shall also be disqualified.
2. Clause (ii) basically seeks to debar persons from submitting resolution plans in which persons suffering from disabilities mentioned under Section 29A are proposed as promoters or in the management of or in the control of the corporate debtor during implementation of the resolution plan. It includes-
- a. would-be promoter;
 - b. person, would-be in the management; and
 - c. person, would-be in control

of the corporate debtor, who suffer from disqualification under section 29A.

For example, A wants to submit resolution plan for B Ltd. A proposes that C shall be in the management of B Ltd. during the implementation of the resolution plan. However, C is a person suffering disability under Section 29A. A, therefore becomes ineligible to submit resolution plan.

Further, in accordance with clause (iii),

- where (a) or (b) or (c) is a company, the holding, the subsidiary, and the associate companies or “related party” of (a), (b), (c) (as the case may be), shall also be disqualified.
- where (a) or (b) or (c) is a natural person, any “related party” of such person shall also be disqualified.

For scope of the term “related party”, see below.

Note that from the scope of “holding company, subsidiary company, and associate company”, the following have been excluded, i.e. the following can proceed to submit the resolution plan-

- a scheduled bank; or
- an ARC registered with RBI under section 3 of the SARFAESI Act, 2002; or
- an AIF registered with SEBI.

Related party

“Related party” has been defined in Section 5 (24); however, the definition is specific to corporate debtor, i.e. the definition specifies the persons who shall be treated as “related party” of the corporate debtor. Hence, where the persons referred to in clauses (i) and (ii) of the Explanation are persons other than the corporate debtor, the definition under section 5(24) becomes irrelevant, and the following may be noted-

Ineligibility Criteria u/s 29A of IBC:

A Net too wide?

- Where one of the person is a company, “related party” shall be interpreted in terms of section 2(76) of the Companies Act, 2013;
- Where none of the persons is a company, the definition of the term “related party” has been left open. In the context of natural persons, generally the term “relative” is used.

Associate Company

For the purpose of determining whether a company is an associate of the other, the definition as under Section 2(6) of the Companies Act, 2013 shall be referred, wherein “Associate company”, in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.

For the purpose of the said definition, “significant influence” means control of at least 20% (twenty per cent) of total share capital, or of business decisions under an agreement.

For example- “Company X” holds 20% of total share capital of Company “Y”, then Company X will be deemed to be an associate company of Company Y.

**“significant
influence”
means control
of at least 20%
of total share**

Relevant time- whether lookback allowed?

A relevant question would be regarding the point of time at which the ineligibility has to be ascertained. The language of the section suggests that only present status of the resolution applicant has to be seen. No lookback period has been prescribed. However, the authors opine that it would be upon the committee of creditors to decide on whether any past event shall be weighed upon while making the final decision.

More of a Diktat?

The Code has been designed to find the best possible way out for an ailing entity- it was meant to be more inclusive in approach. However, the reach of Section 29A extends to four layers (as explained above), and may lead to exactly opposite results. The intent of the Code was not to restrict genuine applicants, but only to exclude participation from habitual miscreants or applicants who might themselves be sick, however, Section 29A may result in elimination of persons who might be interested in buying stakes in the entity.

See *RBL Bank Ltd. v. MBL Infrastructures Ltd.* [CA(IB) No. 543/KB/2017; order dated 18.12.2017], where the NCLT, considering the objective of the Ordinance, 2017, opined that clause (h) of section 29A is not to disqualify the promoters as a class for submitting a resolution plan. The intent is to exclude such class of persons from offering a resolution plan, who on account of their antecedents, may adversely impact the credibility of the processes under the Code. The case is, for the time being, pending with NCLAT³⁰.

³⁰ Last update as on 10.02.2018.

The Code was designed to find the best possible way out for an ailing entity- it was meant to be more inclusive in approach and there was definitely no intention to avoid promoters from submitting resolution plans. However, the reach of Section 29A extends to four layers (as explained above), and may lead to exactly opposite results. It is quintessential to ensure that the citadel of insolvency resolution does not have holes into it but at the same time, it is also important to ensure that the citadel is not inaccessible, with no steps, doors or windows.

The intent of Section 29A will be counter- productive if it results into a whole lot of intending resolution applicants being disintitiled, because the recursive definitions of related party, connected persons etc are cast wide enough, intertwining all the entities promoted by an entity.

Know More . . .

*Most recently, the Hon'ble Supreme Court, in its landmark ruling in **Swiss Ribbons vs. Union of India**, has upheld the constitutional validity of section 29A. In the application moved by Swiss Ribbons, section 29A, a "disqualifier section" was alleged to be unconstitutional as it was in apparent breach of "right to equality" under article 14 of our Constitution. Questions were raised on the grounds that the presumed "vested interest" and malfeasance by all promoters, without differentiating between the unscrupulous and the good is unlawful and hence, the "blanket ban" imposed by the Code on all promoters per se, stands constitutional. It was further argued that by negating the promoters as class, the genuine promoters who are capable to outdo the bids of other resolution applicants are also aggrieved.*

On consideration of the arguments put forward, the Hon'ble Supreme Court observed that section 29A of the Code includes in its purview those persons or class of persons who unfit or are considered to be unfit for acquiring, managing and/or reviving the business of the corporate debtor in question, viz. insolvent persons, persons managing accounts which have been classified as NPA etc. Further, so far as maximization of value by genuine promoters in considered, the Code now provides a window by way of section 12A for withdrawal of the corporate debtor from CIRP.

Section 29A of the Code was hence upheld as good in its entirety, whilst tapering the scope of the "related parties" who have to be tested for the disqualification.

STREAMLINING SECTION 29A OF IBC

A quick round-up of the amendments proposed by the Insolvency Law Committee

- **Sikha Bansal & Megha Mittal**

Editor's Note: As stated in our earlier article, section 29A became a net too wide, such that the idea of inclusivity to revive the corporate debtor seemingly blurred. Therefore, the Insolvency Law Committee came up with proposed suggestions to streamline section 29A. This note discusses the suggestions made by the Committee.

Section 29A is probably the most substantial and rather most debated provision of the Insolvency and Bankruptcy Code, 2016. The section sought to restrict people who with their misconduct contributed to defaults of companies or who were otherwise undesirable, or could misuse their position due to lack of restriction to participate in the resolution process and regain control of the corporate debtor. However, the intent was somehow lost as the net of section 29A became too wide to intertwine even remotely associated entities; thus narrowing the path of resolution for the corporate debtor. The ineligibility layers stipulated by section 29A has been descriptively covered in *"Ineligibility Criteria u/s 29A of IBC: A net too wide!"* (Kindly refer the previous article.)

Therefore, the Insolvency Law Committee, which recently submitted its Report, has proposed several amendments in section 29A. The proposals are meant to streamline section 29A by reducing the layers of ineligibility, stipulating relaxations for pure play financial entities, and relieving guarantors of corporate debtors under resolution. Below is a quick round-up of how section 29A (clause-wise) is proposed to be changed –

1. Main Clause: "29A. A person shall not be eligible to submit a resolution plan, if such person, or any other person acting jointly or in concert with such person –"

Proposed Amendment: The reference to "person acting jointly or in concert" to be deleted.

Before	After
Persons acting jointly or in concert ineligible. Since the phrase was not defined in the Code, the same has to be inferred from SEBI (SAST) Regulations, 2011.	The clause will be omitted, thereby reducing one layer of ineligibility. Instead, "connected person" will also include a person who co-operates with the resolution applicant with a common objective, directly or indirectly, formally or informally, so as to acquire control/voting rights of the corporate debtor.

2. Clause (a) – "is an undischarged insolvent"

Proposed Amendment: None.

3. Clause (b) -- “is a wilful defaulter in accordance with the guidelines of the Reserve Bank of India issued under the Banking Regulation Act, 1949”.

Proposed Amendment: None.

4. Clause (c) – “has an account, or an account of a corporate debtor under the management or control of such person or of whom such person is a promoter, classified as non-performing asset in accordance with the guidelines of the Reserve Bank of India issued under the Banking Regulation Act, 1949 and at least a period of one year has lapsed from the date of such classification till the date of commencement of the corporate insolvency resolution process of the corporate debtor:

Provided that the person shall be eligible to submit a resolution plan if such person makes payment of all overdue amounts with interest thereon and charges relating to non-performing asset accounts before submission of resolution plan.

Proposed Amendment: As under

<i>Before</i>	<i>After</i>
No specific point of time specified at which the NPA is held.	For ineligibility, NPA should be there at the time of submission of resolution plan.
NPA has been classified as such in accordance with RBI issued under the Banking Regulation Act, 1949 only.	NPA classification may be under the Banking Regulation Act, 1949 or guidelines issued by any financial sector regulator in India (e.g. by NHB).
No exemptions for pure financial entities.	<p>“Unrelated” “financial entities” to be exempted. “Financial entity” to be defined in proposed explanation II.</p> <p>Financial entities holding securities of the corporate debtor on account of conversion of debt not to be considered “related”.</p>
Person in management of or in control of a corporate debtor having its account classified as NPA is ineligible to submit resolution plans for other corporatedebtors.	Exemption of 3 years proposed for an acquirer who acquired an NPA account under a resolution plan. The period of 3 years to be calculated from the approval of the earlier resolution plan.

5. Clause (d) – “has been convicted for any offence punishable with imprisonment for two years or more”

Proposed Amendment: As under. Also, amendment in clause (j) will also have some impact.

<i>Before</i>	<i>After</i>
Person convicted for any offencepunishable with imprisonment for 2 years or more.Too	1. To benarrowed down toconviction for offences listed underproposed Schedule

Streamlining of Section 29A of IBC

broad.	XII. ³¹ 2. Disqualification period: 6 years from the date of conviction or from the date of release from imprisonment, whichever is later. 3. Exemption for cases where stay has been granted on the conviction order.
Definition of “connected person” applicable in entirety.	Only sub-clauses (i) and (ii) under the definition of “connected persons” to apply, since a company cannot be a holding/subsidiary/associate of an individual. Also, see notes under Point 11.

6. Clause (e) – “is disqualified to act as a director under the Companies Act, 2013”

Proposed Amendment: None. However, amendment in clause (j) will have the following impact:

Before	After
Definition of “connected person” applicable in entirety.	Only sub-clauses (i) and (ii) under the definition of “connected persons” to apply, since a company cannot be a holding/subsidiary/associate of an individual. Also, see notes under Point 11.

7. Clause (f) – “is prohibited by the Securities and Exchange Board of India from trading in securities or accessing the securities markets”

Proposed Amendment: None

8. Clause (g) -- has been a promoter or in the management or control of a corporate debtor in which a preferential transaction, undervalued transaction, extortionate credit transaction or fraudulent transaction has taken place and in respect of which an order has been made by the Adjudicating Authority under this Code

Proposed Amendment: As under.

Before	After
Person in the management or control of a corporate debtor in which an order against any kind of vulnerable/fraudulent transaction has been made by NCLT. E.g. NCLT made an order against undervalued transaction in the CIRP of corporate debtor	Exemption, where the resolution applicant has acquired such corporate debtor pursuant to resolution plan/scheme or plan approved by financial sector regulator or a court, and such order against vulnerable transaction was made before the acquisition

³¹ Readers are requested to kindly read the instant clause in line with the insertions made by Amendment dated 06.06.2018, which have been discussed towards the end of this article under the head “Know More”.

“A”. However, in due course of resolution proceedings, resolution plan submitted by “X” is approved and “X” acquired “A”. “X” gets disqualified to present Resolution Plan for another corporate debtor “B”.

E.g. “X” is now eligible to present plan for “B”

Clause (h) -- has executed an enforceable guarantee³² in favour of a creditor in respect of a corporate debtor against which an application for insolvency resolution made by such creditor has been admitted under this Code.

Proposed Amendment: As under.

Before	After
<p>Guarantor of a corporate debtor who has executed an enforceable guarantee in favour of a creditor of a corporate debtor undergoing/having undergone corporate insolvency resolution process.</p> <p>E.g.: “X” is the surety for the loans taken by “A Ltd.”. “Y” is the creditor. “Y” initiates corporate insolvency resolution process against “A Ltd.”, and the application is admitted by NCLT. “X” is disqualified from submitting resolution plan for another corporate debtor “B”.</p>	<p>Ineligibility will arise only if such guarantee is invoked and the guarantor dishonours the guarantee.</p> <p>E.g.: Mere presence of guarantee is not sufficient. Therefore, “X” will not be disqualified from submitting resolution plan for “B”. However, say if “Y” invokes guarantee but “X” defaults, then “X” becomes ineligible to be a resolution applicant.</p>

9. Clause (i) – “has been subject to any disability, corresponding to clauses (a) to (h), under any law in a jurisdiction outside India”

Proposed Amendment: “has” to be replaced by “is”.

Before	After
<p>The clause talks about continuing disability, or a disability which existed earlier, but is not present now.</p>	<p>Disability should be there at the time of submission of resolution plan.</p>

10. Clause (j) -- “has a connected person not eligible under clauses (a) to(i)”

Proposed Amendment: As under.

Before	After
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³² The term enforceable guarantee has been substituted with “guarantee” w.e.f. 06.06.2018.

Streamlining of Section 29A of IBC

No reference to person acting with the resolution applicant with a common objective	A person who co-operates with the resolution applicant with a common objective, directly or indirectly, formally or informally, so as to acquire control/voting rights of the corporate debtor will also be a “connected person”. This, in a subtle way, compensates for deletion of ineligibility under the main clause.
Excludes a scheduled bank, ARC, AIF – proviso to explanation I.	To be broadly defined. Will exclude “unrelated” “financial entities”. Financial entities holding securities of the corporate debtor on account of conversion of debt not to be considered “related”.
Clauses (i), (ii), (iii) applicable in entirety to each preceding clause in section 29A.	For clauses (d) (i.e. convicted persons), and clauses (e) (i.e. disqualified directors), only clauses (i) and (ii) will apply, because a company cannot be a holding/subsidiary/associate of an individual. See notes below.

Notes by authors:

In the context of amendments proposed in the definition of “connected persons”, the following suggestions may be noted in order to rationalise the definition –

- (i) The proposed sub-clause (iv) (i.e. a person who co-operates with resolution applicant) shall also be applicable to each preceding clause of section 29A, in a manner similar to sub-clauses (i) and (ii) as stated above. Only sub-clause (iii) in the definition of “connected persons” should be excluded where the reference in the clauses of section 29A is to an individual.
- (ii) The word “related party” should be separated from sub-clause (iii) and shifted to a new sub-clause.
- (iii) Instead of specifically providing for clauses (d) and (e), the proposed provision may clearly state that wherever the person being disqualified is an individual, sub-clause

(iii) of clause (j) will not apply.

11. Other Related Amendments

(i) *Related party*: “Related party” if used in respect of a company other than the corporate debtor shall be interpreted in terms of the definition of “related party” given under section 2 (76) of the Companies Act, 2013. The Committee proposes that the term related party in relation to an individual must be defined in the Code.

(ii) *Exemption for MSMEs*: Since usually only promoters of an MSME are likely to be interested in acquiring it, applicability of section 29A is proposed to be restricted only to disqualify wilful defaulters from bidding for MSMEs.

(iii) *Affidavit confirming eligibility*: A new sub-section (2) is proposed to be introduced under section 29A, which would require the resolution applicant to give an affidavit stating that it is eligible to submit a resolution plan under section 29A. The affidavit must be submitted along with the resolution plan.

Though, as apparent from the perusal of the report, there were several concerns raised by different stakeholders; the Committee thought it fit that those be kept on hold so as to be taken up later after due industry experience. However, the overall scenario which emerges post the amendments are carried out is a welcome move.

Know More...

The amended Clause (d) of section 29A of the Code is *ad-verbatim* produced as follows:

has been convicted for any offence punishable with imprisonment –

- (i) for two years or more under any Act specified under the Twelfth Schedule; or*
- (ii) for seven years or more under any law for the time being in force:*

Provided that this clause shall not apply to a person after the expiry of a period of two years from the date of his release from imprisonment

FAIRLY CONFIDENTIAL OR CONFIDENTIALLY FAIR

IBBI prescribes new rules for valuation of distressed entities

- **Vallari Dubey**

Editor's Note: Maximisation of stakeholder value is one of the core objectives of IBC. The resolution plans submitted by resolution applicants should affirm to this very objective. Also, given that this is a negotiation stage, there can be several parameters which can be used to evaluate a particular resolution plan. IBBI thus came up with the concept of 'evaluation matrix', proposed to be a set of parameters to be used for consideration of resolution plans. The evaluation matrix is to be approved by the CoC and the resolution plans are to be strictly evaluated with reference to this matrix. Evaluation matrix serves as a uniform guiding tool for the resolution applicants – they know the criteria on which their plan will be evaluated.

Besides, IBBI also required fair valuation of the assets of the corporate debtor. This ensured due comparison and assessment of downside by the creditors. To ensure a healthy competition and to ensure that the liquidation value does not become a benchmark, the regulations were amended to require that the values (fair value and liquidation value) be kept confidential, and be shared only with CoC only after receipt of resolution plans. As such, the resolution applicants will have to rely on their own independent valuations while deciding on pay-outs under their respective resolution plans.

The Insolvency and Bankruptcy Board of India has issued the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations, 2018³³, effective from 6th February, 2018 ('Amendment Regulations, 2018'), to make amendments in the CIRP Regulations. The prominent changes made by the Amendment Regulations relate to introduction of "evaluation matrix" and "fair value", information memorandum and invitation of resolution plans. We have covered each of these amendments in detail below:

Evaluation Matrix

The Amendment Regulations define "evaluation matrix" as follows:

2. (1) In these Regulations, unless the context otherwise requires – XX

(ha) "**evaluation matrix**" means such parameters to be applied and the manner of applying such parameters, as approved by the committee, for consideration of resolution plans for its approval;

The concept of 'Evaluation Matrix' has been introduced vide the Amendment Regulations, 2018. As defined, it lays down such parameters for the purpose of analyzing and verifying a resolution plan, as to whether it is good to be considered for approval by the Committee of Creditors ('CoC'). Such matrix should also contain the manner of application of defined parameters.

Note that the parameters are to be approved by the Committee of Creditors.

³³http://ibbi.gov.in/webadmin/pdf/whatsnew/2018/Feb/CIRP%20Amendment%2006022018_2018-02-06%2021:47:42.pdf

Fair Value

The Code read with the CIRP Regulations, 2016 made stipulations only with regard to “liquidation value”. Now, the Amendment Regulations also provide for determination of “fair value”.

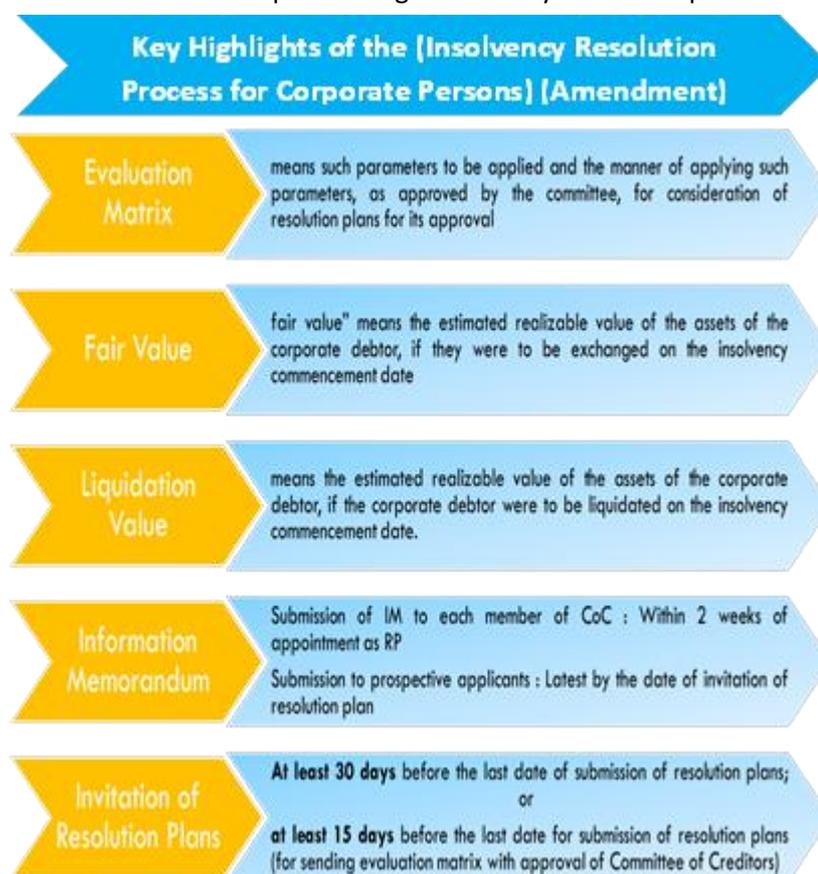
“Fair value” has been defined as follows --

(hb) “fair value” means the estimated realizable value of the assets of the corporate debtor, if they were to be exchanged on the insolvency commencement date between a willing buyer and a willing seller in an arm’s length transaction, after proper marketing and where the parties had acted knowledgeably, prudently and without compulsion;”

XX”

Why fair value?

By the experience of all the interest for resolution plans being received by resolution professionals, it is evident that liquidation values, being more on the conservative side, have been largely driving down the valuation of the assets of the corporate debtors. This combined with the discussions from the [Economic Survey, 2017-18](#), critically highlights the disadvantages held by such liquidation values to the acquisition of assets of distressed entities and its negative impact on one of the objectives of maximization of value of such assets.



Availability of a duly computed and approved fair value will enhance the valuation of the assets of the Company. It may also be useful to compare the two values in order to arrive at the value which is more beneficial than the other.

Such arrived fair value and liquidation value will be made available to the CoC members only on getting a declaration to the effect that they shall

Figure 14: Key highlights of the CIRP Amendment Regulation

Fairly Confidential or Confidentially Fair

maintain utmost confidentiality of such values. Additionally, it is also the responsibility of the RP and the registered valuers.

Fair Value vs. Liquidation Value

Fair value and Liquidation value, both are estimated realizable value of the assets of the company determined with reference to the insolvency commencement date. However, the underlying assumptions in determining these two values are exactly opposite.

As regards liquidation value, the definition of 'liquidation value' has been substituted with the following, which is the replica of regulation 35 (1) of the CIRP Regulations, 2016 itself:

“(k) “liquidation value” means the estimated realizable value of the assets of the corporate debtor, if the corporate debtor were to be liquidated on the insolvency commencement date.”

It may be noted that the definition of liquidation value is derived from the text of regulation 35(1). Earlier, the definition was clause-specific, however, post amendment, it shall become universal for all the provisions, wherever the reference of 'liquidation value' is made, throughout the CIRP Regulations, 2016, and even in the Code.

Therefore, liquidation value is the realizable value of assets, if the company was to be 'liquidated' as on the liquidation commencement date. On the other hand, fair value is the realizable value of assets if assets were to be 'exchanged' between 'willing buyer and willing seller' on arms' length basis 'without any compulsion or pressure'. While the former takes a conservative approach, the latter is optimistic in nature.

For example, in the matter insolvency of Gujarat NRE Coke Ltd., CoC emphasized on selling off one of the assets i.e. windmill because the value of the assets was depleting day by day. Value of windmill doesn't deplete on a daily basis usually, however, the value was depleting in this case because of following reasons:

- a. Asset belonged to a company which was under CDR Mechanism first and then undergoing CIRP;
- b. There was no maintenance of the assets because the company was unable to pay for the maintenance.

Liquidation value in the case was arrived to be at Rs. 180 Crore owing to above factors. Had the above two factors were not in play, fair value of the said asset would have been more than Rs 180 Crore.

Particulars	Fair Value	Liquidation Value
Definition	Basic assumption is that the company will continue as a going concern. It is the estimated realizable value if the assets were to be exchanged between a willing buyer and seller on an arm's length basis, as on the insolvency	Basic assumption is that the company is to be liquidated as on the insolvency commencement date. The values of assets are therefore estimated on this assumption.

	commencement Date	
Arm's length basis/"without compulsion"	Value will be termed as fair only if the exchange of the asset(s) is on an arm's length basis, where: <ol style="list-style-type: none"> 1. <i>Proper marketing</i> has been conducted to ensure wide public disclosure; 2. The parties to the transaction acted: <ol style="list-style-type: none"> a. <i>knowledgeably</i>, b. <i>prudently</i>, and c. <i>without compulsion</i> 	Since the company is assumed to be under liquidation, the value would be arrived, in most of the cases, assuming that the bargaining power of the company would be lower than the counter-party.
Approach	Optimistic	Conservative

Determination of fair value alongwith liquidation value

Regulation 35 has been amended so as to provide for determination of "fair value" as well, in a manner similar to the determination of "liquidation value". Regulation 35 has been substituted with the following regulation:

"35. Fair value and Liquidation value.

(1) *Fair value and liquidation value shall be determined in the following manner:-*

- (a) **the two registered valuers** appointed under regulation 27 shall submit to the resolution professional an estimate of the fair value and of the liquidation value computed in accordance with internationally accepted valuation standards, after physical verification of the inventory and fixed assets of the corporate debtor;
- (b) **if in the opinion of the resolution professional, the two estimates of a value are significantly different**, he may appoint **another registered valuer** who shall submit an estimate of the value computed in the same manner; and
- (c) **the average of the two closest estimates of a value shall be considered the fair value or the liquidation value**, as the case may be.

(2) **After the receipt of resolution plans** in accordance with the Code and these regulations, the resolution professional shall **provide the fair value and the liquidation value to every member of the committee** in electronic form, on receiving an undertaking from the member to the effect that such member shall maintain confidentiality of the fair value and the liquidation value and shall not use such values to cause an undue gain or undue loss to itself or any other person and comply with the requirements under sub-section (2) of section 29:

(3) *The resolution professional and registered valuers shall maintain confidentiality of the fair value and the liquidation value."*

Fairly Confidential or Confidentially Fair

A third registered valuer shall be appointed, if the difference between two estimates of any or both the values is significant, For eg. Valuer A, submitted fair value of Rs. 5 lakhs, Valuer B submitted fair value of Rs. 5.5 lakhs, and Valuer A submitted liquidation value of Rs. 2.5 lakhs and Valuer B submitted liquidation value of Rs. 5 lakhs. There is a significant difference in the two estimates of liquidation values submitted by Valuer A and B respectively. Even if there is no significant difference between fair values provided by A and B, a third Valuer C, shall be appointed for determination of liquidation value.

The Amendment Regulations also require that the fair value too, besides liquidation value, shall be given to each member of the committee of creditors post receipt of resolution plans. Such requirement seems counter-intuitive in nature. The Code requires that the resolution plan shall provide for liquidation value due to dissenting financial creditors and operational creditors. As such, any prospective resolution applicant shall have to proceed independently to determine liquidation value/fair value on the basis of information memorandum supplied by the resolution professional.

Information Memorandum

Timelines have been provided in the Amendment Regulations pertaining to submission of information memorandum (IM). The same are detailed below:

Description	Timeline
Submission of IM to each member of CoC	Within 2 weeks of appointment as RP
Submission to prospective applicants	Latest by the date of invitation of resolution plan under section 25(2)(h)

Description of assets and liabilities

The information memorandum shall now provide “details” of assets of the corporate debtor, which in turn will assist the resolution applicants to determine “liquidation value” and/or “fair values” on their own:

Before amendment	Post amendment
Mandatory to contain details of assets and liabilities	Mandatory to contain the following, but not limited to, description of assets and liabilities: <ol style="list-style-type: none">1. Date of acquisition;2. Cost of acquisition;3. Remaining useful life;4. Identification no.;5. Depreciation charged;6. Book value;7. Any other relevant details.

Invitation of Resolution Plans

Amendment Regulations, 2018 has inserted a new regulation 36A. The regulation mandates RP to issue an invitation including evaluation matrix, to the prospective resolution applicants in accordance with section 25(2)(h) of the Code for submission of resolution plans.

Timeline has been specified in the Amendment Regulations, 2018 for sending invitation or evaluation matrix to prospective applicants:

- a. **At least 30 days** before the last date of submission of resolution plans; or
- b. **at least 15 days** before the last date for submission of resolution plans (for sending evaluation matrix with approval of Committee of Creditors)

RPs are given liberty to modify the invitation or the evaluation matrix.

Amendment Regulations, 2018 bring in **Form G** to facilitate publication of brief particulars of the invitation. The Form shall be uploaded on the website of the Company and on any other website as directed by IBBI. However, nothing is mentioned w.r.t. publication of invitation for resolution plans in Form G by way of newspaper publication.

The RP may choose not to use the format while giving public announcement in newspaper and instead give a link to this Form, as uploaded on the website of the Company, in the announcement.

It is to be noted here that this provision shall not be applicable upon following on going CIRPs:

- a. where a period of less than 37 days is left for submission of resolution plans (for issuing invitation); and
- b. where a period of less than 18 days is left for submission of resolution plans (for sending evaluation matrix).

Authority of RP instead of IRP

Amendment Regulations, 2018 authorize RP in place of IRP for following:

- a. Appointment of Registered Valuers;
- b. Invitation of Resolution Plans;
- c. Preparation and submission of Information Memorandum

Additional measures which may be adopted in Resolution Plan

Regulation 37 has been substituted by a new regulation vide Amendment Regulation, 2018. Amendment Regulations, 2018 provide for two additional measures for resolution of insolvency:

- a. **change in portfolio of goods or services** produced or rendered by the corporate debtor; (Regulation 37(j))
- b. **change in technology used** by the corporate debtor (Regulation 37(k)).

Submission of Resolution Plan

Regulation 39(4) has been substituted with new sub-regulation dealing with submission of the resolution plan as is approved by CoC. The analysis of this amendment is discussed below:

Fairly Confidential or Confidentially Fair

Text before amendment	Text post amendment	Impact
<p>The resolution professional shall submit the resolution plan approved by the committee to the Adjudicating Authority with the certification that:</p> <p>(a) the contents of the resolution plan meet all the requirements of the Code and the Regulations; and</p> <p>(b) the resolution plan has been approved by the committee.</p>	<p>(a) The resolution professional shall submit the resolution plan approved by the committee to the adjudicating Authority, at least fifteen days before the expiry of the maximum period permitted under section 12 for the completion of the corporate insolvency resolution process, with the certification that the contents of the resolution plan meet all the requirements of the Code and the Regulations; and</p> <p>(b) the resolution plan has been approved by the committee: Provided that the timeline specified in this sub-regulation shall not apply to an ongoing corporate insolvency resolution process which has completed 130th day from its commencement date.</p>	<p>1. Earlier, there was no timeline for submission of resolution, except that it was to be submitted within the period of moratorium. Post amendment, the resolution must be submitted to the AA, before the expiry of 15 days of the moratorium period.</p> <p>Proviso has been inserted to the effect that this timeline shall not be applicable to an ongoing corporate insolvency resolution process which has completed its 130th day from its commencement.</p>

Amendment in the Fast Track CIRP Regulations, 2017

Amendments made in the CIRP Regulations, 2016 have also been replicated in the Insolvency and Bankruptcy Board of India (Fast Track Insolvency Resolution Process for Corporate Persons) Regulations, 2017, with minor differences as to timelines vide Insolvency and Bankruptcy Board of India (Fast Track Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations, 2018⁴.

Conclusion

The overall impact of the Amendment Regulations, 2018, seems fairly positive – changes such as introduction of concepts like evaluation matrix, provision of determination of “fair value”, comprehensive description of assets and liabilities in IM, etc. are all welcoming.

We expect to see more such changes in future, as per the requirements of the time and circumstances to be.

Know More....

In the matter of [State Bank of India vs. Su Kam Power Systems Ltd.](#), the Hon'ble NCLT, Principal Bench, *vide* its order dated 05.09.2018, held regulation 36A of the IBBI (Insolvency Resolution Process for Corporate Persons), 2016 as ultra-vires of section 240 (1) of IBC, 2016 which states that the Board i.e. IBBI may, by notification, make regulations **consistent with this Code** and the rules made thereunder, to carry out the provisions of this Code. It was observed by the Principal Bench that it was beyond the powers of the Board to lay down the procedure of inviting expression of interest, linking the same with "form G", by way of an insertion in the CIRP Regulations. The Bench held that such provision negates the salient features of the Code and as such, directed the Board to frame the Regulation according to its competence bestowed upon it by the Code.

Subsequently, pursuant to an appeal filed by IBBI against the said order in the High Court of Delhi, the Hon'ble High Court has, as an interim measure, stayed the order to the extent it declares Regulations 36A as ultravires.

APPLICABILITY OF MORATORIUM ON GUARANTOR'S ASSETS: THROUGH MAZE OF RULINGS

- **Barsha Dikshit**

Editor's Note: *The extent of the role of personal guarantors in the insolvency resolution process has been much talked about. Similarly, there have also been questions whether moratorium outreaches the assets of the personal guarantors too. Varying stance taken by the Adjudicating Authority on this issue have been discussed and analysed hereunder*

The Code envisages calm period during the corporate insolvency resolution process of the corporate debtor. Section 14 of the Code requires the adjudicating authority to declare "moratorium" during which institution or continuation of suits, execution of any decree or order, or alienation or transfer of assets of the corporate debtor is prohibited. The moratorium also bars 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 SARFAESI Act, 2002.

In the context above, the effect of the moratorium provisions on the assets of the *personal guarantors* of the corporate debtor has been a matter of debate before the adjudicating and appellate authorities. The latest judgment rendered in [State Bank of India v. V Ramakrishnan and Vecons Energy Limited](#) [Company Appeal (AT) (Insolvency) No. 213 of 2017] by the National Company Law Appellate Tribunal (NCLAT) goes on to abstruse the issue.

The NCLAT has held that on admission of the insolvency resolution application under the Code, the moratorium will not only be applicable to the property of the corporate debtor *but also* on the property of the personal guarantor. The view taken by NCLAT in the said ruling deviates from the judgements rendered by the appellate authority in [Alpha & Omega Diagnostics \(India\) Ltd. v. Asset Reconstruction Company of India Ltd. & Ors.](#) [Company Appeal (AT) (Insol.) No. 116 of 2017], and later in [Schweitzer Systemtek India Pvt. Ltd v. Phoenix ARC Pvt. Ltd. & Ors](#) [Company Appeal (AT) (Insolvency) No. 129 of 2017]³⁴, as discussed below.

Alpha & Omega Diagnostics (India) Ltd. v. Asset Reconstruction Company of India Ltd. & Ors

In the matter of *Alpha & Omega Diagnostics (India) Ltd. Vs. Assets Reconstruction Company of India Ltd. And ors*, wherein, personal property of the promoters was given as security against the loan taken by the Corporate Debtor, the Hon'ble NCLAT had ruled that corporate debtor is distinct from the guarantor and that the corporate debtor has applied for "its" own insolvency resolution proceedings and the assets would only include the assets of the corporate debtor and not of any third-party including the promoters.

Section 14 (1) (c) of IBC, 2016, itself clarifies its ambit which is limited to the properties of the Corporate Debtor alone. As held by the NCLAT in case of Alpha & Omega, Every word is to be read and interpreted as it exists in the statute with the natural meaning attached to the word. On simple reading of the section, it is very clear that the provision connects to the security interest created by the corporate debtor in respect of its own property. There is no scope of protection to the assets of the guarantor (be it personal or corporate) under the moratorium provisions of section 14.

Schweitzer Systemtek India Pvt. Ltd v. Phoenix ARC Pvt. Ltd. & Ors.

In the matter of *Schweitzer Systemtek India Pvt. Ltd v. Phoenix ARC Pvt. Ltd. & Ors.*, wherein the property of the guarantor was attached during corporate insolvency resolution process and the issue was whether moratorium under the Code would be applicable on the property of the promoters or not. The Hon'ble NCLAT in the said matter had placed reliance on section 14 (1) (c) of IBC, 2016, which reads as follows:

“Section 14 (1) :- Subject to provisions of sub-sections (2) and (3), on the insolvency commencement date, the Adjudicating Authority shall by order declare moratorium for prohibiting all of the following, namely:—

Xx

(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;

Xx.”

The Hon'ble NCLAT in the abovementioned case had recourse strict interpretation of the word “its” and has ruled that the language of the section is so simple that there is no scope to even supply *casus omissus*. Thus, the property not owned by the corporate debtor do not fall within the purview of the Moratorium. In other word, the moratorium shall prohibit the action against the properties of the corporate debtor that reflects in its balance sheet and not on the properties beyond the ownership of the corporate debtor.

State Bank of India v. V Ramakrishnan and Veasons Energy Limited (supra), Mr. V. Ramakrishnan

In *State Bank of India v. V Ramakrishnan and Veasons Energy Limited (supra)*, Mr. V. Ramakrishnan, director of Veasons Energy Limited (“the Corporate Debtor”), has given personal guarantee and has mortgaged collateral security of his assets with State Bank of India (“the Financial Creditor”) against the facility availed by the Corporate Debtor. The Financial Creditor invoked its right against under SARFAESI against the Personal Guarantor under section 13 (2). The notice was challenged by the Corporate Debtor before Hon'ble High Court of Madras and was dismissed by the Hon'ble Court. Having failed to get relief from the Hon'ble Court, the Corporate Debtor proceeded with application under section 10 of the IBC, 2016. The said application was admitted and moratorium was declared for the Corporate Debtor. However, the financial creditor continued taking measures under SARFAESI against the Financial Creditor. Being aggrieved, the Personal Guarantor filed application before NCLT, Chennai, for stay proceeding under SARFAESI. The Chennai bench allowed the

Applicability of Moratorium on Guarantor's Assets Through Maze of Rulings

application and restrained the financial creditor from proceeding against the personal guarantor till Moratorium continues. This order was challenged by the financial creditor before the NCLAT.

After analysing the contention of both the parties, the Hon'ble NCLAT held that the 'Moratorium' will not only be applicable to the property of the 'Corporate Debtor' but also on the 'Personal Guarantor'.

The author's analysis

As is evident from the foregoing discussion, the decision of the NCLAT in *State Bank of India v. V Ramakrishnan and Veasons Energy Limited(supra)*, stands in contrast with its own decisions rendered in the earlier cases.

Therefore, according to the last view taken by NCLAT, when a corporate debtor is under corporate insolvency resolution process, the creditors can neither proceed against the properties of the corporate debtor, nor against the properties of the guarantor.

Here, it would also be relevant to discuss the case of [Sanjeev Shriya v. State Bank of India & Ors.](#) [Writ-C 30285 of 2017], wherein the High Court held that once the proceeding has already been commenced under the Code and moratorium under section 14 of the Code has already been issued and even in the said proceeding the parties have put their appearance before the insolvency professionals, then the proceeding against the guarantors of principal debtor under the RDBFI Act, 1993 is *per se* bad. Also, once the liability is still in fluid situation and the same has not been crystallized, then in such situation two parallel/split proceedings in different jurisdiction should be avoided, if possible. Therefore, the High Court, in essence, opined that the liability of the guarantor and the corporate debtor in respect of a particular debt is in alternative. Where a corporate debtor is under insolvency resolution (and thus under moratorium), the creditors cannot proceed against the guarantors.

The order of NCLAT in *State Bank of India v. V Ramakrishnan and Veasons Energy Limited* in substance, resonates with the view taken in *Sanjeev Shriya v. State Bank of India & Ors.*

However, the author humbly diverges from the view of the High Court and the NCLAT as above. In *Pollock & Mulla on Indian Contract and Specific Relief Act*, Tenth Edition, at page 728, it is observed-

“Co-extensive-Surety's liability is co-extensive with that of the principal debtor.

A surety's liability to pay the debt is not removed by reason of the creditor's omission to sue the principal debtor. The creditor is not bound to exhaust his remedy against the principal before suing the surety, and a suit may be maintained against the surety though the principal has not been sued.”

The principle has been emphasised in a number of rulings.

In [Bank of Bihar Ltd. v. Damodar Prasad & Anr.](#) (1969) 1 SCR 620, the Apex Court referred to a judgment in the case of [Lachhman Joharimal v. Bapu Khandu and Tukaram Khandoji](#)(1869) 6 Bombay High Court Reports 2, in which the Division Bench of the Bombay High Court held-

“The court is of opinion that a creditor is not bound to exhaust his remedy against the principal debtor before suing the surety and that when a decree is obtained against a surety, it may be enforced in the same manner as a decree for any other debt.”

The Supreme Court of India has taken a similar view, in the case of *Industrial Investment Bank of India Ltd. v. Biswanath Jhunjhunwala*[Civil Appeal No. 4613 OF 2000] had observed-

“The very object of the guarantee is defeated if the creditor is asked to postpone his remedies against the surety. In the present case the creditor is a banking company. A guarantee is a collateral security usually taken by a banker. The security will become useless if his rights against the surety can be so easily cut down.”

Therefore, the NCLAT in *State Bank of India v. V Ramakrishnan and Veasons Energy Limited* completely overlooked its own precedents and the settled principle of co-extensiveness of the liability of principal debtor and that of guarantor.

Know More . . .

Amidst persisting dilemma w.r.t. applicability of moratorium on the assets of the personal guarantor, the Hon'ble Supreme Court in the matter of [State Bank of India v. Ramakrishnan and Ors.](#) ,clarified that the moratorium is applicable only on the corporate debtor and not the personal guarantors. The Hon'ble Court observed that the law as it stands does not refer to the personal guarantor but only to corporate debtors. The objects and reasons of the Insolvency and Bankruptcy Code state that once a resolution plan approved by the committee of creditors takes effect, it shall be binding on the corporate debtor as well as the guarantor.

Clearing the Air

- Moratorium of 180 days will apply only to corporate debtors facing insolvency proceedings

This allows debtor a window within which he has to find a way to clear the debt

Neither can the recovery proceedings be initiated against the debtor nor can his assets be disposed of during this period

- SC has ruled that the law won't apply to personal guarantors such as directors and promoters of the company
- Personal guarantors' assets will be used to cover the bad loans

The infographic features a man in a suit pulling a large ball labeled 'LOAN' with a chain. In the background, two figures are running away from a ball labeled 'DEBT'. A gavel icon is also present.

SIMULTANEOUS CLAIM BY A BENEFICIARY OF GUARANTEE

- **Richa Saraf**

Editor's Note: Needless to say that guarantee contracts are highly prevalent in the commercial world and "Liability of a guarantor is co-extensive to that of the surety" is a well-established principle and is the essence of all guarantee contracts. It implies that the creditor has the right to claim its dues from the guarantor prior to the principal debtor/ surety also. It is not necessary that liability of the guarantor shall ONLY arise when the surety makes to fail payment. However, in a scenario where both the surety and guarantor fail to make payment to the creditor, does the creditor have the right to file a claim against both the parties for the same claim in question? Will such simultaneous claim tantamount to dual recovery by the creditor? The following article answers these and several other question in this regard.

Introduction

In a recent case of *Dr. Vishnu Kumar Agarwal v. M/s. Piramal Enterprises Ltd.* Company Appeal (AT) Insolvency) No. 346 of 2018, the NCLAT has held that an application for initiation of corporate insolvency resolution process for same very claim/debt is not permissible. Now, consider a situation where Company A (guarantor) has guaranteed the loans given to Company B (principal debtor). When Company B defaulted in payment, the creditor issued a notice to Company A invoking the corporate guarantee, however, even Company A failed to make the payment. If Company A and Company B both are undergoing insolvency proceedings (whether corporate insolvency resolution process or liquidation), can the creditor who has already filed its claim for the entire debt due with the IRP/ Liquidator of Company A, also file its claim with the IRP/ Liquidator of the Company B for the entire debt due?

Section 5 (8) of the Insolvency and Bankruptcy Code, provides for the definition of financial debt. The relevant extract is reproduced below:

"Financial debt" means a debt along with interest, if any, which is disbursed against the consideration for the time value of

money and includes—

*money borrowed against the payment of interest; ***

*** (i) the amount of any liability in respect of any of the guarantee or indemnity for any of the items referred to in sub-clause (a) to (h) of this clause."*

Accordingly, it is clear that the liability w.r.t. guarantee given by a corporate guarantor is a financial debt, however, the moot question that arises for consideration is that whether having filed a claim with the principal debtor, the creditor can file its claim for the entire amount with the corporate guarantor; below the author tries to answer the same.

Dr. Vishnu Kumar Agarwal v. M/s. Piramal Enterprises Ltd.
"an application for initiation of corporate insolvency resolution process for same very claim/debt is not permissible"

Discussions on Provisions Of Law:

Section 128 of the Indian Contract Act, 1872 stipulates- *“The liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract.”*

It is thus, well settled that the creditor can directly approach the guarantor, without having exhausted its remedies against the principal debtor, but to analyse whether in insolvency cases, the creditor can file dual claims- one against the guarantor and the other against the principal debtor, it is pertinent to cite the following cases:

In [*Bank of Bihar v. Damodar Prasad and Anr.*](#) 1969 AIR 297, 1969 SCR (1) 620, the Hon’ble Supreme Court held:

3. *The demand for payment of the liability of the principal debtor was the only condition for the enforcement of the bond. That condition was fulfilled. Neither the principal debtor nor the surety discharged the admitted liability of the principal debtor in spite of demands. Under Section 128 of the Indian Contract Act, save as provided in the contract, the liability of the surety is coextensive with that of the principal debtor. The surety became thus liable to pay the entire amount. His liability was immediate. It was not deferred until the creditor exhausted his remedies against the principal debtor.*
4. *Before payment the surety has no right to dictate terms to the creditor and ask him to pursue his remedies against the principal in the first instance. As Lord Eldon observed in *Wright v. Simpson* “But the surety is a guarantee; and it is his business to see whether the principal pays, and not that of the creditor”. In the absence of some special equity the surety has no right to restrain an action against him by the creditor on the ground that the principal is solvent or that the creditor may have relief against the principal in some other proceedings.*
5. *Likewise where the creditor has obtained a decree against the surety and the principal, the surety has no right to restrain execution against him until the creditor has exhausted his remedies against the principal. In *Lachman Joharimal v. Bapu Khandu and Surety Tukaram Khandoji* the Judge of the Court of Small Causes, Ahmednagar, solicited the opinion of the Bombay High Court on the subject of the liability of sureties. The creditors having obtained decrees in two suits in the Court of Small Causes against the principals and sureties presented applications for the imprisonment of the sureties before levying execution against the principals. The Judge stated that the practice of his court had been to restrain a judgment-creditor from recovering from a surety until he had exhausted his remedy against the principal but in his view the surety should be liable to imprisonment while the principal was at large. Couch, C.J., and Melvill, J. agreed with this opinion and observed-*

This court is of opinion that a creditor is not bound to exhaust his remedy against the principal debtor before suing the surety and that when a decree is obtained against a surety, it may be enforced in the same manner as a decree for any other debt.”

Simultaneous Claim by a Beneficiary of Guarantee

Again, in [State Bank of India v. Indexport Registered and Ors.](#) 1992 AIR 1740, 1992 SCR (2)1031, it was held that:

“13. In the present case before us the decree does not postpone the execution. The decree is simultaneous and it is jointly and severally against all the defendants including the guarantor. It is the right of the decree-holder to proceed with it in a way he likes. Section 128 of the Indian Contract Act itself provides that “the liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract”.

In the case of *Dr. Vishnu Kumar Agarwal v. M/s. Piramal Enterprises Ltd.*, the NCLAT has also relied on the aforementioned judgments.

Other Relevant Judgments:

In *Jagannath Ganeshram Agarwala v. Shivnarayan Bhagirath and Ors.*³⁵, a Division Bench of the Bombay High Court held that the liability of the surety is co-extensive, but is not in the alternative. Both the principal debtor and the surety are liable at the same time to the creditors.

In *Mukesh Hans & Anr. V. Smt. Uma Bhasin & Ors.*, the Delhi High Court had observed “*the guarantee is an independent contract and in all fairness, has to be honoured to fulfil the contractual obligation between the surety and the creditor*”.

UK Insolvency Act, 1986

The rule against double proof was discussed in detail in the case of [Kaupthing Singer and Friedlander Limited \(in administration\)](#)[2011] UKSC 48, wherein the Supreme Court observed as follows:

“11. The function of the rule is not to prevent a double proof of the same debt against two separate estates (that is what insolvency practitioners call “double dip”). The rule prevents a double proof of what is in substance the same debt being made against the same estate, leading to the payment of a double dividend out of one estate. It is for that reason sometimes called the rule against double dividend. In the simplest case of suretyship (where the surety has neither given nor been provided with security, and has an unlimited liability) there is a triangle of rights and liabilities between the principal debtor (PD), the surety (S) and the creditor (C). PD has the primary obligation to C and a secondary obligation to indemnify S if and so far as S discharges PD’s liability, but if PD is insolvent S may not enforce that right in competition with C. S has an obligation to C to answer for PD’s liability, and the secondary right of obtaining an indemnity from PD. C can (after due notice) proceed against either or both of PD and S. If both PD and S are in insolvent liquidation, C can prove against each for 100p in the pound but may not recover more than 100p in the pound in all.”

Replying on the aforementioned ruling, Fletcher in his famous treatise *The Law of Insolvency*³⁶ has mentioned-

“Where the creditor to whom the liability is owed has already roved in the insolvency of the principal debtor, the surety’s own liability is thereafter reduced to the amount for which the

³⁵AIR [1940] Bombay 247

³⁶Para 23-003, page 728 of *The Law of Insolvency*, Fifth Edition 2017

creditor's proof has been admitted, less the value of any dividends that has been paid to him."

Conclusion:

The issue under consideration is whether a creditor can simultaneously claim its entire amount of due from the principal borrower as well as from the corporate guarantor, and considering the aforementioned, it is clear that the liability of the guarantor and the principal borrower is joint and several. Generally, guarantee deeds also have a clause to the effect that the guarantor is liable in the same manner as if the guarantor is the principal debtor. Under such circumstances, if there is default by the principal debtor, it cannot be that the claim of the creditor against the guarantor can be for any amount lesser than the amount due from the principal debtor. Accordingly, the creditor can claim its dues from the principal borrower and/or the corporate guarantor.

FINANCIAL EXPOSURE OF SECURED CREDITORS AND THE RELEVANCE OF VERTICAL COMPARISON IN RESOLUTION

- **Richa Saraf**

Editor's Note: Resolution plans under IBC are designed based on a benchmark value, referred to as 'liquidation value' – this is supposed to be the minimum pay-out below which a resolution plan cannot be said to be feasible. After all, the whole idea of preferring resolution over liquidation is that a stakeholder receives something 'better' in resolution than in liquidation. Here comes in the concept of 'vertical comparison'. The principle has been widely applied by courts in UK to see and identify the irreducible minimum below which the return in a reorganisation plan cannot go.

This article discusses the concept in the context of resolution plans and exposures of financial creditors (secured and unsecured) under the plans.

Resolution process can be regarded as a mega- restructuring for which an insight into the ranking of claims of various creditors is pertinent. In most of the resolution plans, we can see that the financial creditors are paid a particular value as settlement of claims, and no specific provision exists as to how this amount is to be proportioned amongst various secured and unsecured creditors, or if there will be any priority at all. Most of us are of the understanding that any priority under Section 53 is available only in the case of liquidation, and law does not stipulate for any preferential treatment between the claims of secured and unsecured during resolution process, yet it is a well-established principle that while resolving an entity, the creditors of that entity shall not be put in a situation worse than what would have been in case the entity were to be liquidated (or else, there would be no point in resolving the entity). A comparison between a creditor's entitlement in the resolution plan and in a hypothetical liquidation is referred to as "vertical comparison".

Though there is no explicit provision calling for such vertical comparison, however, inference may be drawn from Section 6 of the UK Insolvency Act, 1986, which provides for challenge of decisions approving a voluntary arrangement on the ground that such voluntary arrangement has the effect of unfairly prejudicing the interests of a creditor, member or contributory of the company under Section 4A. The said rule was emphasised by David Richards J in [Re T & N Ltd. \[2004\] EWHC 2361 \(Ch\)](#), [\[2005\] 2 BCLC 488](#)

"While I am wary of laying down in advance of a hearing on the merits of any scheme or CVA any particular rule, there is one element which can be mentioned at this stage. I find it very difficult to envisage a case where the court would sanction a scheme of arrangement, or not interfere with a CVA, 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 the company, assuming that the return in a winding up would in reality be achieved and within an acceptable time-scale: see Re English, Scottish and Australian Chartered Bank [1893] 3 Ch 385."

In [Prudential Assurance Co Ltd v. PRG Powerhouse Ltd](#), [2007] EWHC 1002 (Ch), [2007] Bus LR 1771, while deliberating on the fairness of a company voluntary arrangement (CVA), Etherton J. said-

“In broad terms, the cases show that unfairness may be assessed by a comparative analysis from a number of different angles. They include what I would describe as vertical and horizontal comparisons. Vertical comparison is with the position on winding up (or, in the case of individuals, bankruptcy). Horizontal comparison is with other creditors or classes of creditors.”

Also, in [Mourant & Co Trustees Ltd v. Sixty UK Ltd](#) (In Administration) [2010] EWHC 1890 (Ch), while relying upon the views expressed in *Re T & N Ltd* (supra) and *Powerhouse* case (supra), the court stated as follows:

“(c) In assessing the question of unfairness, a number of techniques may be used, including what may be described as- vertical and horizontal comparisons. A vertical comparison is a comparison between the position that a creditor would occupy and the benefits it would enjoy in a hypothetical liquidation, as compared with its position under the CVA. The importance of this comparison is that it generally identifies the irreducible minimum below which the return in the CVA cannot go.”

Further, in the case of *HMRC v. Portsmouth City Football Club*³⁷, the court considered the validity of a CVA by examining whether it contravened the general principles of insolvency law by unfairly giving preferential treatment. Several parameters were laid down to regard a CVA as unfairly prejudicial:

1. When considering whether or not any disadvantage resulting from the CVA is unfair, the court will consider both “vertical” and “horizontal” comparisons;
2. When considering the results of a “vertical” comparison, if creditors in general, or a specific class of creditors, stand to receive less in the proposed CVA than they would have in liquidation, the CVA is likely to be regarded as unfair³⁸;
3. In relation to any “horizontal” comparison, the fact that the creditors were treated differently in something which would call for close scrutiny, but any differential treatment does not automatically make the CVA unfair.³⁹

The concepts of unfairness and prejudice are questions of fact. A court is extremely likely to find unfair prejudice and interfere in a CVA if it ‘fails’ the vertical comparison, i.e. if some creditors are to receive less in a CVA than they would on winding-up. It is, therefore, crucial that the company can demonstrate that the CVA will deliver a better result for creditors than a winding up to ensure the vertical comparison is ‘passed’.

³⁷ [2010] EWHC 2013 (Ch); [2011] BCC 149

³⁸ Re: T&N Ltd. [2004] EWHC 2361 (Ch)

³⁹Practical Company Law and Corporate Transactions by Mark Stamp

Financial Exposure of Secured Creditors & The Relevance of Vertical Comparison in Resolution

Similar provisions also exist in the insolvency laws of US. Section 1129 (a) of Chapter 11 of the US Code lists down the minimum requirements which the reorganisation plan shall meet in order to be confirmed, one such requirement is-

“(7)With respect to each impaired class of claims or interests-

(A) each holder of a claim or interest of such class-

(i) has accepted the plan; or

(ii) 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.”

It is, thus, not possible to use a CVA (or for that matter, Resolution Plan) to modify any rights or to alter the priority of payment of a charge holder, by unilaterally modifying any of the contractual provisions. It is unreasonable and unfair in principle to treat the secured creditors *pari passu* with unsecured creditors. Secured claims rank ahead of unsecured claims and the status should be maintained even in the event of insolvency, as regards the application of the proceeds of realisation of the assets, subject to certain preferred expenses i.e. resolution process costs.



Beyond the Lines . . .

In the matter of [Binani Industries Limited vs. Bank of Baroda & Anr.](#), the Committee of Creditors (CoC) of the Corporate Debtor approved a resolution plan which provided for differential payment to the certain financial creditors to which the corporate debtor had 'indirect exposure' and also, payouts to operational creditors were stipulated in the resolution plan depending on the amount of exposure – higher the claim, lower the payout.. The NCLAT, while laying down the law on this issue, held that the objective of the I&B Code is resolution and its purpose is for the maximisation of the value of assets of the corporate debtor and thereby for all the creditors. It is not the maximisation of value for a 'stakeholder' or a 'set of stakeholders' such as creditors and is to promote entrepreneurship. The resolution plan cannot discriminate between creditors who are equally situated.

Therefore, a resolution applicant may propose to resolve the insolvency based on any of the aforesaid actions or measures and this does not necessarily merit equal or similar treatment to the debts of the operational creditor or the financial creditors. In this regard, attention is invited for the long title of the I&B which provides that the insolvency process shall provide for 'balance of interests of all stakeholders'. Therefore, so long as a resolution plan balances the interests of all the stakeholders, which may or may not include equal or similar treatment of dues of the financial and operational creditors, the same cannot be bad in law.

SUBORDINATION OF OPERATIONAL CREDITORS UNDER IBC: WHETHER EQUITABLE

- **Vinod Kothari & Sikha Bansal**

Editor's Notes: We discussed that IBC has uniquely classified creditors into financial creditors and operational creditors, while maintaining the conventional distinction between secured and unsecured creditors. More often than not, operational creditors would be unsecured – and going by the priorities under section 53 such creditors would fall in the residual entry, thereby lagging behind all and sundry – even unsecured financial creditors. This impacts their returns both in resolution and liquidation.

Operational creditors are in no manner, a group not necessary for a business to function – in fact, a business would depend on such creditors for its operations and working capital requirements – as also acknowledged by NCLAT in Binani ruling. Priorities under insolvency law are driven by contractual, social, and sovereign considerations – however, subordination of operational debt below unsecured financial debt does not seem to justify any of the above considerations.

This analytical article discusses principles of prioritisation in general and equitability of prioritisation stipulated under section 53 in the light of economic arguments in favour of operational creditors.

1. Why this Article?

Section 53 of the Code puts unsecured financial creditors above the claims of the governments. These unsecured financial creditors may, actually, be even related parties, and therefore, the underlying financial transaction may be in the nature of accommodation provided by promoters or majority shareholders, often at the instance of lending banks. At the same time, there is no specific mention of the priority status of operational creditors, who are, therefore, left in the residual category of “any remaining debts and dues”, which is 2 notches below unsecured financial creditors.

Financial creditors in this case are unsecured; so are operational creditors. The law, however, puts one class of unsecured creditors two places ahead of the other, in the priority order of distribution. Is this subordination of unsecured operational creditors justified? Or, is it equitable? Is there an economic argument to contend that the suppliers of goods and services who supplied on credit, and therefore, contributed to working capital, should have lower ranking claim to their money than working capital financiers or other unsecured lenders?

This significant question is discussed in this article in the light of global insolvency laws.

2. The Significance of Insolvency Priorities

Prioritisation of debts in liquidation, technically speaking, is specifying the stacking order in which different creditors of the insolvent debtor would be paid their dues.

Prioritisation of claims, commonly known as liquidation waterfall, is one of the most important aspects of insolvency laws, and has evolved globally over the decades of jurisprudence. Insolvent

Subordination of Operational Creditors Under IBC: Whether Equitable

liquidation is obviously a case of shortfall of assets as against the claims, and therefore, who gets paid first, or does every get to share proportionally, is the key question. If food on the dining table at home is short, we will all share what we have, but we sometimes give priorities to children or the elderly. However, in insolvency waterfall, the concept of prioritisation is that unless the one ahead in the queue has eaten belly-full, the next person in the queue does not get to eat even a morsel. Hence, it is not merely a question of “how much”, it is a question of “whether at all”. Therefore, priority in distribution in liquidation is not merely a matter of place in the queue – it is whether a stakeholder gets paid at all, or how much it gets paid. Thus, the recovery rate, and therefore, loss given default (LGD –as bankers call it), is directly connected with the prioritisation.

Since the claim that a claimant files in liquidation proceedings is a property right of the claimant, the prioritisation deals with property rights; hence, any casual or unprincipled approach to prioritisation may be fatal to the inherent property rights of the claimants.

3. Principles of Prioritisation

Priorities are specified considering the following fundamental factors –

(i) **Contractual priorities:** The priorities specified often recognize and respect different commercial bargains which creditors would have struck with the debtor. As stated in the UNCITRAL Legislative Guide on Law of Insolvency, this is to “*preserve legitimate commercial expectations, foster predictability in commercial relationships and promote equal treatment of similarly situated creditors*”. The preservation of contractual priorities in liquidation is based on the principle of certainty, such that creditors are certain of their rights at the time of entering into the contract. For instance, in secured lending, which is in the nature of an inter-creditor and debtor-creditor agreement, the secured lenders are given the first right on the secured assets, and in case the assets are relinquished, then preferential right on the aggregate cashflows of the entity.

(ii) **Social considerations:** Prioritisation policies very often reflect legitimate considerations for certain sections of the society or in public interest. For example, the workmen, and the employees. In India, the priority status was given to workmen after elaborate discussion by the Supreme Court in the case of *National Textile Workers v. P.R. Ramkrishnan and Others*, 1983 AIR 75 : 1983 SCR (1) 9, on workmen’s rights to be heard in winding up proceedings.

(iii) **Sovereign considerations:** Sometimes claims of the State or the Crown are given priority as preferential unsecured claims on the ground of protection of public revenue.

Given the varied nature of claims and obvious conflict arising on the question of their prioritisation, the UNCITRAL Legislative Guide on Law of Insolvency, therefore states –

“While many creditors will be similarly situated with respect to the kinds of claims they hold based on similar legal or contractual rights, others will have superior claims or hold superior rights. For these reasons, insolvency laws generally rank creditors for the purposes of distribution of the proceeds of the estate in liquidation by reference to their claims, an approach not inconsistent with the objective of equitable treatment.”

Therefore, equitability is the key underlying principle to fixation of priorities.

4. Prioritisation: Global Perspective

Globally, the principles, as discussed above, are followed in countries like USA, UK, Singapore and even India (under the Companies Act, 2013). For instance, as follows –

– The Insolvency Act, 1986 of United Kingdom

Under the Insolvency Act, 1986, read with relevant rules, a secured creditor puts a value on security, and the office-holder can redeem the property at such value. Hence, a secured creditor has a superior right over the secured asset.

Section 175 read with section 386 and schedule VI to the Act and relevant rules, prescribes preferential debts which shall be paid in priority to all other debts. The preferential claims, such as debts due to inland revenue, customs and excise, social security contributions, contribution to occupational pension schemes, etc. rank above the claims of body of unsecured creditors. Such rank equally among themselves after the expenses of the winding up and shall be paid in full, unless the assets are insufficient to meet them, in which case they abate in equal proportions. Also, such preferential debts have priority over the claims of holders of debentures secured by, or holders of, any floating charge created by the company, and shall be paid accordingly out of any property comprised in or subject to that charge.

As is evident, there is no distinction between creditors as financial or operational.

– Title 11 of the US Code

Section 706 read with sections 507 and 510 of the dictates the order in which distribution of property of the estate. First, property is distributed among priority claimants, as determined by section 507, and in the order prescribed by section 507. Second, distribution is to general unsecured creditors. Third distribution is to general unsecured creditors who tardily file. Fourth distribution is to holders of fine, penalty, forfeiture, or multiple, punitive, or exemplary damage claims.

Section 507 accords first priority to allowed administrative expenses and to fees and charges assessed against the estate. “Involuntary gap” creditors, are granted second priority, followed by wages, consumer creditors, and taxes (including employment taxes and transfer taxes).

Consumer creditors refer to those who have deposited money in connection with the purchase, lease, or rental of property, or the purchase of services, for their personal, family, or household use, that were not delivered or provided. This can be equated to home-buyers, customers who paid advances for the purchase of goods/services, etc.

Once again, there is no distinction between financial and operational creditors.

– Singapore Companies Act

Section 328 of the Singapore Companies Act (as also the Singapore Bankruptcy Act, 1995) gives the order of payment if the winding up order is passed in respect of the company. In all modes of liquidation (voluntary and compulsory), all unsecured creditors share ratably in the assets of the company subject to exceptions for secured and preferential debts. Secured creditors stand outside the liquidation and if the security is inadequate, they may prove as unsecured creditors for the

Subordination of Operational Creditors Under IBC: Whether Equitable

balance. Priority has been given to costs and expenses of winding up, various payments to workers and employees and taxes.

Here too, the law makes no distinction as to financial and operational creditors.

– The Companies Act, 2013, India

Section 326 of the Companies Act, 2013 prescribes overriding preferential payments, i.e. workmen's dues and unpaid dues of secured creditor who has realized its security. Subject to the provisions of section 326, section 327 specifies priority for debts like government dues, employee dues, etc. Such debts (as specified in section 327) shall rank equally among themselves and be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions, and shall have priority over the claims of holders of debentures under any floating charge created by the company, and be paid accordingly out of any property comprised in or subject to that charge.

5. Creditor classification under the Insolvency and Bankruptcy Code, 2016

IBC makes, for the first time, distinction between financial and operational creditors, while simultaneously retaining the conventional classification of being secured or unsecured. The unique distinction between financial and operational creditors under IBC is based on a recommendation of BLRC which states –

“The Committee deliberated on who should be on the creditors committee, given the power of the creditors committee to ultimately keep the entity as a going concern or liquidate it. The Committee reasoned that members of the creditors committee have to be creditors both with the *capability to assess viability, as well as to be willing to modify terms of existing liabilities in negotiations*. Typically, operational creditors are *neither able to decide on matters regarding the insolvency of the entity, nor willing to take the risk of postponing payments for better future prospects for the entity*. The Committee concluded that, for the process to be rapid and efficient, the Code will provide that the creditors committee should be restricted to *only* the financial creditors.”

The BLRC Committee reasoned that members of the creditors committee have to be creditors both with *the capability to assess viability, as well as to be willing to modify terms of existing liabilities in negotiations*.

Therefore, it was the “capability to assess viability, and willingness to modify terms of existing liabilities in negotiations”, which inspired BLRC to prefer the financial creditors over the operational creditors. The financial creditors were presumed to be *strong creditors* able to decide on matters regarding the insolvency of the debtor and *who are willing to take the risk of postponing payments*. The operational creditors are not expected to bear the burden of postponing payments, let alone foregoing the claims, partly or wholly. This argument may, questionably, be relevant for determining the eligibility to be on the creditors' committee. But should the distinction continue right upto distribution priorities? For example, related parties do not have a place on the committee of creditors, but that does not deny their right in the waterfall, where they are at par with other unrelated parties. This, in turn, paves way for unscrupulous debtors and their related creditors to misuse the machinery for their benefit, at the cost of unsecured operational creditors.

The irony is, the unsecured operational creditors, being placed last, will get a soupçon only after the financial creditors have filled up their bellies, to the extent the plate has to offer. In fact, in many cases, the operational creditors might end up no payment at all, because most insolvencies are deep enough. All because of the prioritisation contemplated under section 53, *as discussed below* – which besides being applicable in liquidation, is also relevant for ascribing liquidation values under resolution plan.

6. Prioritisation of Creditors under Section 53

Section 53 is the relevant section dealing with priorities in liquidation under the Code. The stakeholders have been distinguished and ranked as follows –

1. IRP and liquidation costs;
2. Workmen's dues (for 24 months), *and* secured dues, if the security has been relinquished;
3. Employees' dues (for 12 months);
4. Unsecured financial creditors;
5. Government dues, *and* unpaid dues to secured creditor, if the security has been realized;
6. Remaining debts and dues [which include, unsecured operational debts];
7. Preference shareholders;
8. Equity shareholders.

Notably, distinction under section 53 is a two-fold distinction – (i) secured/unsecured, and (ii) operational/financial. As regards secured creditors, it does not matter whether the creditor is financial or operational, since section 53(1)(b) uses the expression “secured”, and there is no indication as to the nature of debt (financial/operational) owed to such secured creditor. However, when it comes to unsecured creditors, unsecured *financial* creditors appear in the 4th rank; but unsecured operational creditors come in the 6th rank.

7. Equitability of Prioritisation under section 53

As seen above, the unsecured financial creditors have been raised above government dues, while unsecured operational creditors merely become a part of the residual entry. It is important to question as to what could be the basis for this discrimination? Contractually, unsecured financial creditors and unsecured operational creditors stand in the same ranking. Now, if the statute pushes the operational creditors to two notches below the unsecured financial creditors, it is important to question the *vires* of the statute in doing so.

The idea of BLRC to distinguish financial and operational creditors for constitution of committee of creditors is still understandable. The objective might have been based on the consideration that the operational creditors are many, and diversified, and therefore, they may not be in a position to vote on a resolution plan. In any case, many of them may not have the financial acumen required to understand and vote on resolution plans. **But** if the discussion stretches to priority ranking in the waterfall as well, then there are essential questions of principle to be raised.

Subordination of Operational Creditors Under IBC: Whether Equitable

The BLRC, in its report [page 14], states –

“The Committee has recommended to keep the right of the Central and State Government in the distribution waterfall in liquidation at a priority below the unsecured financial creditors in addition to all kinds of secured creditors for promoting the availability of credit and developing a market for unsecured financing (including the development of bond markets). In the long run, this would increase the availability of finance, reduce the cost of capital, promote entrepreneurship and lead to faster economic growth.”

The BLRC recommendation, as above, justifies the preferential treatment of unsecured financial creditors over government dues but does not provide any reasoning for not treating unsecured financial and operational creditors at par.

8. Economic argument of operational creditors

As such, the prioritisation under section 53 fails to consider and appreciate the following –

(i) An economy runs not merely on the financial system, but on the system of supply of goods and services. Goods and services are supplied for credit, which is why operational creditors arise. Supply of goods and services on credit becomes a part of the working capital for the entity, which exactly serves the same purpose as served by financial lenders.

(ii) Supply of goods and services on credit is a crucial part of the economy. The base of the economy of any country is its real sector; financial sector is important, but not at the cost of the real sector. Suppliers of goods and services, including MSMEs, are a part of the real sector.

(iii) How will MSMEs continue to supply goods and services on credit to their customers, if they were to be told that if the customer goes into a default, all the money will go first to bankers, and money will be paid to the suppliers only if there is a surplus left?

9. Concluding Remarks

For the reasons discussed above, the distinction between unsecured creditors, *inter-se*, does not appear to be intelligible; or even if it is intelligible, it lacks economic rationale. The approach for prioritisation under section 53 does not seem to be consistent with the umbrella objective of equitable treatment.

The *vires* of distinction between financial and operational creditors has already been challenged before the courts, with Calcutta High Court upholding such distinction [refer, [Akshay Jhunjhunwala & Anr. v. Union of India through the Ministry of Corporate Affairs & Ors.](#), W.P. No. 672 of 2017], and the Supreme Court directing the High Courts to refrain from entering the debate [refer, [Shivam Water Treaters Private Limited v. Union of India & Ors.](#), SLP No.1740/2018]. However, the way the distinction has percolated the priorities under section 53, is yet to be taken up for discussion and debate.

Beyond the Lines . . .

The Hon'ble Supreme Court, in the matter of [Rajputana Properties Pvt. Ltd. v Ultratech Cement Ltd. & Ors.](#), held that dues of operational creditors must get at least similar treatment as compared to the dues of financial creditors, if not same. *Vide* its order, the Hon'ble Supreme Court, upheld the order of the National Company Law Appellate Tribunal by which the Resolution Plan proposed by Rajputana Properties was identified as discriminatory towards the Operational Creditors and as such was not approved by the Appellate Authority.

The principle that treatment can be differential but not discriminatory was very evidently put forward by the Hon'ble Supreme Court.

THE CURIOUS CASE OF HOME BUYERS: ALL IS WELL?

- **Sikha Bansal**

Editor's Notes: IBC does not confer a right to initiate application, to creditors other than financial and operational creditors. Home buyers, who made prepayments to real estate promoters were thus unable to take recourse to IBC, as NCLTs, in majority cases, held that the home buyers are neither financial nor operational creditors. Though, where the home buyer was assured a guaranteed return, the same was considered to be a financial debt. In view of the concerns surrounding safeguarding the interests of home buyers, the definition of 'financial debt' was amended vide Insolvency and Bankruptcy Code, (Second Amendment) Act, 2018, to create a deeming effect that any amount raised from a real estate allottee shall be 'deemed' to be having 'commercial effect of borrowing'.

Therefore, having being conferred the status of 'financial creditor', the home buyers are in a position to initiate corporate insolvency resolution process in respect of the defaulting real estate entities and be a part of the CoC therein – however, is this a happy ending? This critique examines the potential effectiveness of the amendment.

All the hullabaloo surrounding the inclusion of “home-buyers” in the category of financial creditors was put to rest by the promulgation of the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018 (“the Ordinance”). The Ordinance amends the definition of “financial debt” u/s 5 (8) of the Insolvency and Bankruptcy Code, 2016 (“IBC”) so as to include in clause (f):

The Ministry of Corporate Affairs stated:

“The Ordinance provides significant relief to home buyers by recognizing their status as financial creditors. This would give them due representation in the Committee of Creditors and make them an integral part of the decision making process. It will also enable home buyers to invoke Section 7 of the Insolvency and Bankruptcy Code (IBC), 2016 against errant developers.”

“any amount raised from an allottee under a real estate project shall be deemed to be an amount having the commercial effect of a borrowing”

The Ministry of Corporate Affairs, in a statement released in respect of the Ordinance, stated:

“The Ordinance provides significant relief to home buyers by recognizing their status as financial creditors. This would give them due representation in the Committee of Creditors and make them an integral part of the decision making process. It will also enable home buyers to invoke Section 7 of the Insolvency and Bankruptcy Code (IBC), 2016 against errant developers.”

At the outset, it might be interesting to note that the amounts raised from the allottees, in every case, might not be classifiable as financial debts in substance. For instance, where allotment/contract is *cancelled* by the home-buyer and there is a

claim of return of principal sum with interest, the NCLT in [Pawan Dubey & Another v. M/s J. B. K Developers Private Limited](#) held that such an amount cannot be claimed as a financial debt. The

Ordinance makes no distinction for these cases and creates a “deeming” provision, by using the words “*deemed to be an amount having the commercial effect of a borrowing*”.

Is this happy ending? A pensive thought refuses accepting that all is well.

What about the priority?

Been accorded the status of “financial creditors”, the home-buyers will get a seat on the CoC. As such, they can exercise their voting rights to decide on resolution or liquidation of the entity.

However, being a financial creditor and being a secured one, are two different things. The Code, while introducing the differentia as to operational and financial creditors has retained the conventional classification of secured and unsecured creditors too. The same is evident from the definition of “financial debt” and “secured debt” and also priority enlisted under section 53 of the Code. As such, a financial creditor need not be a secured creditor.



While the Ordinance postulates home buyers as financial creditors, there has been no clarification as to such creditors being secured or unsecured. No changes have been made in section 53 to allot a specific priority to the home-buyers. As such, the monies of home-buyers will fall under clause (d), i.e. financial debts to unsecured creditors.

A secured creditor, irrespective of whether financial or operational, occupies second priority at par with workmen’s dues. However, financial debts owed to unsecured financial creditors rank after the dues of secured creditors, workmen, employees [for specified periods].

Therefore, the benevolent Ordinance seems to have performed the job partly. The home-buyers might still be left in a dry.

Home, Sweet home?

The entire exercise will very much depend upon whether the home-buyers are keener to get their flats ready or just get refund of their money. Say, if the objective of home-buyers is to get their flats ready, the recourse under the Code will not be of much help. The only feeble way in which they can ensure this is to utilize their voting rights to stall liquidation and get the corporate debtor in resolution mode, so that their flats can be completed and handed over to them.

On the other hand, if the objective of the home-buyers is to get their money back, as stated earlier, they do not seem to be at an advantageous position. The liquidation value ascribable to them would be very low in view of their sub-ordinated priority in the waterfall. As such, whether resolution or liquidation, there are fragile chances of home-buyers regaining their hard-earned money.

Why not RERA?

Section 18 read with section 19 (4) of the Real Estate (Regulation and Development) Act, 2016 already provides for refund of amount of allottees if the promoter fails to complete or is unable to

***The Curious Case of Home Buyers:
All is Well?***

give possession of the property. Several provisions of RERA stipulate adjudication of compensation and penalty for non-compliances by promoters.

In situations where the promoter fails to deliver the flats as well as refund the said amounts, and for some reasons also goes into insolvency before NCLT; there seems no benefit for the home-buyers to be a part of CoC, for reasons cited above. That is, in any case, the monies they would get would be limited to the extent of “liquidation value”.

Hence, the home-buyers are in no better situation, so far as return of their own money is concerned.

In search of a better deal . . .

For reasons as above, it seems that IBC is not a holistic shelter for the home-buyers.

Instead of awarding the status of financial creditor to the home-buyers, a better solution would have been to define the priority of home-buyers such that they could get their refunds alongside the dues of secured creditors and workmen.

There would have been another probable solution: RERA provides for maintaining a separate account for depositing the amounts realized for the real estate project from the allottees, from time to time, to cover the cost of construction and the land cost. Such a provision, in a manner, implies that the moneys so obtained by the promoters would be in the nature of money held in trust. Applying the analogy, if the money taken from home-buyers is accorded the status of “money held in trust”, the corpus will not be a part of the “assets” or “liquidation estate” of the promoter entity, and therefore would be out of the purview of section 53.

However, for the time being, the possible solution before home-buyers is either RERA or the amendment brought in by the Ordinance. The efficacy of this amendment will be pronounced only in times to come.

In the news....

Despite rule-making, confusion still prevails regarding voting by home buyers.

The insolvency process of Jaypee Infra has been in the news ever since its commencement. While the role of Jaypee Infra has been immense in recognizing Home Buyers as a class of creditors, most recently, the Hon'ble National Company Law Tribunal, Principal bench has rejected a plea by a group of homebuyers to treat them as a separate.

The plea was made in light of the fact that any home-buyers were not present at the CoC meeting due to which despite having claims of upto 58.2% voting share, the votes constituted only around 31% of the votes casted at the meetings and as such has acted as a setback for plan to shore up votes for NBCC bid.

The appellate bankruptcy court on June 10 declined to pass an order on Jaypee Infratech's prime lender IDBI's petition opposing NBCC's bid to take over the embattled firm and said that its lenders are free to vote for or against the bid. Earlier, on the bankers' plea, the NCLAT had on May 17 annulled voting by homebuyers and lenders on NBCC's bid and allowed a renegotiation on the offer by May 30

AMENDMENT IN DELISTING REGULATIONS: AXING THE MINORITY RIGHTS

- **Sikha Bansal**

Editor's Notes: SEBI (Delisting of Equity Shares) Regulations, 2009 provide exit opportunity to existing shareholders when the company seeks to delist its equity shares from stock exchanges – such opportunity is necessary as 'listing' carries an inherent feature of 'liquidity' which gets curbed when the shares are 'delisted'.

Facilitating smooth implementation of IBC called for supportive amendments in various SEBI regulations, including the delisting regulations. The amendment calls for inapplicability of the regulations where delisting is done pursuant to a resolution plan approved under IBC – this, however, is subject to the condition that the public shareholders get exit price which shall not be less than the liquidation value.

The note below studies if this is at all a fair deal for the minority shareholders.

A protective framework for minority shareholders ensures a robust and dynamic secondary market for securities. As such, the laws shall aim shielding the rights of minority shareholders in disadvantageous circumstances, ensuring that the market is safe and that the possibilities of them losing out on their monies is unlikely except when the market goes red. This holds true as conventional wisdom and as such, there should have been no exceptions while facilitating implementation of the Code.

Magical resolution plans?

However, the regulators seem to have relied on the magic of resolution plans framed under IBC so much so that in one of the [Circulars](#) [October, 2017], the Ministry of Corporate Affairs clarified that the approval of the shareholders of the corporate debtor for a particular action required in the resolution plan for its implementation, which would have been required under Companies Act, 2013 or any other law if the resolution plan was not being considered under IBC, is *deemed to have been given* on its approval by the adjudicating authority [i.e. NCLT].

Endorsing the above, SEBI came up with a [Discussion Paper](#) [March, 2018], soliciting views on compliance requirements by listed entities undergoing corporate insolvency resolution process under IBC. The Discussion Paper, among other things, proposed relaxations in the provisions of the LODR Regulations, 2015 as well as the Delisting Regulations, 2009.

The notion of an *all-pervasive all binding* resolution plan is based on section 31 of IBC which says that a resolution plan approved by NCLT shall be binding on the corporate debtor and its employees, members, creditors, guarantors and other stakeholders involved in the resolution plan. The conclusion arrived at by the regulators fails to appreciate that resolution plan, though a statutory plan, is substantially a contract between the financial creditors, the existing promoters, and the potential acquirer of the corporate debtor. All others, *viz.* operational creditors and minority shareholders are merely spectators bound by the resolution plan. Section 30 (2) of IBC provides for

repayment of liquidation value due to operational creditors and to dissenting financial creditors; however, is completely silent on the rights of minority shareholders.

Amendment in Delisting Regulations

The Delisting Regulations regulates the conditions under which, and the procedure by which, it is possible to delist the securities of a listed entity. The delisting regulations provide for an exit opportunity for existing shareholders at a price determined through reverse book building process. The reason behind providing this exit opportunity at a market-determined price is simple – the investments which the existing shareholders hold in liquid form will become illiquid once the shares are delisted; hence, leaving the shareholders with no option but to tender their shareholdings at whatever price being offered to them by principal shareholders. The exit opportunity ensures a fair bargain for the minority shareholders.

SEBI, recently *vide* [SEBI \(Delisting of Equity Shares\) \(Amendment\) Regulations, 2018](#) [“the amendment”], has amended the delisting regulations to provide that these regulations shall not apply to any delisting of equity shares of a listed entity made pursuant to a resolution plan approved under IBC, provided *any of* the following 2 conditions are fulfilled –

- The resolution plan lays down specific procedure to complete the delisting; *or*
- The resolution plan provides exit opportunity to the existing public shareholders at a specified price, which ***shall not be less than the liquidation value*** ascribed in accordance with section 53 of IBC. However, where existing promoters/any of the shareholders, whether directly or indirectly, are allowed exit at a higher price (i.e. higher than the liquidation value), the public shareholders shall receive no less.

The Amendment assures the public shareholders of getting a minimum of liquidation value where the corporate debtor is sought to be delisted pursuant to a resolution plan. Interestingly, the expression “liquidation value to equity-holders” sounds like an oxymoron in the context of insolvent liquidations.

Fruits of the amendment? One positive effect is easing out the process for the acquirers; however, the news might not be so good for the minority shareholders.

The liquidation value assurance: a careless concern

The amendment assures the public shareholders of getting a minimum of *liquidation value* where the corporate debtor is sought to be delisted pursuant to a resolution plan. Interestingly, the expression “*liquidation value to equity-holders*” sounds like an oxymoron in the context of *insolvent liquidations*. Had there been a liquidation value attributable to equity-holders, there would have been no question of insolvency. A positive liquidation value to equity-holders implies that there is enough for the debt-holders to have their dues paid off. So, where is the insolvency?

Amendment in Delisting Regulations: Axing the Minority Rights

That makes it clear - one can expect nothing but erosion of value in the hands of minority shareholders. Liquidation value attributable to an equity-holder in an insolvent entity, in usual cases, would not be more than *nil*. Consequentially, the market value of the public shareholding comes down to *zero*. Hence, the exit opportunity at liquidation value is not even a deal for minority. So, where is the minority protection? Unfortunately, it seems to have lost in the amendment.

Minority to be blamed?

A point often in argument is when a company goes insolvent, the creditors take control and that the equity-holders should take a backseat. So, classification as a principal shareholder or as a minority shareholder is irrelevant.

The amendment seeks to equalize the exit value available to minority shareholders with the exit value offered to principal shareholders. The amendment says where the existing promoters or any other shareholders are provided an opportunity to exit at better prices, the existing public shareholders shall also be provided exit opportunity at least at the same price. In liquidations under IBC, promoters' equity being written off is not uncommon. Hence, the utility of this provision in safeguarding the worth of minority shareholders' investments is questionable.

Besides, this idea of keeping a principal shareholder and a minority shareholder at the same pedestal seems to neglect the very fact that minority shareholders have negligible say in the business decisions of the entity, even if they exercise their right to vote. So, the eventuality of a principal shareholder not getting anything shall not preclude a minority shareholder from receiving his paper's worth. The position of a minority shareholder in resolution process is no better than an operational creditor – no opportunity of being heard, no representation in the decision-making body, and yet bound by whatever has been decided by a completely different set of stakeholders.

It may be noted that similar exemption was there for schemes framed under BIFR regime, if the scheme provided an exit option to the existing public shareholders at a specified rate. The intent was clear, that is, protection of the rights of minority shareholders. Notably, there was no concept of "liquidation value" during BIFR regime. This is evident of the underlying objective of such regulations – where an entity is sought to be delisted, those not agreeing to such delisting should be allowed to disagree (and therefore, exit), by taking their fair share.

What's the solution?

Regulatory dicta like these seem to turn a Nelson's eye to the basic tenets of law-making including principles of natural justice; and fundamental democratic set-up of company law. The fallacy of guaranteed liquidation values during the resolution phase might not work well in serving the interests of those who have not been parties to the resolution plan. The big question is regarding determination of the value of the minority shareholding. The answer probably lies in the difference between the fair value of the entity and the total debts.

There was definitely a need for amending the delisting regulations and making things easier for the acquirer; however, it is to be ensured that the same does not send negative ripples across the secondary market.

ROLE OF ADJUDICATING AUTHORITY IN APPROVING/ REJECTING A RESOLUTION PLAN

- **Richa Saraf & Ananya Raghuvendra**

Editor's Notes: A resolution plan submitted by a resolution applicant has to pass through various filters before being sent to the Adjudicating Authority for its approval. The plan has to comply with the conditions as laid down in section 30 (2) of the Code – the resolution professional shall examine each resolution plan received vis-à-vis the mandatory conditions. Only such resolution plans which fulfil the conditions are passed on to the CoC, which may approve a plan with 66% majority. The plan approved by CoC is submitted to the Adjudicating Authority for its sanction. A resolution plan so sanctioned becomes binding on all stakeholders involved in the resolution plan.

Now, questions arise as to the extent of discretion or mind which the Adjudicating Authority can exercise while considering approval/rejection of resolution plan – Shall it adopt “tick mark” approach? Can it go into commercial details and justness of the plan? Can it reject what the CoC, in its wisdom, has decided to approve by majority? The articles discusses some recent rulings in the context

The insolvency resolution process of Binani Cements have been through various ups- and downs. On 19.11.2018, the Hon’ble Supreme Court in the case of *Rajputana Properties Pvt. Ltd. v. UltraTech Cement Ltd. & Ors.* dismissed Dalmia Bharat’s plea to seek stay on Ultratech’s bid for Binani Cement, upholding the UltraTech Cement’s bid for Binani Cement sale. Previously, on 14.11.2018, the NCLAT had also held UltraTech’s offer for Binani Cement as valid, stating that Dalmia Bharat’s offer was discriminatory against some creditors.

The primary question that arises out of all this chaos is whether Tribunals are allowed to intervene in the functions of the CoC and overturn their decisions in respect to resolution plans. The UK Insolvency Act, 1986 provides for remedies in case the voluntary agreement is either unfairly

prejudicial to the interests of creditors or there has been some material irregularity in relation to the relevant qualifying decision procedure. Despite no specific provision existing in the Insolvency and Bankruptcy Code, 2016, the Adjudicating Authority has, in various cases, expanded the scope of its power under Section 31 in examining resolution plans and in a way, provided remedies for creditors whose interests have been affected. The article tries to answer the question, by analyzing the case in hand.

Rajputana Properties Pvt. Ltd. v. UltraTech Cement Ltd.

- *Rajputana discriminated b/w FC who are equally situated & did not balance the interest of OC.*
- *NCLAT held that the plan of Rajputana was discriminatory and hence, rejected it.*

Facts of the Case:

The Tribunal noted that Rajputana Properties Private Limited in its resolution plan had discriminated between some of the financial creditors who are equally situated and did not balance

the interest of stakeholders such as operational creditors. The non-application of mind by the CoC and the discriminatory behaviour in approving the plan was apparent. The NCLAT held that the plan of Rajputana Properties Private Limited was discriminatory and contrary to the scheme of the Code. It further held that if the resolution plan is shown to be discriminatory against any one or other financial creditor(s) or operational creditor(s), such plan can be held to be against the provisions of the Code.

The Adjudicating Authority held that merely because a discriminatory plan has been placed before the CoC and has received their approval, does not mean that it should be approved by the Adjudicating Authority, as the same will be against the basic object of maximization of the assets of the corporate debtor on one hand and the object of balancing the stakeholders on the other hand.

The two major issues considered by the Tribunal was:

- Whether CoC has discriminated between the eligible resolution applicants, while considering the resolution plan of Rajputana Properties Private Limited?
- Whether the resolution plan submitted by Rajputana Properties Private Limited is discriminatory?

The Tribunal considered the financial terms of the plans to establish that the CoC has discriminated between the resolution applicants, which was evident from the fact that the proposal for negotiation and better proposal given by the Ultratech Cement Limited was not at all considered. The Tribunal also pointed out that the RP as well as the CoC are duty bound to ensure maximization of value within the time frame prescribed under the Code, and observed that the object in finding out a resolution applicant who can offer maximum amount so as to safeguard the interest of all stakeholders of the corporate debtor is lacking from the side of the CoC.

“with respect to a plan rejected by the CoC, considering that the AA cannot approve a plan unless approved by the requisite majority of CoC, the NCLAT held that the AA cannot revisit the decision of CoC to determine the viability and feasibility of a resolution plan”

Scope and Extent of Power Vested on the Adjudicating Authority:

Earlier, in [Bhaskara Agro Agencies v. Super Agri Seeds](#), with respect to a plan rejected by the CoC, considering that the Adjudicating Authority cannot approve a plan unless approved by the requisite majority of CoC, the NCLAT held that the Adjudicating Authority cannot revisit the decision of CoC to determine the viability and feasibility of a resolution plan, and in the case of [Darshak Enterprise Pvt. Ltd. v. Chhaparia Industries Pvt Ltd](#), NCLAT held that in absence of any discrimination or perverse decision, it is not open to the Adjudicating Authority or this Appellate Tribunal to modify the plan.

However, it failed to note that one of the conditions precedent to the approval of a plan by the Adjudicating Authority is “satisfaction”. This implies that for a resolution plan to receive the approval of the Adjudicating Authority, it must be “satisfied” that the resolution plan approved by the CoC meets the requirements of Section 30(2). This principle was applied by the Hon’ble Supreme Court, wherein it examined certain extracts of the resolution plan to ascertain the eligibility of the resolution applicant, in [Arcelor Mittal India Private Limited v. Satish Kumar Gupta](#)⁴⁰. The Apex Court

⁴⁰ Ibid

Role of Adjudicating Authority In Approving/ Rejecting a Resolution Plan

deliberated on the extent to which the Adjudicating Authority can exercise the power under the provisions of Section 31, and the following observations were made:

- Once a plan is approved by the CoC, it is to be submitted to the Adjudicating Authority; and at that stage, a judicial mind is applied by the Adjudicating Authority, who then, after being satisfied that the plan meets (or does not meet) the requirements mentioned in Section 30, may either approve or reject such plan.
- The Adjudicating Authority, acting quasi-judicially, can determine whether the resolution plan violates the provisions of any law, including Section 29A of the Code, after hearing arguments from the resolution applicant as well as the CoC.

In [Pratik Ramesh Chirana v. Trinity Auto Components Ltd](#) as well, NCLT, Mumbai Bench interpreted the phrase “if the adjudicating authority is satisfied...” under Section 31, observed that “satisfaction” must be objective, subjective or both, and to form an opinion, thorough study of a resolution plan is required.

- **Objective Satisfaction:** The objective satisfaction revolves around the object of enactment of the Code, enshrined in the Preamble.
- **Subjective Satisfaction:** This depends upon logical analysis of the financial data supplied, where a methodical scrutiny of the financial statement is expected before concurring with approval of the CoC.

Again, in the case of [J.R. Agro Industries P Limited v. Swadisht Oils Pvt Ltd.](#), it was observed that the pros and cons of the resolution plan must be studied and if the Tribunal approves the plan, it should record in writing its satisfaction, in the judgement approving the resolution plan.

Global Provisions:

In countries like UK and US, there are provisions which provide remedies to creditors against unfair prejudice. [Section 6](#) of the UK Insolvency Act, 1986 provides that an application can be filed by any aggrieved person, on the following grounds:

That the voluntary arrangement **unfairly prejudice** the interests of a creditor, member or contributory of the company; and/ or

That there has been some **material irregularity** at or in relation to either of the meetings, the meeting of the company or in relation to the relevant qualifying decision procedure.

If the court is satisfied as to either of the grounds mentioned above, it may either revoke or suspend the decision approving the voluntary agreement or give directions to summon further meetings, to consider any revised proposal or reconsider the original proposal.

In the case of **Daewoo Singapore Pte Ltd. v. CEL Tractors Pte Ltd.** [2001] SGCA 53, Singapore Court of Appeal held that:

“After a scheme is accepted by the creditors, an objecting creditor can persuade the court to withhold its approval, or to approve it subject to such alternatives or conditions as it thinks fit. The objecting creditor would succeed if he can show that the creditors did not vote bona fide for the benefit of the creditors or the company as a whole, or that the scheme is not fair and reasonable.”

US courts follow a cramdown test, wherein the court approves the plan over the objections of the creditor(s), if the plan does not discriminate unfairly, and is “fair and equitable”. The principle requires that the plan meet certain standards of fairness and is in best interest of creditors. The court may confirm over a dissent if the members of the class are unimpaired. Subsection 1129(a) of US Bankruptcy Code enumerates the requirement governing confirmation of a plan. The court is required to confirm a plan if and only if all of the following requirements are met:

- (i) plan comply with the applicable provisions of chapter 11, governing contents of the plan; and
- (ii) plan have been proposed in good faith, and not by any means forbidden by law⁴¹.

The criterion of unfair discrimination is not derived from the fair and equitable rule or from the best interests of creditors test; rather it preserves just treatment of a dissenting class from similarly placed class. Though different courts employ different tests in determining whether a plan is discriminates unfairly. In essence, a plan does not discriminate unfairly with respect to a dissenting class if the plan protects the legal rights of a class in a manner inconsistent with the treatment of other classes that hold similar rights. Again, no plan is approved if the principal purpose of the plan is the avoidance of taxes, or if the court determines that the plan is not feasible.

Concluding Remarks:

The present case of Binani Cements clarified one thing that the approval of the Adjudicating Authority is not a mere requirement/ formality, although the Adjudicating Authority is not permitted to alter the terms of the plan, the ultimate authority to approve or reject a plan vests with the Adjudicating Authority, and for that it should consider the following aspects:

- (i) whether the plan complies with the requirements of Section 30(2)?
- (ii) whether the plan is fair and equitable or there is any unjust discrimination not envisaged in law?
- (iii) whether the plan adheres to the object of the Code i.e. maximises the value of assets and balances the interests of all the stakeholders?

Only if the aforesaid questions are answered in satisfactory, the plan is confirmed, if not the Adjudicating Authority may deny its confirmation.

⁴¹<https://www.law.cornell.edu/uscode/text/11/1129>

Role of Adjudicating Authority In Approving/ Rejecting a Resolution Plan

Know More . . .

The Hon'ble Supreme Court in the matter of *K Sashidhar v. Indian Overseas Bank and Ors.* laid down that National Company Law Tribunal has no jurisdiction and/ or authority to analyse or evaluate the decision of the Committee of Creditors (CoC) to enquire into the justness of the rejection of the resolution plan by the dissenting financial creditors. It is at this stage that a judicial mind is applied by the Adjudicating Authority to the resolution plan so submitted, who then, after being satisfied that the plan meets (or does not meet) the requirements mentioned in Section 30, may either approve or reject such plan. An appeal from an order approving such plan is only on the limited grounds laid down in Section 61(3).

Upon receipt of a "rejected" resolution plan the Adjudicating Authority is not expected to do anything more; but is obligated to initiate liquidation process under Section 33(1) of the I&B Code. The legislature has not endowed the Adjudicating Authority with the jurisdiction or authority to analyse or evaluate the commercial decision of the CoC muchless to enquire into the justness of the rejection of the resolution plan by the dissenting financial creditors.

ADJUDICATORY TIME LIMIT PRESCRIBED BY IBC NOT MANDATORY

- **Richa Saraf**

Editor's Notes: The Preamble of the Code describes IBC as "An Act to consolidate and amend the laws relating to reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time-bound manner...". As such, IBC envisages timelines to be followed by parties. While there are time limits for each party (the IRP, RP, bidder, claimant, etc.), there are several time limits for the adjudicatory authorities as well. Are the latter mandatory? While judicial thinking in this regard has been discussed in the article, it is humbly submitted that the tight timelines and the objective of putting India's insolvency resolution in a different trajectory than in the past will be realised only if the timelines are followed by every participant in the process.

In the case of *Surendra Trading Company v. Juggilal Kamlapat Jute Mills Co. Ltd. & Ors.*, the Apex Court was concerned with the correctness of the order passed by NCLAT whereby it was held that the time of 7 (Seven) days prescribed in proviso to section 9(5) of the Insolvency and Bankruptcy Code, 2016 (IBC), for admitting or rejecting a petition or initiation of insolvency resolution process, is mandatory in nature and the Hon'ble Supreme Court has set aside part of the impugned judgment of NCLAT. The ruling is broadly discussed below.

Timeline laid down for AA:

To ascertain admissibility
of Application- 14 days

Provision of Law:

IBC stipulates time limits for taking certain actions by either the operational creditor or adjudicating authority. As per section 9 (1), application can be filed after the expiry of period of 10 (Ten) days from the delivery of notice or invoice demanding payment, which is in tune with the provisions contained in section 8 that gives 10 (Ten) days' time to the corporate debtor to take any of the steps mentioned in section 8 (2). As per section 9(5), once such an application is filed and received by the adjudicating authority, 14 (Fourteen) days' time is granted to the adjudicating authority to ascertain whether default on the part of corporate debtor exists or not. In case the adjudicating authority, after the scrutiny of the application, finds that there are certain defects therein, the proviso to section 9 (5) mandates that before rejecting the application, the adjudicating authority has to give a notice to the applicant to rectify the defect in his application within 7 (Seven) days of receipt of such notice.

View Taken By NCLAT:

The statutory scheme laying down time limits sends a clear message that time is the essence of IBC. Notwithstanding this salutary theme and spirit behind the Code, the NCLAT has concluded that as far as 14 (Fourteen) days' time provided to the adjudicating authority for admitting or rejecting the application for initiation of insolvency resolution process is concerned, this period is not mandatory,

Time Limit for Adjudicating Authority- Not Mandatory

whereas period of 7 (Seven) days given to the operational creditor for rectifying the defects is mandatory in nature. The relevant extract of the judgment is reproduced hereunder-

“43. Thus, in view of the aforementioned unambiguous position of law laid down by the Hon’ble Apex Court and discussion as made above, we hold that the mandate of sub-section (5) of section 7 or sub-section (5) of section 9 or sub-section (4) of section 10 is procedural in nature, a tool of aid in expeditious dispensation of justice and is directory.

44. However, the 7 days’ period for the rectification of defects as stipulated under proviso to the relevant provisions as noticed above is required to be complied with by the corporate debtor whose application, otherwise, being incomplete is fit to be rejected. In this background we hold that the proviso to sub-section (5) of [section 7](#) or proviso to sub-section (5) of [section 9](#) or proviso to sub-section (4) of [section 10](#) to remove the defect within 7 days are mandatory, and on failure applications are fit to be rejected.”

Judgment Of Supreme Court:

The Hon’ble Supreme Court has observed that the nature of the provisions contained in section 7 (5), 9 (5) and 10 (4) of IBC is procedural in nature cannot be treated to be a mandate of law. The object behind the time period prescribed under the aforementioned sections is to prevent the delay in hearing the disposal of the cases and the Adjudicating Authority cannot ignore the provisions, but in appropriate cases, for the reasons to be recorded in writing, it can admit or reject the petition after the period prescribed under section 7, 9 or 10. Also, at times applicants or their counsel may show laxity by not removing the objections within the time given and make take it for granted that they would be given unlimited time for such a purpose. There may also be cases where such applications are frivolous in nature which would be filed for some oblique motives and the applicants may want those applications to remain pending and, therefore, would not remove the defects. In order to take care of such cases, a balanced approach is needed.

The Apex Court also opined that the object of specified timelines is to expedite the hearing and not to scuttle the same. The process of justice may be speeded up and hurried but the fairness which is a basic element of justice cannot be permitted to be buried. Stipulating time limit spells out a disability on the applicant but does not impose an embargo on the power of the court to extend the time. Such provision, being in the domain of the procedural law, has to be held directory and not mandatory.

Some relevant cases cited in this regard are as hereunder.

Hon’ble Supreme Court in *Smt. Rani Kusum v. Smt. Kanchan Devi*:

- *“...Unless compelled by express and specific language of the statute, the provisions of CPC or any other procedural enactment ought not to be construed in a manner which would leave the court helpless to meet extraordinary situations in the ends of justice...”*
- *“...A procedural law should not ordinarily be construed as mandatory; the procedural law is always subservient to and is in aid to justice. Any interpretation which eludes or frustrates the recipient of justice is not to be followed....”*

In *P.T. Rajan Vs. T.P.M. Sahir and Ors.*⁴², the Hon'ble Supreme Court observed that where Adjudicating Authority has to perform a statutory function like admitting or rejecting an application within a time period prescribed, the time period would have to be held to be directory and not mandatory. In the said case, Hon'ble Apex Court observed:

"48. It is well-settled principle of law that where a statutory functionary is asked to perform a statutory duty within the time prescribed therefor, the same would be directory and not mandatory. (See [Shiveshwar Prasad Sinha v. The District Magistrate of Monghur & Anr.](#) AIR (1966) Patna 144, [Nomita Chowdhury v. The State of West Bengal & Ors.](#) (1999) CLJ 21 and [Garbari Union Co-operative Agricultural Credit Society Limited & Anr. V. Swapan Kumar Jana & Ors.](#) (1997) 1 CHN 189).

49. Furthermore, a provision in a statute which is procedural in nature although employs the word "shall" may not be held to be mandatory if thereby no prejudice is caused."

The Hon'ble Supreme Court in the matter of [Smt. Rani Kusum v. Smt. Kanchan Devi](#)⁴³, concurring with the ratio laid down in *Kailash v. Nanhku and Ors.*⁴⁴ held-

"10. All the rules of procedure are the handmaid of justice. The language employed by the draftsman of processual law may be liberal or stringent, but the fact remains that the object of prescribing procedure is to advance the cause of justice. In an adversarial system, no party should ordinarily be denied the opportunity of participating in the process of justice dispensation. Unless compelled by express and specific language of the statute, the provisions of CPC or any other procedural enactment ought not to be construed in a manner which would leave the court helpless to meet extraordinary situations in the ends of justice.
**

*** 12. The processual law so dominates in certain systems as to overpower substantive rights and substantial justice. The humanist rule that procedure should be the handmaid, not the mistress, of legal justice compels consideration of vesting a residuary power in the judges to act *ex debito justitiae* where the tragic sequel otherwise would be wholly inequitable. Justice is the goal of jurisprudence, processual, as much as substantive. (See [Sushil Kumar Sen v. State of Bihar](#) [(1975) 1 SCC 774])*

*13. ** A procedural law should not ordinarily be construed as mandatory; the procedural law is always subservient to and is in aid to justice. Any interpretation which eludes or frustrates the recipient of justice is not to be followed. (See [Shreenath v. Rajesh](#) [(1998) 4 SCC 543: AIR 1998 SC 1827])*

14. Processual law is not to be a tyrant but a servant, not an obstruction but an aid to justice. Procedural prescriptions are the handmaid and not the mistress, a lubricant, not a resistant in the administration of justice."

Analysis:

⁴²(2003) 8 SCC 498

⁴³(2005) 6 SCC 705

⁴⁴(2005) 4 SCC 480

***Time Limit for Adjudicating Authority-
Not Mandatory***

As correctly pointed out in the instant case, the power of the court to extend time beyond the time schedule cannot be completely taken away. However, such extension shall not be granted just as a matter of routine and merely for the asking, more so when the period stipulated under IBC has expired. Extension of time may only be allowed on the satisfaction of the court that there existed exceptional circumstances, occasioned by acts beyond the control of the applicant and that non-extension would cause grave injustice. Further, affidavit or documents in support of the grounds pleaded for extension may be demanded, the reasons assigned by the applicant shall be placed on record in writing by the court and the court may also impose costs.

INTERIM FINANCING BECOMES EFFECTIVE AND ATTRACTIVE

- **Megha Mittal**

Editor's Note: *Interim Finance is no less than an SOS when it comes to an insolvent company in corporate insolvency resolution process. In order to keep the entity as a going concern during the process or even maintain the entity as is, it is crucial to have a minimum liquidity – the situation becomes more critical when the company is already running into losses and has nil or depleting cash reserves. Interim finance provides for these emergency/urgent outflows. For this very reason, interim finance is accorded super-priority in payment waterfall across jurisdictions.*

However, for all commercial wisdom, the privilege of super-priority may not be sufficient for the interim financier to block its funds in an insolvent company, the fate of which lies uncertain. As such, the interim-financier has to be duly incentivised in terms of "return on investment", and "return of investment", so as to encourage interim-lending practices. As such, the Liquidation Regulations were amended to provide for interest on interim-finance post commencement of liquidation. The article discusses the amendment and its impact.

Interim financing, known by various names such as rescue financing, DIP financing, post-petition financing, etc., is a very important way for companies into resolution proceedings to financethemselvesforpressingfundingneeds,whetherforkeepingtheiroperationsgoingorfor the very effort of coming of distress. Globally, rescue financing is not merely the way for beleaguered companies to find their way to survival, it is also an attractive lendingopportunity.

With nearly 15 months of experience of resolutions in India, several companies in resolution have used interim financing; many lenders have also created lending desks for such funding. However, one of the biggest hurdles was the fact that there was no interest accrual once liquidation proceedings commence. This is the same for any lender - including a rescue lender. As a result, the interim financier faced the threat of losing interest for the number of months it would take to liquidate the assets of the company to do a take-out for the rescue financier. The amended Liquidation Regulations try to resolve the issue. This article discusses this new opportunity.

Interim finance means any financial debt raised by the resolution professional during the insolvency resolution process period

Introduction:

As per section 5(15) of the Insolvency and Bankruptcy Code, 2016 ("Code"), "interim finance" means any financial debt raised by the resolution professional during the insolvency resolution process period.

In simple words, as the name suggests, the term refers to the funds that the RP raises during the CIRP so as to retain the going concern nature of the entity and to carry out regular expenditure required for the same, until a resolution plan is approved by the CoC and

Interim Financing Becomes Effective & Attractive

subsequently by the NCLT.

Why is it needed?

As we know, while the CIRP is under process, the RP has to ensure the going concern status of the Corporate Debtor. While doing so, the RP has to make certain payments at any circumstances like payment to professionals appointed (valuers, RPs fees, etc.), payment to the workmen, payment to the security personnel etc, which are vital and cannot be kept on hold until the approval of the resolution plan. The cashflows of the entity may have dried up completely or may be insufficient to make such outlays. To make such payments, the RP surely requires funds and, at times, the company is not in a position to generate even the bare minimum amount required to cater the payments illustrated above.

In such cases, the RP raises interim fund subject to the permission of the CoC.

What is the priority of repayment of interim fund?

As per section 53 read with section 5(13), “the amount of any interim finance and the costs incurred in raising such finance” being a part of insolvency resolution process cost takes the first priority under sec 53 (1) (a). This is true for both the repayment of principal as well as payment of interest on interim financing. Both of these qualify, along with other insolvency resolution and bankruptcy process costs for the first layer of payment to be made in the waterfall, in priority to any payments to any other stakeholders.

Why were the fund providers hesitant earlier?

Even though the status of interim funds is that of a “super priority loan” i.e. the loan that shall be repaid before all other loans that exists in the books of the company, lenders were hesitant to lend funds. This is because, as per the Code, the lenders were entitled to interest only for the period upto the order of liquidation of Corporate Debtor or completion of moratorium period (along with extension of 90 days), whichever is earlier. The interest would stop from the date of the liquidation order. Even though interim financing had its super-priority, but any priority has no meaning in absence of cashflows. If the entity slips into liquidation, the only way cashflows would occur is by disposal of assets, and the same may take time. During the time that lapses between order for liquidation and actual realisation of assets sufficient to pay off the interim financier, the financier would go dry. This made many lenders fear about loss of a huge sum of interest.

Liquidation Regulations amended to the extent to allow interest on interim finance for a maximum period of 12 months:

IBBI, vide Insolvency and Bankruptcy Board of India (Liquidation Process) (Amendment) Regulations, 2018 dated 28th March, 2018, has provided, that w.e.f 01.04.2018, liquidation cost includes interest on interim finance for a period of twelve months or for the period from

the liquidation commencement date till repayment of interim finance, whichever is earlier.

This implies that interest on the interim finance till the date of order of liquidation shall form part of the CIRP cost, and the interest on the funds for a period of 12 months or period of liquidation (that is, period from liquidation order date till the actual realisation of the assets to pay off the financier), whichever is lower, shall now form a part of the liquidation cost. Thus, lenders will now be able to accrue interest for a maximum period of 1 year during liquidation. That is to say, lenders will need to sacrifice interest only if the liquidation proceedings take more than 1 year to realise the assets sufficient to pay off the interim financier.

It is important to understand that the liquidator, in liquidation proceedings, does not have to wait for disposal of all the assets before he starts settling the stakeholders as per sec. 53. Of course, the liquidator has to settle the list of stakeholders by filing the same with the adjudicating authority. Having done that, he may make interim distributions. Therefore, even if the assets are partly sold, the liquidator may pay off the whole or any part of the interim financing costs.

There are two interesting issues here – one, how does the interim financier file his claim at the time of commencement of liquidation, and two, how does liquidation process accommodate a variable amount of the claim, which increases as the interest accrues.

On the first issue, the interim lender may file claim to the extent of interim finance already outstanding as on the commencement of liquidation (since all claims are with reference to the liquidation commencement date). However, since the interest is a part of the liquidation costs, the same may be settled as a part of the costs of the liquidation process, in the same manner as other operating costs are paid – such as professionals' fees.

On the second issue – the cost of interim financing is a moving target – the amount obviously accrues and grows until it is fully settled. The liquidation process entails filing list of stakeholders and the amounts owed to them to the adjudicating authority, before starting any distribution. Any variation in the amounts of claims admitted may be done with the approval of the adjudicating authority. Once again, it may not be necessary to run for approval of the adjudicating authority for the accrued interest, because the same is a part of the liquidation cost.

Interim Financing Becomes Effective & Attractive

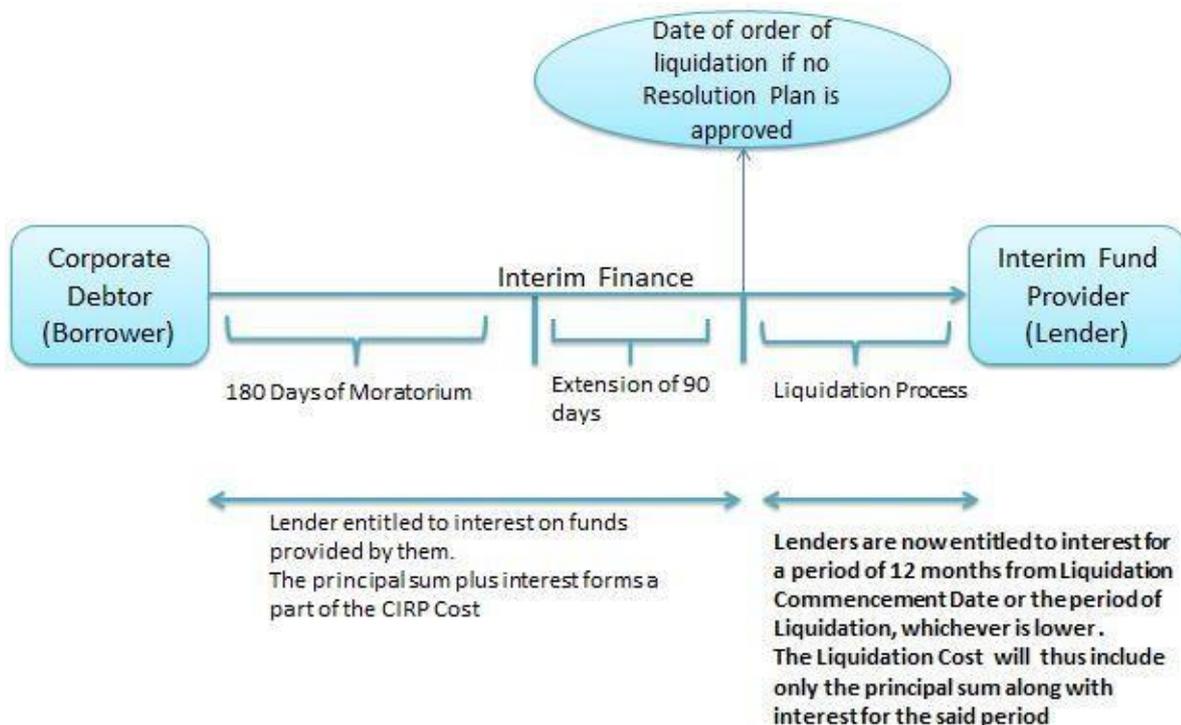


Figure 15: Timeline representing various stages of insolvency at which and its impact on Interim Financing

Effect of the Amendment:

One of the most critical aspects of rescuing companies under insolvency from the risk of liquidation is the availability of sufficient funds and the aforementioned amendment has made the availability of such funds easier. Lenders will now be more confident about lending funds to companies during the CIRP, which will make interim financing lucrative, and availability of such funds easier. This might also reduce the probability of the companies going into liquidation.

Benefits to the Lenders:

1. Higher InterestRate:

Interest rates on which funds are provided is higher than the market rate of loans, because the risk involved is comparatively higher. Also, while with the discussed amendment, interim funding becomes quite an interesting and lucrative market to explore, however, as a matter of fact, currently there are only handful of players and that also is one more reason for better interest rates from the point of view of lender.

In our experience of interim financing, the rates quoted by lenders, and approved by committees of creditors, have been at least 500-600 bps higher than comparable lending rates to normal companies. This is a huge net interest margin for lenders.

2. Priority Status of Loan:

The lenders enjoy a super priority status of loan i.e. their loan is repaid before any other loan existing in the books of the Corporate Debtor.

3. Super secured loan

That the interim funds are repaid as superpriority (even before the workmen and the secured creditors), they are super secured. There is no security for interim financing as such – that is, no collateral rights over assets. However, since the super priority is statutory, there is no need for any security as such.

4. Interest for a longer period:

The biggest advantage of the amendment has been that the lenders will now be entitled to interest even after commencement of liquidation and will enjoy the priority status during the liquidation process too.

Can a corporate debtor raise funds during liquidation?

The one word answer to the question is “No”. There cannot be any borrowing done while the company is already under liquidation.

Conclusion:

The aforesaid amendment brought by the Board can completely change the current scenario of the Insolvency Process where the lenders will be voluntarily willing to provide interim funds to the Corporate Debtor. This might prove to be a big leap towards the achievement of an effective and hindrance-free resolution process. Keeping in mind the benefits to the lenders, commensurate with the amendment, to lend interim funds can also be seen as a prospective profitable business by many.

Stopping of accrual of the interest from the liquidation commencement date was the biggest demotivator for interim financing all this while; now that this hitch is removed, it seems that this will motivate more players to come in the market and do such funding.

The least this amendment will do is save a company from going into liquidation for mere scarcity of funds during CIRP.

Thus, it will not be an exaggeration to say that the Insolvency and Bankruptcy Board of India (Liquidation Process) (Amendment) Regulations, 2018 can prove to be a game changer in the CIRP process.

FRAUDULENT INITIATION OF INSOLVENCY PROCEEDINGS

- **Richa Saraf**

Editor's Note: IBC is a benevolent law – it seeks to help a falling debtor and simultaneously explores avenues for value maximisation in the hands of creditors. However, one cannot rule out the vulnerability of the law as to potential misuse by unscrupulous persons – the rampant way in which section 22 of SICA was (mis)used is not unknown. Therefore, in order that the provisions of IBC are not misused for defrauding stakeholders, section 65 calls for imposition of penalty in such cases. Here, application of judicial mind may become necessary at the time of admission of application for corporate insolvency resolution process.

Section 65 was incorporated in the Code so that the provisions of IBC cannot be misused by any person, who has initiated the insolvency resolution process or liquidation proceedings, with a fraudulent or malicious intent, and for any purpose other than for the resolution of insolvency or liquidation, as the case may be. The article will be particularly focusing on the effect of this provision on persons who have fraudulently or maliciously initiated insolvency proceedings. We will also be relying on a recent case law, wherein NCLT has taken broad and sweeping interpretation, in consonance with the spirit of law.

In the matter of [Shobhnath v. Prism Industrial Complex Ltd.](#), (05.07.2018), the NCLT Allahabad discussed a very pertinent question- whether insolvency petition can be entertained in a case where financial fraud exists? The petitioner, being a financial creditor, contended that the petition is complete in all aspects, and in conformity with Section 7 of the Code. There was existence of debt, duly acknowledged by the corporate debtor, and subsistence of default, duly fulfilling the conditions laid down under Section 3 (11) and 3 (12). Not only this, the petitioner filed one affidavit stating that the proceedings will be in the interest of the stakeholders (debenture holders/ depositors, in the instant case) and the corporate debtor. Also, similar affidavit was filed by the corporate debtor, stating that the insolvency proceedings will be in the best of interests of the corporate debtor as well as its stakeholders, as the claims of various classes of creditors can only be satiated by disposing the assets of the corporate debtor, however, considering the adverse market position, the value derived from the asset may not be sufficient to repay all the debts.

Consideration of The Issues Involved:

While examining the matter, the Hon'ble NCLT considered several aspects:

- a) **Report of Amicus Curiae:** The Bench relied on the report of the Amicus Curiae, appointed in another matter (against the same corporate debtor), and considered the possibility of diversion of funds to group companies and/ or directors and/ or associates, and also raised suspicion that all the properties/ assets of the corporate debtor might have been sold/ disposed of illegally.
- b) **Perusal of financial statements of the corporate debtor:** NCLT relied on the balance sheet of the corporate debtor for determination of several issues:

- (i) The recent updated balance sheet of the corporate debtor was not available, hence, it was difficult to ascertain the current state of affairs of the corporate debtor and its properties.
- (ii) On perusal of the last available balance sheet, it was observed that land is the sole tangible asset of the corporate debtor, which was highly inadequate to quench all the claims.
- (iii) The fact that there was no information available about the area, location or market value of the land, was taken on record.
- (iv) **Odds of diversion/ siphoning of funds:** It was also evident from the study of the balance sheet that having raised money from numerous investors, the promoters/ directors have siphoned the funds out into various affiliated companies.
- c) In the instant case, interests of a large number of retail investors was involved, however, none of these retail investors, could be intending to be benevolent to think of resolution or revival of the corporate debtor.
- d) **The after-effects of admission of petition:** The consequential impact of commencement of insolvency proceedings was analysed:
- (i) **Initiation of moratorium-** means the creditors will not be able to take legal action against the corporate debtor.
- (ii) **Constitution of committee of creditors and the system of voting on the basis of majority by value-** NCLT could not rule out the probability that the corporate debtor might have created creditors with high value, who may care least for the interest of retail investors, from whom money has been raised, and hence, the so- called resolution plan may harm the interest of such investors.

Issues considered by Hon'ble NCLT:

- *Report of Amicus Curiae*
- *Financial Statements of CD*
- *Odds of siphoning of funds*
- *Impact of admission*
- *Moratorium*
- *Constitution of CoC*

The intent of the corporate debtor was regarded as suspicious, malafide and intended to divert the attention of the Tribunal from the main issue and to linger on the proceedings. The Tribunal further went on to state that on perusal of the report of the Amicus Curiae, it appears that the corporate debtor has committed a financial fraud.

The enactment of insolvency resolution process under the Code, is a step towards resolution or rectification of an insolvency, wherein a company is under financial distress and the creditors are proposing to collectively bail the company out. These provisions are for repairing a broken house which can still be repaired, and can avoid demolition. The intent of insolvency proceedings cannot be to interfere in cases where there are financial irregularities, illegalities or indication of a financial fraud. Considering the object for which the Code was formulated, public interest involved, and for meeting ends of justice, it was held that the petition cannot be admitted only on the ground that the corporate debtor has not opposed the petition.

Fraudulent Initiation of Insolvency Proceedings

NCLT regarded that while Section 65 only stipulates for punishment for fraudulent and malicious initiation of insolvency proceedings, the intent is very clear that while a petition is filed, under the Code, fraudulently with malicious initiation of insolvency proceedings, then in that case, the petition should not be admitted. Thus, the petition was dismissed and a show cause notice was issued under Section 65 of the Code, against the petitioner as well as the corporate debtor.

Conclusion:

There may be several instances where the application is filed at the behest of the corporate debtor itself, or the applicant is a mere puppet in the hands of the corporate debtor. The Adjudicating Authority, in such cases, should place the matter under strict scrutiny and declare that the parties are acting hand-in-glove.

Suppose the corporate debtor has availed money from its related party, and paid the dues of the workmen and secured financial creditors, who are to get priority during liquidation (or during resolution for that matter), and has instead created another class of secured financial creditors, replacing all the other secured financial creditors. The operational creditors and the unsecured financial creditors could not be paid. The intent can be to defraud such operational creditors or they may genuinely want to repay the debts of poor workmen, and of course the secured creditors were paid off to acquire the security interest in the assets of the corporate debtor, so that the assets may be utilised to pay other stakeholders as well. However, it might so happen that due to some unavoidable circumstances, the very new category of secured creditors, who are also related party to the corporate debtor, initiate insolvency proceedings the corporate debtor. The intent may be for resolution of the corporate debtor, however, there will only be either of the two aftermaths:

- a) a resolution plan be submitted as regards the corporate debtor, in such a case, operational creditors and dissenting unsecured financial creditors will be getting liquidation value only, which is equivalent to nil in most cases; or
- b) the corporate debtor goes into liquidation, again, the operational creditors and unsecured financial creditors will not be able to recover anything, since the liquidation estate might not be sufficient and there might not be anything left for the unsecured financial creditors and the operational creditors, after discharge of liabilities towards the secured creditors.

Can the above scenario be considered to be round-tripping of funds? Consider another situation, where the loan agreement itself states that the corporate debtor is in distress, and the loan is needed for making urgent payments, required to be made by the corporate debtor. Considering that the corporate debtor was admittedly into financial distress, such a lending, and that too, by way of an unsecured loan, would not be intuitively expected from an arms-length lender. Therefore, there is a natural reason to explore whether there existed relationship between such lender and the corporate debtor, more so, if the amount is payable on demand and there is no tenure for claiming back the amount. Now, if such a distress lender, seeks repayment by way of a demand notice within few months of granting of such loan, and thereafter on non-payment within stipulated time, initiates insolvency proceedings, under Section 7 IBC, again, within few months of granting of loan, whether such an application can be considered to be one in good faith or whether the case will be considered to be a fit case for fraudulent initiation of insolvency proceedings, as per Section 65 of the Code?

Even if the applicant is able to demonstrate that the application complies with all the requirements of law, and regardless of whether the corporate debtor has acknowledged the debt and is not resisting the insolvency proceedings, the Adjudicating Authority, before admitting any such application, should examine the prima facie facts and material available on record. Whether the loan amount was transferred via proper banking channels or was the debt only a balance sheet entry, with no nexus to actual lending, is another point, which should be considered while framing a decision.

POST-ADMISSION WITHDRAWAL OF INSOLVENCY PROCEEDINGS

Balancing Between Creditors' Supremacy and Adjudicators' Discretion

- **Richa Saraf**

Editor's Note: IBC, as originally enacted, did not permit withdrawal of insolvency proceedings once admitted by the Adjudicating Authority. Later, pursuant to various rulings of the Apex Court, section 12A was inserted in the Code to allow for withdrawal of applications made under sections 7, 9, or 10. The section requires that the withdrawal application can be made with approval of 90% of CoC, and the Adjudicating Authority "may" allow such application.

Can the Adjudicating Authority turn down an application made with the consent of 90% of creditors? This article studies the boundaries of creditors' supremacy and discretion of the Adjudicating Authority in deal with withdrawal applications.

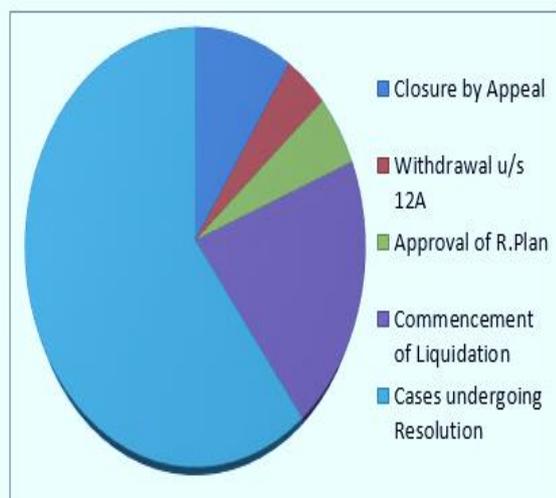
Initiation of insolvency proceedings, whether by creditors or by the debtor himself, may be compared with the *Brahmastra*: as the latter cannot be retracted without killing the target, the former, once admitted, cannot be withdrawn. However, after all, any insolvency resolution process is a case of a mutual contract between the creditors and the debtor - with requisite majority of creditors, it gets the seal of approval of the Adjudicating Authority and becomes a "statutory contract". Resolution is, therefore, a consensus in substance. Isn't it possible for the creditors to reach to a consensus with the debtor outside of the insolvency resolution process, and thus, recall the proceedings? In banking parlance, can there be a one-time-settlement (OTS) after admission of insolvency proceedings?

Section 12A was inserted specifically providing for withdrawal after admission. It is well known that the section was inserted after the Supreme Court ruling in [Lokhandwala Kataria Construction Private Limited v. Nisus Finance And Investment Managers LLP](#), where the Apex Court had to use its plenary powers under Article 142 of the Constitution of India to permit withdrawal after admission of resolution process. The SC subsequently eased out the process of withdrawal by its ruling in [Brilliant Alloys Private Limited v. Mr. S. Rajaopal & Ors.](#)

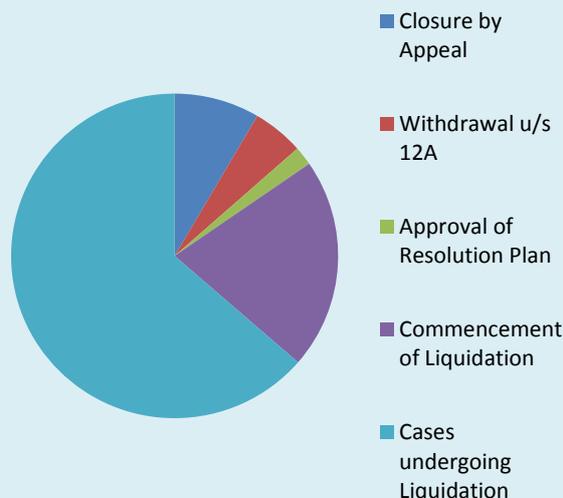
Post this ruling, there has been a spate of withdrawals under Section 12A. [Data from IBB](#) shows that out of the 142 cases closed, 63 have been withdrawn under Section 12A.

This article intends to get into the limits, if any, of creditors' discretion in withdrawal under Section 12A. The article reviews the law in this regard based on precedents under the winding up regime under the Companies Act, 1956, and international experience. Finally, the article tries to identify the boundaries of creditors' wishes and the discretion of the Adjudicating Authority.

Status of Insolvency cases as on 31.12.2018



Status as CIRP cases on 31.03.2019



Law of Section 12A

As per Section 12A of the Insolvency and Bankruptcy Code, 2016, the Adjudicating Authority may allow the withdrawal of application admitted under Sections 7, 9 or 10, with the approval of ninety per cent. voting share of the committee of creditors. Considering that the proceedings are primarily carried on behalf of and for the benefit of stakeholders of the corporate debtor, the section stipulates two layers of consent. While it is understood that this is the sole requisite is consent of the majority of creditors, the ultimate authority to permit withdraw or not to permit vests with the Adjudicating Authority.

The Hon'ble Supreme Court in the case of [Brilliant Alloys Private Limited v. Mr. S. Rajaqopal & Ors.](#) held that Section 12A contains no time stipulation and allowed the settlement, even after issue of invitation for expression of interest, thereby annulling the CIRP proceedings.

Further, the National Company Law Appellate Tribunal in [V. Navaneetha Krishnan v. Central Bank of India, Coimbatore](#) held:

"In view of Section 12A even during the liquidation period if any person, not barred under Section 29A, satisfy the demand of COC then such person may move before the Adjudicating Authority by giving offer which may be considered by the COC, and if by 90% voting share of the COC, accept the offer and decide for withdrawal of the application under Section 7 of IBC, the order of liquidation passed by the Adjudicating Authority will not come in the way of Adjudicating Authority to pass appropriate order."

In [Satyanarayan Malu v. SBM Paper Mills Ltd.](#), NCLT Mumbai permitted withdrawal of CIRP at the stage when resolution plan was pending approval of the NCLT, after acceptance by CoC. The Bench took into account the offer of one-time settlement (OTS) made by the corporate debtor to the financial creditor, which was more economical than the resolution plan.

Post-Admission Withdrawal of Insolvency Proceedings

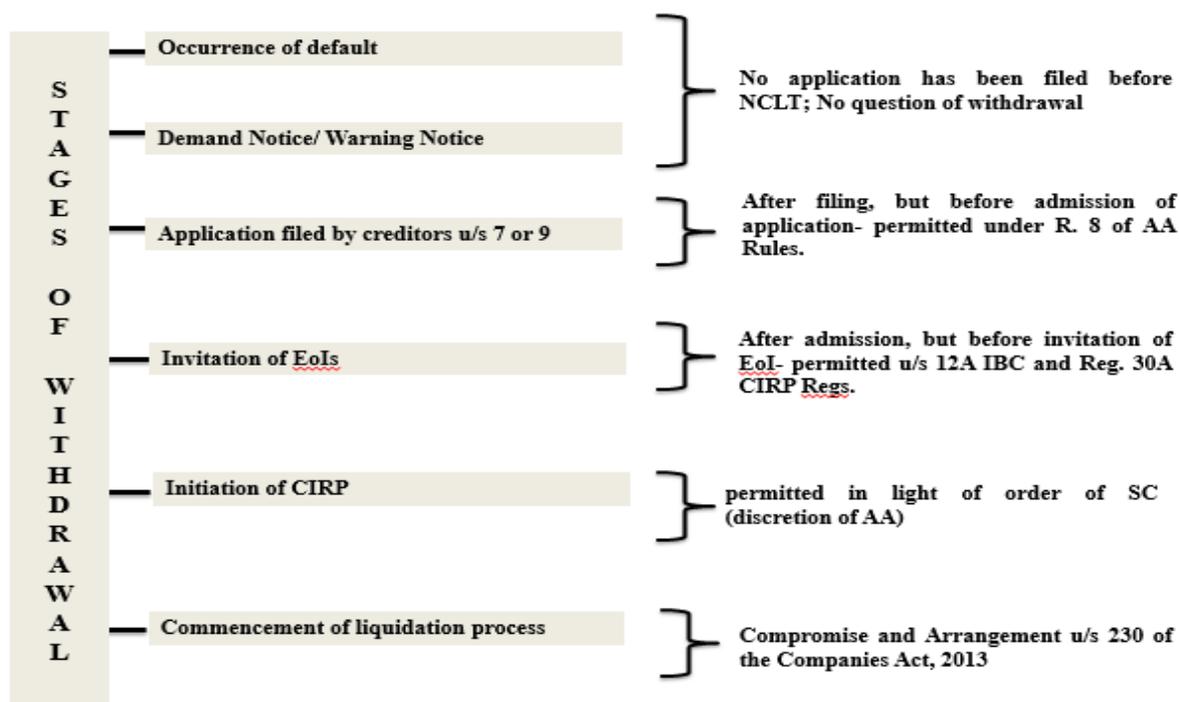


Figure 16: Stages of Withdrawal

Previous Law:

Similar provisions were contained in Section 35 of the Provincial Insolvency Act, 1920, which provides for power to annul adjudication of insolvency. Under the Companies Act, the general rule was that **“wishes of the majority creditors prevail”**. If the majority show confidence in the continuance of the business of the company, the court will not interfere. The law on this point is stated in Palmer’s Company Law 21st Edition, page 742, as follows:

Palmer’s Company Law 21st Edition, page 742, as follows:

“The right to winding up order is, however, qualified by another rule, viz., that the court will regard the wishes of the majority in value of the creditors, and if, for some good reason, they object to a winding up order, the court in its discretion may refuse the order.”

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The wishes of the creditors will, however, be tested by the court on the grounds as to whether there are matters which should be inquired into and investigated if a winding up order is made. The court is invested with a wide jurisdiction, and if the facts disclose an unsatisfactory state of affairs so as to make out a strong case for investigation, the court will not hesitate to make a winding up order, inspite of the wishes of the creditors⁴⁵. [See [Madhusudan Gordhandas & co. v. Madhu Woollen Industries P. Ltd.](#)]

⁴⁵ Re Clandown Colliery Co. 91915) 1 Ch 369.

Considering the facts and circumstances of the case, and in exercise of its inherent powers under Rule 9 of the Companies (Court) Rules, 1959, the courts have on several occasions allowed revival of a company even after winding up order was passed. In the case of NGEF Ltd., since attempts to revive the company by clearing the debts had failed, as per the suggestions of Board for Industrial & Financial Reconstruction, the Karnataka High Court had on 3rd August, 2004 ordered the winding up of the company. However, on 22nd June, 2017, the court recalled its 13-year-old order⁴⁶. In the said case, while the minority shareholder claimed that there was no provision in law for recalling a wind-up order and there was no scheme placed by the state for revival; the court very clearly held that though there is no specific provision in the Companies Act for recalling of a wind-up order, the law does not restrict the court from it either, if the circumstances requiring such recall are established by any of the applicants, be it the Official Liquidator, or a creditor, or a contributory or a shareholder. The court also went on to state that revival of a company does not necessarily mean revival and restoring of the usual manufacturing or business activity. It is a broader term including therein, the best utilisation of the assets. It is only the live and operating companies or business, which contribute to the economic welfare of the country and not the process of winding up of companies, which achieves this objective of larger public good.

In [*Sudarsan Chits \(I\) Ltd v. O. Sukumaran Pillai*](#), the Apex Court observed that it is well settled that a winding up order once made can be revoked or recalled.

Global Law:

Section 706(a) of US Bankruptcy Code bestows upon the debtor one-time absolute right of conversion of a liquidation case to a reorganization or individual repayment plan case. If the case has already once been converted as such, then the debtor cannot exercise the right. The policy of the provision is that the debtor should always be given the opportunity to repay his debts, and a waiver of the right to convert a case is unenforceable. Section 706(b) permits the court, on request of a party in interest and after notice and a hearing, to convert the case to one under reorganisation at any time. The decision whether to convert is left on the sound discretion of the court, based on what will most inure to the benefit of all parties in interest. For instance, in ***Re Wallace, 191 B.R. 925, 927 (Bankr. M.D.Fla. 1995)***, the bankruptcy court has taken due cognizance to the fact that conversion of a bankruptcy case to one under reorganisation would be a futile, where there exists circumstance that will cause reconversion to bankruptcy.

Section 261 of the UK Insolvency Act, 1986 also stipulates that a debtor can make a proposal for voluntary arrangement, and if creditors approve the voluntary arrangement, the bankruptcy order may be annulled by the court. As to all matters relating to the winding up of a company, the court will give effect to the wishes of the majority⁴⁷ (Section 195). Section 282 further provides for court's power to annul bankruptcy order. The considerations for annulling the order is provided under Section 282(1) of the Act. The relevant extract is reproduced below for reference:

*“The court **may** annul a bankruptcy order if it at any time appears to the court-*

⁴⁶<http://judgmenthck.kar.nic.in/judgmentsdsp/bitstream/123456789/173277/1/CA184-15-22-06-2017.pdf>

⁴⁷ P. & J. Macrae Ltd. (1961) 1 WLR 229; (1961) 31 Com Cases 424; (1961) 1 All ER 302 CA

Post-Admission Withdrawal of Insolvency Proceedings

(a) that, on any grounds existing at the time the order was made, the order ought not to have been made..”

on plain reading of the provision, it may be stated that the court retains a discretion whether to annul the adjudication or not, for Section 282(1) merely mentions that the court “may” annul the bankruptcy order under the circumstances described⁴⁸. Thus, a bankrupt may still be denied an annulment if his conduct has been in some way improper [Refer *In Taylor, Re (1901) 1 QB 744 (DC)*].

Discretion of the Adjudicating Authority:

Section 12A stipulates that the Adjudicating Authority **may** allow the withdrawal on an application made with the approval of ninety per cent. voting share of the committee of creditors. While the pre-condition is approval of CoC members holding 90% share, the final discretion to allow or disallow vests with the Adjudicating Authority. The report of the Bankruptcy Law Reforms Committee also discussed that “*Once a bankruptcy petition is filed, it cannot be withdrawn without the leave of the Adjudicating Authority*”⁴⁹.

In case where no resolution plan has been received or the resolution plan is not approved before the expiry of the insolvency resolution process period or the maximum period permitted for completion of the corporate insolvency resolution process, the Adjudicating Authority shall pass an order for liquidation of the corporate debtor, in terms of Section 33 of the Code. As against the mandatory provisions of Section 33, Section 12A is not an automatic remedy. If the debtor files an OTS scheme, the creditors may consider the same. However, the ultimate authority to approve withdrawal of CIRP vests with the Adjudicating Authority, and the power should be exercised, considering commercial as well as social interest.

The Adjudicating Authority has adequate powers to deal with illegal activity or abusive conduct. The considerations for permitting withdrawal may be nature of OTS, in terms of fundamental requirements. The provisions of the Code should not be misused by any stakeholder to strip asset value or otherwise work to the detriment of the business or other stakeholders. The intent of IBC was to provide a reasonable opportunity for rehabilitation of a business before a decision is taken to liquidate and the Adjudicating Authority may allow withdrawal if the pre-conditions are met, however, Section 12A should not provide the debtor with an opportunity to abuse the process of law. The Adjudicating Authority should, therefore, have relevant information about the debtor for effective consideration of withdrawal. If required, the Tribunal may obtain independent comment and analysis of that information by experts.

Section 12A and Section 29A:

Can Section 12A be used as the surrogate to enable what is not possible under Section 29A? It may be noted that Section 29A is ineligibility to submit resolution plan by promoters. Section 12A is not a resolution plan- Section 12A hits at the very roots of the initiation of the process itself. However, if in guise of withdrawal of CIRP, the creditors are actually agreeing to a resolution plan, then the Adjudicating Authority may exercise discretion. The idea of withdrawal under Section 12A is akin to a declaration by overwhelming majority of creditors that the circumstance which led to initiation of

⁴⁸ Askew Peter Dominic Ltd. (1997) BPIR 163; Coney, Re (1998) BPIR 333

⁴⁹https://ibbi.gov.in/BLRCReportVol1_04112015.pdf

insolvency do not exist anymore. If the facts are that the entity is intrinsically insolvent, the idea of Section 12A cannot be perpetuation of insolvent business. Section 12A should not be allowed to become a re-run of the process under BIFR or earlier regime where an insolvent business could continue to run without any hard time lines. The IBC regime does not want deadwood to continue to lock economic resources, and unsuccessful/unscrupulous promoters to continue to manage businesses. Hence, if the circumstances that led to initiation of insolvency continue to prevail, the Adjudicating Authority will be justified in using its discretion to refuse to allow withdrawal.

LIQUIDATION BEFORE RESOLUTION?

- **Richa Saraf**

Editor's Note: 'Resolution before liquidation' is the maxim propagating the objective of the Code. However, can liquidation be a more feasible option than resolution? If so, in what circumstances? This article discusses certain cases in which liquidation was preferred even before trying for resolution.

A survey by World Bank⁵⁰ pointed out that it took 10 years on an average to wind up/liquidate a company in India as compared to 1 to 6 years in other countries. Such lengthy time-frames are detrimental to the interest of all stakeholders. The process should be time-bound, aimed at maximizing the chances of preserving value for the stakeholders as well as the economy as a whole.

[Report of the Expert Committee on Company Law- "Restructuring and Liquidation"](#) noted that the Insolvency law should strike a balance between rehabilitation and liquidation. It should provide an opportunity for genuine effort to explore restructuring/ rehabilitation of potentially viable businesses with consensus of stake holders reasonably arrived at. Where revival/ rehabilitation is demonstrated as not being feasible, winding up should be resorted to. Where circumstances justify, the process should allow for easy conversion of proceedings from one procedure to another.

"Restructuring and Liquidation" noted that the Insolvency law should strike a balance between rehabilitation and liquidation. It should provide an opportunity for genuine effort to explore restructuring/ rehabilitation of potentially viable businesses with consensus of stake holders reasonably arrived at.

Companies Act, 2013 stipulated for creditors' voluntary winding up, however, since the same has been omitted now, the only option remaining with the creditors is to move an application before NCLT under the provisions of the Insolvency and Bankruptcy Code. Liquidation procedures cannot be initiated by creditors as a first resort on payment default. The Code prescribes that a financial or operational creditor can initiate the corporate insolvency resolution process in case of failure by the corporate debtor to pay at least Rs. 1,00,000, and only in the case of failure to work out a resolution plan, the corporate debtor will be liquidated. The general motto is- "Law should provide a reasonable opportunity for rehabilitation of a business before a decision is taken to liquidate it so that it can be restored to productivity and become competitive".

Also, the intention of the code is that first resolution should be attended and if the resolution fails, then liquidation should be attempted. The meaning of liquidation is selling of the assets, which will mean the company is no longer in existence and if this happens many workers will also lose their job.

⁵⁰Doing business in 2005- India Regional Profile

We have been long hearing this phrase- “Resolution before liquidation”. This being the general notion, let us examine a situation where the company is already dead, there is no chance of revival. Here, there can be two scenarios, if there are cracks in a building, it can be repaired. However, if the building is already demolished, the only option is to remove the vestiges and rebuild a new structure. If we now relate the said case to insolvency proceedings, once the application for initiation of corporate insolvency process is admitted by the Tribunal, the process commences, the interim resolution professional forms a committee of creditors and the first meeting of the committee of creditors is held within 30 days’ time.

The following events may lead to liquidation trigger:

- the committee of creditors cannot agree on a workable resolution plan within 180 days (which can be extended once by 90 days);
- the committee of creditors decides to liquidate the company;
- the tribunal rejects the resolution plan;
- the corporate debtor/ resolution applicant contravenes the requisites of resolution plan.

However, an important question that crops up before us is “***Can the creditors decide to liquidate the company in the very first meeting?***”

Section 33 stipulates in clear terms that where the resolution professional any time during the CIRP but before confirmation of a resolution plan, intimates to the NCLT the decision of the committee of creditors to put a company into liquidation by the requisite majority, a company may be put into the liquidation process. On perusal of Section 33(2) of the Insolvency and Bankruptcy Code, 2016, one can infer that the answer is in affirmation. Such a decision has been taken in several cases before the NCLT.

Commenting on the high level of liquidation proceedings, M.S. Sahoo, chairman of the Insolvency and Bankruptcy Board of India, stated⁵¹-

“Many of the 450-odd companies where insolvency proceedings have been admitted by the NCLT have been struggling for survival for years, much before the IBC was implemented late last year. Therefore, these are almost ‘dead’ cases where chances of insolvency resolution are very remote, and liquidation is the only natural outcome.”

Going by the number of cases moving towards resolution, it seems most of the companies will not be able to achieve the resolution plan in the 180 days or the extended period of 270 days. After that the mandate of is to liquidate the company and that is what is going to happen. However, in case of highly stressed businesses, liquidations may be a valid commercial outcome to realise the assets trapped.

In [*VIP Finvest Consultancy Private Limited v. Bhupen Electronics*](#), the committee of creditors was constrained to decide that it is prudent for the company to go for liquidation, as the company had

⁵¹ <http://www.financialexpress.com/industry/insolvency-law-more-firms-going-for-liquidation-than-resolution-over-20-face-closure/988676/>

Liquidation Before Resolution?

not been operational for decades and had no employee on its payroll. In the instant case, the only valuable asset remaining with the Company was its fixed assets i.e. land and building, and the committee of creditors did not firm up any resolution plan nor did it receive any from others.

Another interesting case was of [Chivas Trading Private Limited v. Abhayam Trading Limited](#), wherein the corporate debtor was liquidated as there was lack of business opportunity, and the creditors felt there was no point putting good money to recover bad money. The committee of creditors made the following observations:

- a) There is no business prospects with the company;
- b) There is no substance in chasing the legal suits and cases for recovery;
- c) There is no point in spending good money to make efforts to recover bad money, having very remote chance of recovery;
- d) The assets with the company are not sufficient to repay the amounts of creditors;
- e) The assets in the form of land and shares are also not easily recoverable.

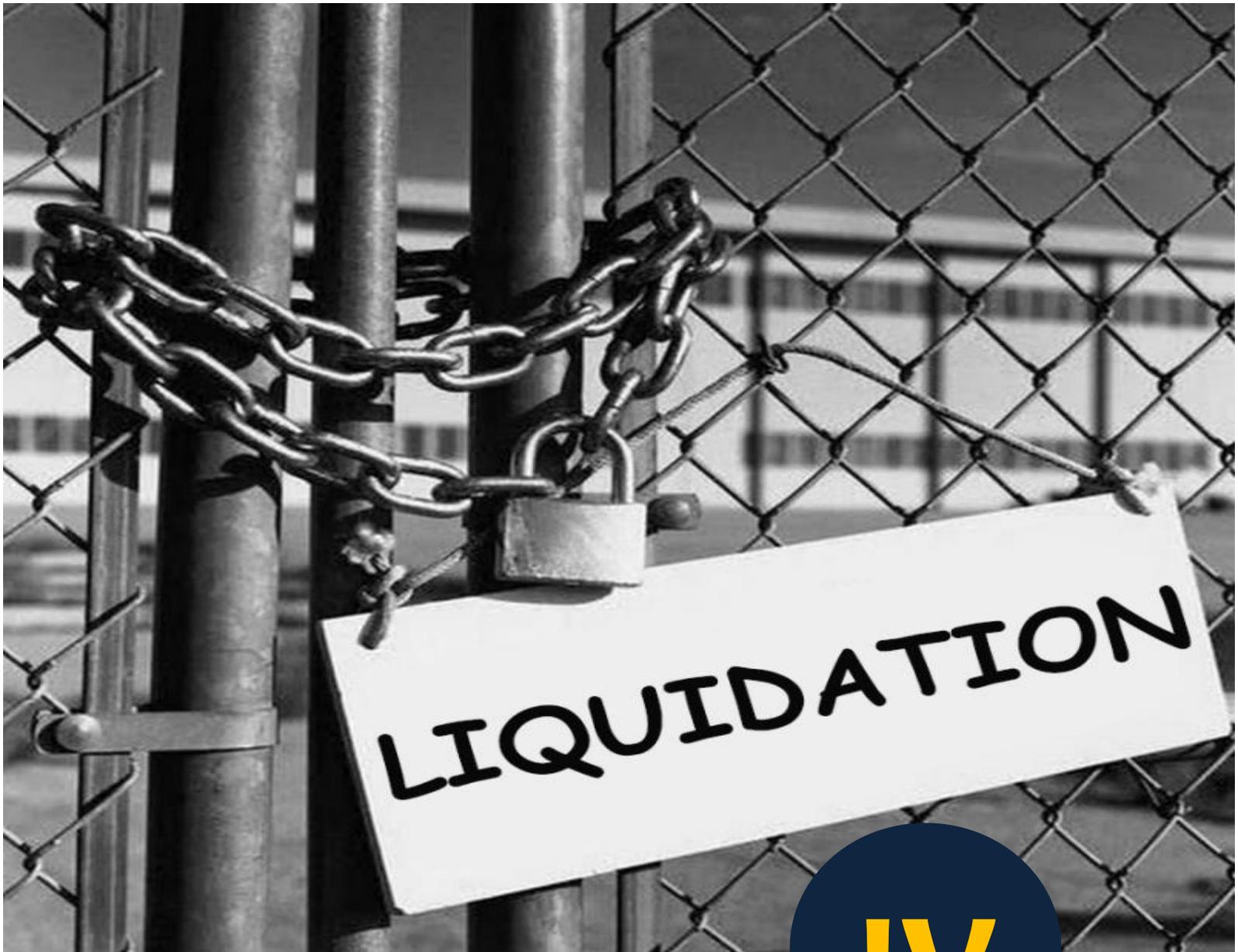
The Corporate Debtor had also given its response stating that:

- a) The business is not feasible and there is lack of business opportunity;
- b) Any resolution plan is not possible, which could enable the company to pay the entire debts;

The Corporate Debtor also mentioned that if the creditors are willing to take substantial haircuts in their loan amounts and grant additional time to repay, the company would work on the resolution plan proposing new business activities.

Again, in the case of [Best Deal TV Pvt. Ltd.](#), the committee of creditors recommended liquidation since the business activities were already closed down and all employees had left the corporate debtor. In one case where a liquidation order was passed by the NCLT, Mumbai, the ex-chairman of the corporate debtor i.e. [Esskay Motors Pvt. Ltd.](#) contended that the resolution professional did not invite bids from interested parties, however, the committee of creditors noted that inviting bids would only prolong the process of resolution and will not yield any result as the corporate debtor was not a going concern.

The paradox that although the creditors cannot initiate the winding up proceedings against a company, they have the power to place a company in liquidation by their decision during corporate insolvency resolution process. Why not give a right to initiate winding up itself?



SECTION IV: LIQUIDATION PROCESS

Liquidation Process

Editor's Note:

"Liquidation is the last resort" is the principle on which the Code is drawn upon, as is evident from the preamble itself. After expiry of the moratorium, if no resolution plan is achieved or the CoC decides to liquidate the Corporate Debtor before expiry of the moratorium, the Corporate Debtor goes into liquidation vide an order of the AA, under section 33 of the Code. The AA, in its order also appoints an insolvency professional as the liquidator of the corporate debtor. It may so happen that the resolution professional is appointed as the liquidator, subject to his consent for the same.

Once liquidation process commences, the liquidator shall make public announcement of the same and thereby invite claims from all creditors, upto the date of liquidation. The creditors who filed their claims during CIRP are also required to file fresh claims upto the liquidation commencement date. These claims must be filed within 30 days (please see: As per the Draft IBBI (Liquidation Process)(Amendment) Regulations, 2019 ("[Draft Regulations](#)"), claims along with proof, if not filed within 30 days, shall be filed within 45 days of Liquidation Commencement Date). If it so happens that the claims are not filed within the stipulated time frame, the claims are categorised as delayed claims. The Code has neither denied nor explicitly allowed a liquidator to accept delayed claims; and as such, in order to ensure admission of its claims, the creditor shall file an application under section 42 of the Code, for condonation of delay by the AA.

Though there exists no mandatory requirement for constitution of a CoC under liquidation process, the Draft Regulations provide for mandatory constitution of a Stakeholders Committee, comprising of representation from financial creditors, employees, workmen, operational creditors, representatives of the Government and

Liquidation, like death, is the last resort, but sometimes becomes inevitable. If that is the hard reality of a business, the Code must facilitate efficient and equitable distribution of the assets.

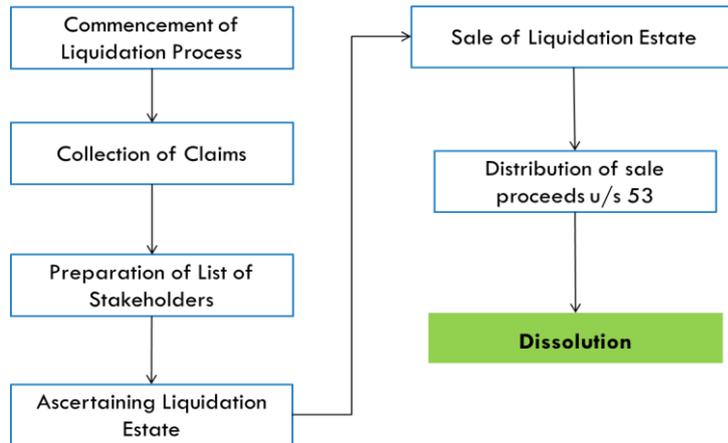
shareholders, where relevant, to advise him on matters relating to the liquidation process; the advice however, shall not be binding on the liquidator.

The most vital duty of the liquidator is to ascertain the assets that shall form part of the Liquidation Estate u/s 36 of the Code. A pertinent question here is relinquishment of security interest by secured creditors. Section 52 of the Code provides that unless the secured creditor relinquishes its security interest w.r.t. asset, the liquidator shall not include the same under Liquidation Estate. In light of the dilemma w.r.t. such relinquishment, the Draft Regulations provide that if the secured creditor does not provide an explicit relinquishment within 60 days of Liquidation Commencement Date, it shall be a deemed relinquishment. On ascertainment of the Liquidation Estate, the Liquidator shall cause sale of the same by way of e-auction. Another interesting angle that has gained much importance off-late is sale on going-concern basis. While the Code always provided for sale of corporate debtor on going-concern basis, vide Notification dated 22.10.2018, sale of the business of the corporate debtor on

going concern has also been brought under the ambit of the Code. While there have been several deliberations on the same, our detailed opinion has been provided in our write-ups on going concern sales.

Realisation from sale proceeds shall be then distributed to the stakeholders in the order of priority laid down in section 53 of the Code. Section 53 of the Code is one of the mainstay provisions of any insolvency law; evidently, therefore, this provision has attracted the most attention from the beginning. There have been several questions and judicial developments w.r.t the constitutional

validity of section 53 and its implications. The same has been discussed in details in our write-ups.



The fee of the liquidator, unless specifically fixed by the CoC before commencement of liquidation, is provided for in Code in terms of percentage of the amount realized on sale of assets and subsequently in the amount distributed.

All employees and directors of the corporate debtor stand terminated and he liquidator may, if s/he deems fit retain officials of the Corporate Debtor in consideration of a retainership fee.

The Regulations provide that the liquidation process will usually be completed within 2 years of commencement, failing which the liquidator shall take the approval of the Adjudicating Authority for extension.

Finally, on completion of the liquidation process, the liquidator shall file an application before the Adjudicating Authority, for dissolution of the corporate debtor.

SCHEMES OF ARRANGEMENT IN LIQUIDATION: A NEW RAY OF HOPE

- **Vinod Kothari**

Editor's Note: *The principle on which the Code has always functioned is "Revival, not Liquidation". However, once the company goes into liquidation, is there a hope for revival? Interestingly, recent rulings suggest that revival schemes can be filed even after liquidation proceedings have commenced. While the such revival schemes have not yet been imbibed in the Code, it is common knowledge that the good-old Companies Act has always enabled schemes of arrangement to be filed during winding up. The Draft Regulations on IBBI (Liquidation Process)(Amendment) Regulations, 2019 have provided the timeline which shall be applicable in cases where a revival scheme is proposed after commencement of liquidation of the corporate debtor. Once again, this is subordinate law; if section 230 of the Companies Act permits a liquidator to prepare and file a scheme of arrangement, the lurking question will remain – are the timelines directory or mandatory?*

In the following article, the author has discussed various aspect of arrangement vis-à-vis arrangement schemes under IBC, during winding up.

The recent rulings of appellate judicial and quasi-judicial authorities in India permitting the pursuit of schemes of arrangement even after initiation of liquidation proceedings may have sounded surprising to many. However, the history of schemes of compromise and arrangement is indeed replete with examples of such arrangements seeking to bail out an entity that is otherwise doomed to be liquidated. Since India stands out in the world, having enacted section 29A of the Insolvency and Bankruptcy Code, 2016, which disqualifies a promoter from submitting resolution plans or acquiring the assets of the entity in liquidation, the issue causing a lot of debate is – how does the possibility of a scheme of arrangement co-exist with this principle of promoter disqualification? Or, if the promoters, disqualified from either heading a resolution exercise or acquiring assets in liquidation, can find a surrogate route in schemes of arrangement, is there a potential of negating the very objective of insertion of section 29A?

Another major question is: unlike the erstwhile Companies Act, 1956 regime where both schemes of arrangement and winding up were to occur under the same law and before the same forum, schemes of arrangement are now under the Companies Act, and liquidation under the Code. Therefore, if a scheme of arrangement has been suggested, should liquidation proceedings in the meantime stand stayed, as otherwise the very existence of a chance of revival through the scheme route will get nullified if liquidation achieves some milestones? Further, is it alright for the jurisprudence relating to the apparent overlap and, to an extent, conflict between arrangement and liquidation to develop on its own, or should the lawmakers interfere and write the law, instead of waiting for long winding route of litigation to reach a finality? This post seeks to address these issues, and seek answers for the various questions.

Schemes of arrangement for companies in winding up

Not only is it possible for schemes of compromise or arrangement to be presented for companies in liquidation, it may be interesting to note that the entire concept was originally intended, both in UK and India (and other countries drawing inspiration from the UK law), to be a bail-out device for companies otherwise headed for winding up. In fact, as far back as in the Indian Companies Act, 1913, section 153 pertaining to compromise or arrangement defines the word “company”, relevant to this section, as a company “liable to be wound up under this Act”. The definition continued in section 390 (a) of the Companies Act, 1956.

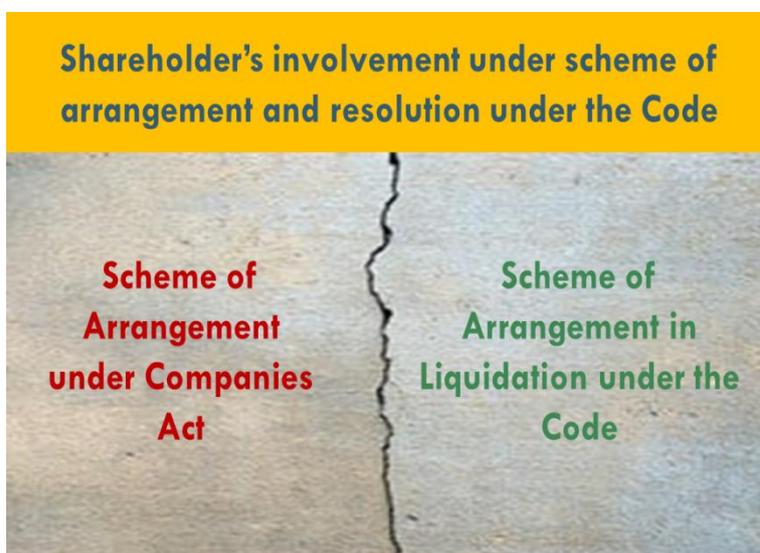
To a lay person, a “company liable to be wound up” meant a company that was either on the brink of bankruptcy, or was already into liquidation (since section 391 explicitly permitted a scheme to be presented by the liquidator, if the company was in winding up). It was only due to judicial interpretation of the expression “company liable to be wound up” that the expression includes every company which may be wound up under the Act following the procedure laid for winding up; healthy companies could also be covered under the chapter pertaining to schemes of compromise or arrangement. The ruling of the Bombay High Court in [Khandelwal Udyog and Acme Manufacturing Co Ltd.](#), (1977) 47 Com Cases 503, marked a departure from the principle earlier held by the same court in [Seksaria Cotton Mills Ltd. v. A.E. Naik](#), (1967) 37 Com Cases 656, that the provision was meant only for a company on the brink of bankruptcy.

There have been numerous instances in India, and many in UK, where companies which have been in liquidation for years altogether have been ordered to be revived based on schemes of arrangement. [Meghal Homes P. Ltd. v. Shree Niwas Girni K.K. Samiti](#), (2007) 139 Com Cases 418, is a case where the company was ordered to be wound up in 1984 and the scheme of arrangement was proposed in 1994.

Key differences between schemes of arrangement and resolution under Code

There are several significant differences between schemes of arrangement under corporate laws and resolution procedures under the Code. *First*, resolution schemes have practically no shareholders’ involvement. The structure of the Code seems to be exclude shareholders’

participation in resolution schemes, on the understanding that commencement of insolvency passes control from shareholders to the creditors. Indian law has gone to the extent of explicitly disabling the promoters (mostly majority shareholders) from proposing any resolution plan [section 29A(c) of the Code], or acquiring any assets of the company under liquidation [proviso to section 35(1)(f) of the Code]. On the contrary, schemes of arrangement under section 230(1) of the Companies Act, 2013 explicitly mandates meetings of creditors (and every class of creditors) and shareholders to be called separately, and an approval of the scheme by a supermajority vote in each of them. It may be noted that the need for approval by *both* shareholders and creditors depends on whether the



Enabling Going Concern Sale in Liquidation

arrangement involves the interests of shareholders as well as creditors (note the words in section 230 “as the case may be”). Most revival schemes of a company under liquidation will involve shareholders’ interest as well – hence, approval by both shareholders and creditors will be mandatory in case of a revival scheme.

Second, the supermajority approval requirement under section 230(6) has both a head count requirement as well a super-majority vote by value. The specific majority requirement, which was there in the 1956 Act as well, ensures that the supermajority in value does not completely cram-down the minority. Therefore, creditors of small value and small shareholders also wield the power to hold back the consent of larger creditors and shareholders. (See, however, an [article](#) by my colleague arguing that the head-count test was consciously dropped based on recommendations of JJ Irani Committee).

Third, it is important to note that section 230 requires consent of every “class of creditors”. As to what is meant by a class in this context and the difficulties in identifying a class has been discussed elaborately in [State Bank of India and others v. Altstom Power Boilers](#), 116 Comp. Cas 1 (2003). (Palmer’s Company Law also discusses as to what constitutes a class for the purpose of compromises and arrangements. These were discussed in the landmark Supreme Court ruling in [Miheer N Mafatlal v Mafatlal Industries Limited](#) (1996)). Generally speaking, secured creditors, preferential creditors and unsecured creditors will form different classes. It may also be argued that one of the ways of recognising classes, in case of a company under bankruptcy, is their position in the waterfall under section 53 of the Code.

Fourth, the creditors’ or members’ meetings under section 230 cannot be reduced to a farce by only recognising the votes of only those members who are able to make it to the meeting – because the law explicitly recognises voting by proxies in such meetings. Additionally, requirements imposed by SEBI in case of listed entities have put several additional safeguards, including mandatory facility of e-voting in such meetings, and a separate recognition of votes of “independent shareholders” (see Annex I Para I(A) point 9 of SEBI [Circular](#) dated 10 March 2017).

Can section 230 scheme be a surrogate route for ineligible promoters?

One of the most important questions concerning schemes of arrangement is – do the schemes permit the promoters to do what they are not able to do by virtue of section 29A – submit and approve schemes of revival whereby the promoters will perpetuate their stay in the company? The object of introducing section 29A in the Code, unusual in insolvency laws around the world, is to debar existing promoters of the company in default to perpetuate their stay in the company by submitting resolution plans. The sweep of the section is indeed very wide – it is not only limited to promoters of the company in question, but also any other defaulter company. Section 29A has blocked the submission of resolution plans in several high profile insolvency cases in the country, and it will be illogical to allow the submission of revival plans by promoters or controlling shareholders who cannot submit resolution plans by virtue of section 29A.

On the other hand, it may be argued that section 230 is a provision under the Companies Act, which has no equivalent of section 29A. In any case, the scheme of arrangement has the supermajority vote, not only of the shareholders, but also each of class of creditors. If the company in question is a listed entity, the shareholders’ consent must at least meet simple majority by disregarding the votes

of promoter-shareholders. Thus, if the creditors and shareholders, in their separate meetings, have anyways reposed faith in the scheme as proposed, should the company not be allowed to come out of the Code and be revived under the Companies Act? After all, a section 230 compromise is not a resolution plan and in any case if the NCLT, who would be sitting for approving such scheme, is able to see that the so-called scheme for a revival is an abuse of the process of law, the NCLT may always turn the scheme down. But there does not seem to be sufficient reason to have a generalised disqualification for promoters or shareholders in proposing the scheme.

At the same time, the NCLT also needs to be careful in ensuring that the scheme does not become a device to hold the process of liquidation in limbo and perpetuate the stalemate. Very often, the interest of promoter-shareholders lies in prolonging the uncertainty – when they see that the ultimate is their exit from the management, they try to prolong the stalemate. This is a real risk that NCLTs presiding over the schemes of arrangement will have to safeguard against.

Mechanics of schemes of arrangement during liquidation

How would a scheme of arrangement work during liquidation? The scheme may be proposed by shareholders, or creditors, or the liquidator himself. Typically, the initiation of an application before the NCLT under section 230 happens by the board of directors approving a scheme and making an application for convening a meeting of shareholders and members. During liquidation, since the directors relinquish their offices, there is no scope for the board submitting a scheme. Presumably, the mechanics may be for a substantial shareholder block proposing the liquidator to put a scheme before the NCLT. Creditors, of course, may propose the same directly to the NCLT. If the liquidator sees prima facie strength in the scheme, the liquidator may put forth the scheme before the NCLT.

The meetings of shareholders and creditors for approving the scheme are called at the instructions of the NCLT. Unless the NCLT dismisses the application in the very first hearing, the issue is – while the meetings of creditors and shareholders are being called, will the process of liquidation be stayed? It seems that it will be logical that the winding up proceedings should be temporarily stayed, until the shareholders' and creditors' meetings are called to consider the scheme. The principles for stay of winding up proceedings were contained in section 466 of the Companies Act, 1956 – this provision, and several English and Indian authorities on this regard has been discussed at length in [Forbes and Company and another v. Official Liquidator](#) (2013). If the schemes have the approval of the shareholders and creditors, then the NCLT may go by the principles well enunciated in *Miheer N Mafatlal* and similar rulings and, if eventually the NCLT passes order approving the scheme, the initiation of liquidation will be liable to be reversed.

Conclusion

It appears that when the Code was being written, the overlap of section 230 was not clearly visible, even though section 230 as amended by the Code itself makes a reference to liquidator appointed under the Code. However, now that this possibility has been opened up by jurisprudence, it is appropriate that we have codified law, rather than the uncertainty of a judicial law-making. Revival is always preferable over death, unless the so-called revival is just another ploy to permit a promoter using limited liability to continue to do unfair trading.

ENABLING GOING CONCERN SALE IN LIQUIDATION

-Resolution Services Team, Vinod Kothari & Company

Editor's Note: *The reasons/ events due to which a company goes into liquidation does not necessarily mean that the business itself was not viable. It may have so happened that the company became insolvent due to factors like weak administration and management, unavailability of workforce. The intent of the Code is not to end the business, but the business entity. Hence, in order to keep going the viable and profitable business, the Code enables going concern sale in liquidation.*

The basis of the concept of going concern sale, its presence in our global counterparts and its impact have been discussed herein below:

1. Background:

An economic unit may be either a going concern or a gone concern. Easiest analogy can be a live tree, versus a dead tree. A going concern goes into distress – presumption is that the entity can still be revived, with a bit of help from all stakeholders and a bit of judicial protection. This is the key objective of insolvency laws all over the world – to the extent an economic enterprise can be saved, it must be saved. There is too much of loss of economic value in destroying an enterprise that it is burden on the society to let entities be demolished, whether by creditor action or otherwise. However, protectionism has its limitations and we cannot, forever, continue to keep entities on the ventilator. Therefore, when the entities are beyond repair or restoration, they are taken the demolition route, which is the bankruptcy or liquidation process.

Presumably, an entity is going concern in insolvency, and is a gone concern when it goes into liquidation. The classic jurisprudence of winding up or liquidation laws has been that the liquidator can keep the entity as a going concern, only to the extent required for beneficial liquidation.

It is also a settled economic argument that for lots of entities, there is much better value as a going concern, and too much of a loss of value if the assets of a business are disposed of. In fact, the whole argument of liquidation, which is a collective remedy, rather than enforcement of security interest by creditors, which is an individual remedy, is that a slump sale or a going concern sale by the liquidator as a fiduciary for all creditors is likely to fetch better value for all stakeholders. The unique feature of a going concern sale is that, since the business of the corporate debtor can be transferred as a going concern, there exists a possibility of transfer of a whole lot of intangibles forming part of a business – contracts, leases, licenses, concessions, operational assets, manpower, technology, and so on. If all that is transferred is the assets of a business, several of these assets either may not be transferable at all, or may require third party concurrence for each such transfer, which may be a great hassle in liquidation.

With this viewpoint the Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016, was amended to permit sale of the corporate debtor as a going concern. Subsequently, a

further amendment, IBBI (Liquidation Process) (First Amendment) Regulations, 2018, was made to introduce the concept of “sale of the business of the corporate debtor as a going concern”.

Though after a series of amendments, the Liquidation Regulations still do not clarify as to what is a going concern sale, what are the determinants of a going concern sale, how will the liabilities and employees be tacked in a going concern sale and what will happen to the legal entity of the corporate debtor in case of a going concern sale. It is not clear as to whether there will be an order of the AA in case of a going concern sale, and what are the statutory powers under which the AA can pass such orders. Notably, there is nothing equivalent to Section 31 of the Code in case of a liquidation proceeding.

All these questions have so far substantially limited the scope for going concern sales in liquidation. There have been scattered examples of going concern sales in liquidation, but their success or adaptability, replicability or precedent value, is limited. Also, as a matter of policy, it is much better to draw up clear rules as far as possible, because in absence of statutory clarity, depending on adjudicatory discretion is leaving a room for substantial confusion, which takes a long time to resolve,

2. History of going concern sale in winding up in India

[The Eradi Committee Report](#), 2000 seems to have made the first recommendation for explicit provisions in the Companies Act to permit going concern sale in liquidation. The Committee recommended as follows:

7.5. The Tribunal shall have the power to direct the sale of business of the company as a going concern or at its discretion to sell its assets in a piece-meal manner.

Pursuant thereto, an amendment was made in Section 457(1) (ca) of Companies Act, 1956 by the Companies (Amendment) Act 2002 as follows:

(ca) to sell whole of the undertaking of the company as a going concern;

However, it is well known that the Amendment of 2002 remained unenforced, until the Companies Act, 1956 itself was repealed. Therefore, the aforesaid provision found its inheritor in Companies Act, 2013 in sec 282 (2). Once again, these provisions of this Act 2013 were also never enforced, as the IBC was introduced in the meantime. In the IBC itself, there is no explicit provision permitted going concern sale in the statute, since, apparently, the BLRC was inspired by the UK Act rather than the amended Companies Act, 1956 or Companies Act, 2013 itself.

The gap in the statute was purportedly filled in by the amended Liquidation Process (Second Amendment) Regulation cited above.

3. Relevant Provisions of the Code

Section 35(1)(f) of the Code lays down the powers and duties of the liquidator, one of it being, to sell the immovable and movable property and actionable claims of the corporate debtor in liquidation by public auction or private contract, with power to transfer such property to any person or body corporate, or to sell the same in parcels in such manner as may be specified.

Concerns on Going Concern

Regulation 32 of the Liquidation Regulations specifies the manner of sale, wherein the Liquidator may sell- (a) an asset on a standalone basis; (b) the assets in a slump sale; (c) a set of assets collectively; (d) the assets in parcels; (e) the corporate debtor as a going concern; or (f) the business(s) of the corporate debtor as a going concern.

4. Relevance of Going Concern Sale

The quintessential feature of a going concern sale is that it aims at value preservation of the undertaking including intangible assets.

- a. The acquirer who acquires the undertaking will have a smooth transition, as it works well with the existing template.
- b. There are numerous soft and intangible assets in every company. These include leases, licenses, concessions, trademarks, registrations, contracts and vendor registrations. All of these are reduced to zero value if the entity is taken into liquidation. On the contrary, as the legal entity survives in a going concern sale, the value of the above intangibles will be preserved.
- c. A going concern sale helps achieving synergy as the collective value of the assets (taking them with a view to generate future potential returns) would be higher than salvage value of assets disposed separately.

5. Meaning of Going Concern:

While the Code recognises going concern sale as one of the methods of sale, however, it does not provide for the definition of “going concern”. The meaning of the term has been provided in AS-1, analysed by the insolvency law reform committee, and has also been interpreted in various rulings. The same is discussed below:

a. Insolvency Law Committee Report:

Reference may be made to the report of the [Insolvency Law Committee](#) dated 26.03.2018, where in the committee examined the term “going concern” as follows:

The phrase “as a going concern” implies that the corporate debtor would be functional as it would have been prior to initiation of CIRP, other than the restrictions put by the code.

b. [Note of the Insolvency and Bankruptcy Board of India](#)

One round table of the Insolvency and Bankruptcy Board of India was held with stakeholders on 21.05.2018, referring to the case of [Gujarat NRE](#), to understand difficulties in selling corporate debtor as a going concern, and several challenges were brought up, pursuant to which a note was published by IBBI, defining “going concern”, as follows:

“Going Concern means all the assets, tangibles or intangibles and resources needed to continue to operate independently a business activity which may be whole or a part of the business of the corporate debtor without values being assigned to the individual asset or resource.”

In this regard, it was also mentioned that the corporate debtor may be sold as a going concern, as provided in the extant regulations. As the company survives, there will be no need for dissolution of the company in terms of Section 54 of the Code. The assets along with all attendant claims, limitations, licenses, permits or business authorizations remain in the company. The company survives as it was; the ownership of the company is transferred by the liquidator to the acquirer. The liquidator shall make an application to the Adjudicating Authority for approval of the sale of the corporate debtor as a going concern and the Adjudicating Authority may pass an order with respect to:

- (i) Sale of the corporate debtor to the intended buyer as a going concern;
- (ii) Transfer of shares of the corporate debtor to the intended buyer;
- (iii) Transfer of the going concern of the corporate debtor to the buyers;
- (iv) Continuation of the authority, powers and obligations of the Liquidator to complete the liquidation process as provided under the Code and the regulations including the control, operations and continuation of the liquidation bank account of the corporate debtor;
- (v) Payment to stakeholders in accordance with Section 53 from the liquidation bank account; and
- (vi) Protection of the intended buyer from all claims and liabilities pertaining to the period prior to the sale of the corporate debtor as a going concern.
- (vii) It was further proposed that in case of going concern sale, the final report of liquidator, as required under clause (3) of Regulation 45, shall form part of the application for the closure of the liquidation process of the corporate debtor and not for the dissolution of the corporate debtor.

c. Accounting Standards:

Although the definition of “going concern” may not be much of relevance from accounting perspective, but considering that the term was conceptualised from the accounting principles, it is important to draw reference to the same. Going concern is defined in AS- 1 as follows:

“The enterprise is normally viewed as a Going Concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.”

The term going concern was examined in the case of [Rajashri Foods Pvt Ltd](#), where it was observed that:

“A going concern is a concept of accounting and applies to the business of the company as a whole. Transfer of a going concern means transfer of a running business which is capable of being carried on by the purchaser as an independent business. Such transfer of business as a whole will comprise comprehensive transfer of immovable property, goods and transfer of unexecuted orders, employees, goodwill etc.”

Concerns on Going Concern

Also, in [International Standard on Auditing 570](#), various parameters have been laid down for the auditor to determine whether an entity is a going concern. *Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations.*

d. Income Tax Act, 1961:

The transfer of business as a going concern is a well-known concept, and has been analysed in various tax rulings as well. Demerger of an undertaking into another undertaking usually happens by transferring the undertaking to a new company on a going concern basis. The said condition has been interpreted by the Delhi High Court in of [In Re IndorRama Textile Limited \(2013\) 4 CompLJ141](#), as meaning if assets and liabilities being transferred constitute a business activity capable of being run independently for a foreseeable future.

In [KBD Sugars & Distilleries Ltd., Bangalore v. Asstt. Commissioner of Income- Tax\(30.10.2013\)](#), ITA Nos 1362 & 1362 of 2011, it was held that going concern always means to say 'alive', whether profit-making or not.

Also, the Income Tax Appellate Tribunal (ITAT) held in the above case, for a going concern to mean, that *the undertaking constituted a business activity capable of being run independently for the foreseeable future*. Similar view was taken in the case of [Hindustan Engineering by ITAT, Kolkata \(16.03.2016\) I.T.A No.330/Kol/2013](#).

e. Central Goods and Services Tax Act, 2017:

In the Central GST Act, there is a specific provision for transfer of a business as a going concern. If the transfer of goods happens as a part of a transfer of a business as a going concern, then there is no GST on such a transfer (Item 4 of Schedule II).

f. Distinction between sale of corporate debtor as a going concern and sale of business of corporate debtor as a going concern

It is crucial to identify the distinguishing factor between sale of corporate debtor as a going concern [Regulation 32(e)] and sale of business of corporate debtor as a going concern [Regulation 32(f)]. Under both the clauses, the assets are not sold by way of slump sale or piecemeal sale, the acquirer buys the business with the assets. The business can either operate under the existing brand and structure of the Corporate Debtor or not. Seemingly the only difference between "the corporate debtor as a going concern" and "the business(s) of the corporate debtor as a going concern" is that in the former situation, the corporate debtor itself will be retained, will not be dissolved, and will be transferred along with the assets. However, in the latter case, the business will be transferred as a going concern, without transferring the legal entity, and therefore, the legal entity will be taken for dissolution.

6. Going Concern Sale under the Companies Act, 1956/2013

The transfer under winding up provisions of the Companies Act, 2013 took place under the supervision of the court. The court would give an order, mostly based on a mutual compromise.

In the matter of [AMCO](#), the winding up court emphasised on the interests of the employees and keeping the economic activities intact:

“as the Court considered the interest of the workers to be of paramount importance and a matter to be considered along with the interest of the Company, inasmuch as it was the hard labour of the workers which was created the Company to exist all these years. Now that the Company faced closure, it would not be right to throw them out on the street, when there is an offer for the Company to run, and an offer made to re-employ all the workers who had been on the payroll...factory should be sold in running condition so that the factory workers should not be thrown out of work and / or employment.”

In the matter of [National Tannery Co Ltd](#) a committee of management was formed to run the company until its sale on going concern basis and, eventually the West Bengal Government offered to acquire the company on a going concern basis, pay consideration, and also agree to pay the wages of the workmen.

The general judicial impression of going-concern sales was that the employees will be passed on to the acquirer. Several rulings have actually noted that if the entity was shut for some time, it should first be run at least for a day before transfer, and then transferred as a going concern. The impracticality involved in the process has been noted in a Supreme Court ruling in [Allahabad Bank v. ARC Holding and another](#) (26.09.2000), C.A. Nos. 5411-5413 of 2000 [Arising out of SLP (C) Nos. 4084-4086 of 1999], wherein the Apex Court observed as follows:

“But subsequent order directs sale of the entire assets of the company as a ‘going concern’. This means revive the company first to make it operational, re-employ its employees, which would involve huge investment by the prospective buyer, a Herculean task, making execution practically infructuous.”

In most cases of going-concern sales in winding up proceedings, the acquirer will come with some kind of a compromise with the stakeholders- including workmen, and the final settlement would be filed for a consent decree before the court.

7. Global Examples of Going Concern Sale

The concept of going concern sale is not unique to India. Reference to going concern sale has been made in UK [Value Added Tax \(Special Provisions\) Order 1995](#), wherein when a business in the UK is transferred, the sale will qualify as a ‘transfer of a going concern’

(TOGC) for VAT purposes, where the transfer is regarded as neither a supply of goods nor a supply of services under the VAT rule given under Article 5. Hence, VAT need not be charged on the sale consideration. There are various rulings in UK which have discussed the concept of going concern. [The Central Goods and Services Tax Act 2017](#) also recognizes the concept of going concern sale, and provides for certain tax benefits on sale as going concern. Below we discuss some of the rulings and laws on going concern:

71. In the case of [HCL Equipment Ltd v. Revenue and Customs](#), in ascertaining whether VAT was applicable or not, the UK VAT & Duties Tribunal had first determined whether the sale was a transfer of the business or a transfer of assets of a business. The court observed that the test

Concerns on Going Concern

would be to ascertain whether the purchaser carries on, after the purchase, a similar kind of business. It is not necessary that the two businesses are identical, merely that there is a reasonable resemblance between them. It was held that HCL took over a going concern and hence, VAT was not due on the consideration paid for it.

72. Again, in *Farm Facilities (Fork Lift) Ltd v. Customs and Excise Commissioners (1987) VATTR 80*, it was held that the mere fact that there are differences between the manner in which the business was carried on before the sale, and the manner in which it is conducted after the sale, does not preclude the conclusion that there has been a takeover of a going concern.

Provisions in Malaysian Jurisdiction:

73. [The GST Act of Malaysia](#) also provides for sale of going concern under Section 3 which says that the disposition of a business as a going concern is a supply made in the furtherance of business, subject to the Second Schedule. Section 68 specifically deals with the Transfer of Going Concern, specifying that in case of sale of going concern, the transferee shall be treated as having carried on the business before as well after the transfer. When a business is transferred as a going concern, any liability that exists at the date of transfer to furnish a return or to account for or pay tax under Section 41, shall become the liability of the transferee.
74. [The Malaysian Guide on Transfer of Business as a Going Concern](#) stipulates that Transfer of Business as a Going Concern (TOGC) may involve the transfer of a whole or part of a business as a going concern, and in the case where only part of the business is transferred, that part of the business must be able to operate on its own. Below are examples of common transfers, but the list is not exhaustive:
- (i) There is a sale of business assets or part of business to a person who carries on the business as a going concern; or
 - (ii) The assets may be transferred to another legal entity.

For there to be a transfer capable of being treated as a TOGC it must include the transfer of business assets. Where the assets are transferred from one person to another, the transfer may, subject to the fulfilment of the conditions, be covered by the TOGC provisions. For TOGC provisions to apply it is important that the assets, whatever they are and however many are to be transferred, put the purchaser in possession of a business, rather than simply assets.

75. The Malaysian Guide on TOGC, also provides illustrative list of conditions which may be referred for considering whether transfer of business assets can be regarded as a TOGC. Such conditions include:
- (i) The business transferred must be a going concern before and immediately after the transfer. Any business which has actually ceased operation on or before the transfer date does not qualify for TOGC. However, a short period of break or temporary closure immediately after the transfer to facilitate the smooth transfer might be permissible.

- (ii) The assets necessary for the carrying on the business must be transferred to the transferee. The transferee must use the transferred assets to continue with the same kind of business of the transferor.
 - (iii) If only part of the business is sold or transferred, that part of business must be capable of separate operation. However, for the new owner, it does not matter whether the transferred business will be operated separately from any other businesses that he is already operating. There must be an actual or current operation. The agreement to dispose of a business yet to commence or a dormant business is not a going concern. The business transferred to the transferee must be in the capacity to continue.
 - (iv) Business or part of the business transferred as a going concern shall be an income earning activity on the transfer date.
 - (v) The transferor shall transfer all the essential and necessary assets to the transferee for the transferee to be able to carry on the business, without which the transferee cannot continue the same kind of business.
 - (vi) The transferor must ensure that he has transferred to the transferee any license(s) related to the operation of the business that is being transferred as a going concern, without which the transferee cannot operate the business lawfully. If the transferor is not able to transfer the license(s) or the licenses are held to be non-transferable, it must be surrendered.
76. The Guide on TOGC also provides for instances where the transfer of a business will not come within the scope of TOGC, such as follows:
- (i) **A mere sale or transfer of capital assets:** A sale or transfer of capital assets which does not result in the purchaser taking over the business of the seller is not a TOGC.
 - (ii) **Transfer of shares which do not change the entity of the business:** A mere transfer of shares from one shareholder in a limited company to another shareholder or person does not constitute a TOGC as the ownership of the business assets still remains within same business entity.
 - (iii) **A series of immediate consecutive transfers of the same business:** A purchaser of a business who made an immediate sale of the business to another party is deemed to have not carried out the business of the first vendor. This would make both his purchase and subsequent sale to be outside the scope of TOGC.
 - (iv) If the transferor fails to transfer any one or more business assets to the transferee, then the transfer of business cannot be concluded as a TOGC.

Provisions in United Kingdom:

77. Article 5 of the VAT (Special Provisions) Order 1995 provides for the meaning and characters of a TOGC, wherein a transfer of business as a going concern is the sale of a business

Concerns on Going Concern

including assets which must have the following conditions as per the [HM Revenue and Customs Guidelines](#):

- (i) The assets must be sold as part of a 'business' as a 'going concern'.
 - (ii) The purchaser intends to use the assets to carry on the same kind of business as the seller.
 - (iii) Where only part of a business is sold it must be capable of separate operation.
 - (iv) There must not be a series of immediately consecutive transfers.
78. The approach to determining whether or not a TOGC has occurred has been developed through a number of cases- *ZitaModes Sàrl v Administration de l'Enregistrement et des Domaines (C-497/01)*, *Finanzamt Lüdenscheid v. Schriever (Case C-444/10) [2012] STC 633* and *Staatssecretaris van Financiën v. X BV (Case C-651/11) [2013] STC 1893*. The following principles were extracted from these cases, which was summarised in the Upper Tier decision in *Intelligent Managed Services Ltd (FTC/27/014)*:
- (i) In order to be a transfer of a totality of assets, or part thereof, the assets transferred must together constitute an undertaking capable of carrying on an independent economic activity.
 - (ii) This is to be distinguished from a mere transfer of assets.
 - (iii) The nature of the transaction must be ascertained through an assessment of the factual circumstances including the intention of the transferee (as determined by the objective evidence) and the nature of the economic activity which is sought to be continued using the assets.
 - (iv) The transferee must intend to operate the business, or the part of the undertaking, transferred without the intention to simply liquidate the activity concerned immediately.
 - (v) The nature of the transaction must be such as to allow the transferee to continue the independent economic activity previously carried on by the seller.
79. In the case of **Edward James Caunt (MAN/83/160)** the tribunal decided that there was no TOGC due to a change in the nature of business after the transfer.

For a transfer of a business as a going concern, there must be a consensus between vendor and purchaser. In cases where evidence of consensus may be lacking, the expression "transfer of a going concern" must be interpreted as meaning the succession by way of continuity of the previous business, succession by itself not being conclusive.

- 7.10 In **Intelligent Managed Services Ltd ([2015] UKUT 0341 (TC [2015] UKUT 0341 (TCC)C)**, Mr Justice Barling reiterated that point and held- "*although succession to the business is not a condition but a consequence of the application of the no-supply rule, the nature of the transaction must be such as to allow the transferee to continue the independent economic activity previously carried on by the seller.*"

8. Different modes of asset disposal in liquidation and their comparative view

8.1. Piecemeal/ Standalone sale of the assets:

There may be different classes of assets, which are unrelated, and thus, may or may not be sold together. The Liquidator has the option of selling the assets individually, piece by piece, to one or more buyers, by way of separate transactions.

Further, even if the Liquidator sells the corporate debtor or the business of the corporate debtor as a going concern, there may be certain peripheral assets/ scraps, which may be sold separately. This is indicatively the purpose of distinguishing between sale of corporate debtor as a going concern and sale of business of the corporate debtor as a going concern.

8.2. Slump Sale of the assets:

In this case, there is transfer of assets of the corporate debtor including all rights, title and interest in the undertaking of the corporate debtor. It means sale for a lump sum consideration, without assigning separate values to individual assets for the computation of such consideration, and without precluding, after such computation of agreed consideration has been done, the appropriation of such lump sum consideration to items of assets contained in such slump sale.

Slump sale has been defined in the Income Tax Act as follows:

“Section 2(42C)- slump sale means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales.”

Further, as per Explanation 1 to Section 2(19AA), *“undertaking shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.”*

Therefore, a sale in order to constitute a slump sale must satisfy the following tests:

- (i) Assets are sold off as a whole;
- (ii) Sale is for a lump-sum consideration; and
- (iii) Material available on record do not indicate item- wise value of the assets transferred.

Notably, slump sale and sale as going concern are two different concepts and may or may not necessarily be used as a combination strategy for sale of the assets of the corporate debtor. Every slump sale might not be a sale as going concern. A going concern sale, however entails slump sale of the assets of the corporate debtor, whether including or excluding non-business assets.

8.3. Sale of the corporate debtor on going concern basis:

There already existed the option of slump sale, however, the amended Liquidation Regulations now permits the liquidator to cause a sale of the corporate debtor on going concern basis as well. The only potential meaning of the going concern can be that the equity shareholding of the corporate

Concerns on Going Concern

debtor gets transferred, and the acquirer takes over the undertaking of the corporate debtor, with all the licenses, assets, entitlements, etc.

Here, the term “undertaking” shall include the whole of the undertaking of the corporate debtor, its businesses, assets, properties, rights, titles and benefits, whether movable or immovable, real or personal, in possession or reversion, whether corporeal or incorporeal, whether tangible or intangible, whether present or contingent and including but without being limited to land and building (whether owned, leased, licensed), all fixed and movable plant and machinery, vehicles, fixed assets, work in progress, current assets, investments, reserves, provisions, licenses, registrations, copyrights, patents, trade names, trademarks and other rights and licenses in respect thereof, applications for copyrights, patents, trade names, trademarks, leases, licenses, tenancy rights, premises, ownership, flats, hire purchase and lease arrangements, computers, office equipment, telephones, telexes, facsimile connections, internet connections, communication facilities, equipment and installations and utilities, electricity, water and other service connections, benefits of agreements, contracts and arrangements, powers, authorities, permits, allotments, approvals, consents, privileges, liberties, advantages, easements and all the right, title, interest, goodwill, benefit and advantage, deposits, advances, receivables, deposits, and all other rights, benefits of all agreements, etc, in connection/ relating to the corporate debtor and other claims and powers, of whatsoever nature and where so ever situated belonging to or in the possession of or granted in favour of the corporate debtor, excluding any cash or bank balances, provided that any liabilities, obligations, dues or claims against the Corporate Debtor shall be settled from out of the liquidation estate, in terms of the Code.

The corporate debtor survives, as only the ownership of the corporate debtor is moved by the liquidator to the acquirer i.e. transfer of all rights, title and interest in the undertaking of the corporate debtor, and, shall include transfer of the legal entity of the corporate debtor as well. Thus, the very basic difference between a going concern sale and slump sale is that in the former case, the foremost condition is that the acquirer shall carry on the business of the corporate debtor, and in the latter, no such pre-condition exists.

Further, in a normal liquidation method, the assets become a part of the so-called liquidation estate. These assets, whether collectively or separately or in a set, are sold. The realisations are then distributed to the stakeholders in terms of the priorities envisaged under Section 53 of the Code. Once, the pool is exhausted, the liquidator files an application for dissolution of corporate debtor, and, so far as the liabilities are concerned, the part unsettled under Section 53 is automatically extinguished, as the maximum possible value out of the liquidation estate has already been extracted. In a going concern sale, *the company as a legal entity will itself be a part of the liquidation estate*. All the assets of the company are still a part of the liquidation estate. A general feature of going concern sale is transfer of liabilities along with transfer of assets. However, a going concern sale *in liquidation* has to be distinguished from a going concern sale in general. In a going concern sale in liquidation, there cannot be a question of the liabilities being a part of the undertaking, as that will be a case of business transfer, and not a case of liquidation. In bankrupt liquidation, there has to be a case of settling the liabilities in the priority order listed in Section 53. Hence, the business of the company as well as its assets becomes part of the liquidation estate. The legal entity continues and gets transferred to the acquirer. The proceeds realised by transfer of both of these are used by the liquidator to settle the claims, in the manner provided in Section 53.

Considering the above, going concern sale will be the most apt method of sale, since the same will result in maximization of value of assets of the corporate debtor, as compared to that under piecemeal sale, or for that matter, in case of slump sale. If the corporate debtor is sold as a going concern, it will have social and economic benefits, the employees will retain their jobs, and a better value will be available for the stakeholders. Further, any acquirer aiming to run the business of the corporate debtor will be at an upper hand if he can acquire the entity as a going concern, as the formalities or compliances will be less if the corporate debtor is transferred as a going concern than having to obtain fresh permits/ licenses business authorizations for the entity.

8.4. Sale of Business(s) as a going concern:

Vide the IBBI (Liquidation Process) (First Amendment) Regulations, 2018, the Liquidator was permitted to sell the corporate debtor as a going concern. Subsequently, the Second Amendment Regulations introduced the option of selling the business(s) of the corporate debtor as a going concern. The amendments have been made considering that the acquirer may or may not want to continue with the same legal entity, and may or may not be interested in one or more business(s) of the corporate debtor. Essentially, a corporate debtor may have multiple line of business and each business can be sold separately as a going concern. Also, the assets of the corporate debtor can be categorized as “business assets” and “non-business assets”. While the business assets will have to be sold along with the business, the non-business or the peripheral assets may be sold separately on piece meal basis or otherwise.

9. Indicators of Going Concern Sale:

The following elements, although may not be necessary pre-conditions for going concern sale, but may definitely serve as indicators to determine whether a sale may be regarded as a going concern sale or not:

- a. **Continuity of former business:** The business that is transferred need not be a flourishing business, but must be in existence at the time of the transfer. Even if the business has been scaled down because of financial difficulties or in anticipation of a sale, there may still be a TOGC. (*Baltic Leasing v CCEVATTR 2088 (LON/84/198)*). The principle that a business which is in financial difficulties including liquidation, receivership or bankruptcy can still be a going concern was confirmed in *Dearwood (STC 327/1987)*. In this case, although the intention of Dearwood was to change the nature of the business acquired, what it had acquired was a business capable of being continued. The High Court found that a dying business, in liquidation, was nevertheless transferred as a going concern.
- b. **Stock:** Transfer of stock is often a fundamental part of the transfer of a business. If a business is transferred, all of a large part of the stock is usually sold to the purchaser of the business.
- c. **Premises:** Transfer of premises is significant in two cases. Firstly when some businesses are so closely linked to the premises from which they are run that if they are not transferred, it would be unlikely that the business gets transferred. Secondly, if

Concerns on Going Concern

goodwill is attached to the premises such that their transfer is a good indication of a TOGC.

- d. **Plant and equipment:** If the equipment transferred is needed to carry on the business, its transfer would be an indication of a TOGC.
- e. **Staff:** One of the possible indications of a TOGC would be if the new business takes over the contracts of existing staff. Transfer of Undertakings- Protection of Employees Act (TUPE)⁵² exist to protect staff involved in takeover situations, including takeovers in the event of insolvency.
- f. **Business name:** The transfer of business name, although not mandatory, is an indication of goodwill being sold and hence, a TOGC.
- g. **Goodwill:** Transfer of goodwill, whether through transfer of business name/ premises/ trademarks etc. is an important factor in determining whether a TOGC has taken place.

10. Requisites of Going Concern Sale

On the basis of the aforesaid discussions, the following may be considered to be the basic conditions of a going concern sale:

- a. **Retention of legal entity:** In case of sale of the corporate debtor as a going- concern, the legal entity continues, forms part of the liquidation estate, and is transferred to the acquirer, i.e. the entire undertaking of the corporate debtor, including all contracts, licenses, concessions, agreements, benefits, privileges, rights or interests may be transferred, whether based on an order of the Adjudicating Authority, or otherwise. In case of sale of business of the corporate debtor as a going concern, the entity may be dissolved, however, the business assets including intangibles still stands transferred to the acquirer.
- b. **Capital contribution by the acquirer:** In case of sale of the corporate debtor as a going-concern in liquidation, the consideration which the acquirer pays to acquire the business concern and its assets will be split into share capital and liabilities, based on a capital structure that the acquirer decides. To the extent of the share capital, there will be an issuance of shares by the legal entity being transferred. This cannot be a case of transfer of existing shares, as existing shareholders become claimants in the process of liquidation, though they are the last in the waterfall provided in Section 53. In case of sale of business of the corporate debtor as a going concern also, the shares are extinguished.
- c. **Variation in terms of employment:** Since the liquidation commencement is deemed to be notice of discharge of employees, there is no transfer of employees, however, for running the acquisition, if the acquirer intends to retain the employees, he may negotiate on the terms and conditions of employment. Any changes, which should

⁵²<http://www.legislation.gov.uk/uksi/2006/246/contents/made>

necessarily be compliant with statutory employment rights, must be agreed with employee or trade union representatives.

- d. **Fate of encumbered assets:** On sale as a going concern, a question may arise as to whether the encumbrances which existed on the asset prior to the sale shall pass on with the entity to the acquirer. The liquidator does not have much of the role where the secured creditors decide to realise the security interest all on their own. However, where the security interest is relinquished, there is no question of passing of the encumbrances on the assets of the entity, against the interest of the acquirer.
- e. **Transfer to be carried out by a slump sale, not by itemized sale:** The sale must be of the assets put together, i.e. all such assets which constitute an integral business activity or enterprise must be transferred, and the consideration must be for the entire undertaking as a whole, and must not be for each of the assets individually.
- f. **Liquidation without dissolution:** It is well-settled that a liquidation can occur without a formal or legal dissolution. A company can go through the entire process of ceasing business operations, selling its assets and paying off creditors while not formally dissolving. A business may do this if it wants to keep the legal identity of a business for use in another venture. For example, the business may have a name with strong brand recognition that it wants to preserve or may simply want to reuse the current legal structure between the owners for a new venture⁵³.
- g. **Transfer of liabilities:** If there are any liabilities, obligations, dues or claims against the corporate debtor shall be settled from out of the liquidation estate, in terms of the Code.
- h. **Idea must be to run the business:** The idea of a going concern is normally equated with that of a running concern. If the concern in question has long stopped its operations, the general notion is that the corporate debtor cannot be sold as a going concern, since it is hard to conceive as to how the undertaking could be a going concern. However, the object with which the acquirer acquires the corporate debtor should be kept in mind while analysing whether it is a going concern sale, i.e. if the acquirer is intending to run the business, and not to dismantle or cannibalise it, the sale should be categorised as “going concern” sale.

The differentiating factors between the various modes of sale are summarised as below:

Sl. No.	Points of Discussion	Piecemeal Sale	Slump Sale	Sale of corporate debtor as going concern	Business of as going concern
a.	Transfer	Any one or more assets of the	Assets of the corporate debtor	The corporate debtor itself	Any one or more

⁵³<https://bizfluent.com/info-8282875-differences-liquidation-dissolution.html>

Concerns on Going Concern

	corporate debtor gets transferred	getstransferred as a whole, without assigning separate value to individual assets.	gets transferred. There might be several peripheral assets, which may be sold separately.	business(s) of the corporate debtor may be sold. The assets relevant to the particular business has to be sold along with the business. However, non-business assets may be sold separately
b.	Equity shareholding of the corporate debtor	Gets extinguished once the distribution is done as per Section 53 of the Code	Gets extinguished once the distribution is done as per Section 53 of the Code	The equity holding gets transferred. Gets extinguished once the distribution is done as per Section 53 of the Code
c.	Retention Business as going concern	The liquidator may carry on the business of the corporate debtor to the extent required for its beneficial liquidation.	The liquidator may carry on the business of the corporate debtor to the extent required for its beneficial liquidation	The acquirer is expected to carry on the business of the corporate debtor after acquisition. The business of the corporate debtor is to be continued by the acquirer.
d.	Discharge of the employees	Liquidation order amounts to automatic discharge of employees from the liquidation commencement date	Liquidation order amounts to automatic discharge of employees from the liquidation commencement date	The going concern decision is taken by the liquidator after liquidation process has been initiated. Therefore, the discharge would have happened here as well. However, in order for smooth transition to the

				the acquirer, employees the employees may be re-may be re-engaged.
e. Liabilities	All the liabilities are settled from the sale proceeds, in accordance with Section 53.	All the liabilities are settled from the sale proceeds, in accordance with Section 53.	All the Liabilities are settled from the sale proceeds, in accordance with Section 53.	All the Liabilities are settled from The sale proceeds, in accordance with Section 53.
f. Encumbrances on the Assets	The assets were sold after relinquishment of security interest by the secured creditors, hence there is no question of passing on the encumbrances after the conclusion of sale.	These assets were sold after relinquishment of security by the secured creditors, hence, there is no question of passing on the encumbrances after the conclusion of sale.	After relinquishment of security interest by the secured creditors, there exists no question of continuance of encumbrance.	After relinquishment of security interest by the secured creditors, there exists no question of continuance of encumbrance.
g. Dissolution of Legal Entity	The assets are sold and the corporate debtor is dissolved, once the liquidation is complete.	The assets are sold and the corporate debtor is dissolved, once the liquidation is complete.	As the corporate debtor is acquired, the legal entity of the corporate debtor survives.	Since only the business(s) of the corporate debtor is transferred, the corporate debtor may be dissolved.

11. Amendments required in the Code

- a. If the corporate debtor is sold as a going concern, the company survives, and therefore, there will be no need for dissolution of the corporate debtor in terms of Section 54. Accordingly, there may have to be an order pertaining to sanction of sale of the corporate debtor as going concern, issue of shares, settlement of all existing claims and liabilities pertaining to the period up to the completion of liquidation. Requisite amendment is required to be made in the Code to facilitate liquidation without dissolution, in case of sale of corporate debtor as going concern.
- b. If the corporate debtor is transferred as a going concern, there is no question of disposal of the assets of the company, either by way of a piecemeal sale or a slump sale. Therefore, it may be argued that the waterfall mechanism stipulated under

Concerns on Going Concern

Section 53 of the Code also does not apply. However, in a going concern sale in liquidation, there cannot be a question of the liabilities being a part of the undertaking, as that will be a case of business transfer, and not a case of liquidation. In bankrupt liquidation, there has to be a case of settling the liabilities from the realisations, as per the priority set out in Section 53, and the liabilities shall stand extinguished once the distribution is made to the best extent possible. Accordingly, once sale is concluded and distribution is also done, an application may be made to the Hon'ble NCLT, along with the final report of the liquidator, to pass necessary orders for extinguishment of liabilities. The provisions of the Code should accordingly be amended in line of the same.

- c Possible definition of going concern sale for the purpose of liquidation regulations:

Placing reliance on the above, it is proposed that the definition of going concern sale may be included in the Code itself. The suggestive definition is as follows:

“a sale of the assets of the Corporate Debtor, where, pursuant to order of the Adjudicating Authority or otherwise, the legal personality of the Corporate Debtor is retained and is transferred to the acquirer, or it is otherwise provided in the terms of sale that all the contractual rights of the Corporate Debtor, including any rights or benefit under contract, license, concession, entitlement, privilege, lease, etc., are transferred to the acquirer.”

Suggested: ‘sale as going concern’, for the purpose of these Regulations, whether of the corporate debtor or of the business of the corporate debtor, shall mean a sale of either whole or part of the undertaking of the corporate debtor capable of being operated independently, which may or may not provide for dissolution of the legal entity of the corporate debtor, as may be approved by an order of the adjudicating authority.

CONCERNS ON GOING CONCERN:

PROPOSED AMENDMENTS IN LIQUIDATION REGULATIONS NEED RELOOK

- **Vinod Kothari**

Editor's Note: The following is in line with the preceding articles and specifically deals with the Draft Regulations on IBBI (Liquidation Process)(Amendment) Regulations, 2019. One of the provisions of the Draft Regulations is to the effect that there will be a transfer of liabilities along with assets.

The possibility of going concern sales in liquidations, visualised by Adjudicating Authorities in several early cases, got a regulatory recognition *vide* IBBI (Liquidation Process) (Second Amendment) Regulations, 2018. Since then, there has been a lot of work on how exactly will going concern sale work in liquidation. Our previous write-ups on going concern sale are [Liquidation sale as going concern: The concern is dead, long live the concern!](#) and [Enabling Going Concern Sale in Liquidation](#). IBBI itself has organised several meetings around this; there have been meetings organised by other groups such as Society of Insolvency Practitioners of India (SIPI).

Recently, the IBBI released a draft of the amendments to the [Liquidation Regulations](#), which includes regulatory amendments pertaining to going concern sale as well.

This Note highlights the need to have a relook at these proposed amendments, in context of going concern sale.

Relevance of going concern sales in liquidation:

The king is dead- long live the king. Kings die; kingdom continues. Similarly, in liquidation, the legal entity owning the concern dies, but if the concern can be saved from being dismembered and sold in pieces, the concern must be saved. The idea of social advancement is to preserve what we have painstakingly created, as long as it is of contemporaneous value. Therefore, we must intend to chop off dead wood, but save live woods.

Going concern sales in liquidation versus schemes of arrangement

Going concern sale (GCS) in liquidation is different from schemes of arrangement while in liquidation. The schemes are an alternative to liquidation – if the scheme succeeds, it will obviate liquidation altogether. GCS in liquidation is merely one of the modes of disposal of the assets of the entity in liquidation, and therefore, is an act in furtherance of liquidation. It is not, unlike the schemes of arrangement, an alternative or a way out of liquidation. Rather, GCS is done by the liquidator, as a part of the liquidation of the liquidation estate. This is clear from Regulation 32 of the Liquidation Regulations, which stipulates that the Liquidator may sell – (a) an asset on a standalone basis; (b) the assets in a slump sale; (c) a set of assets collectively; (d)

“The key objective in GCS may be preservation of contractual and intangible assets.”

Concerns on Going Concern

the assets in parcels; (e) the corporate debtor as a going concern; or (f) the business(s) of the corporate debtor as a going concern.

So, in what way is GCS sale different from a slump sale? The basic and inherent difference lies in the subject of transfer – where I sell a bunch of assets, without assigning individual values to the assets, whether or not actively used for ‘running’ business, the same is a slump sale; however, where I sell an activity carried on as a business, with assets, the subject of sale is a ‘going concern’.

The key objective in GCS may be preservation of contractual and intangible assets. Often, these assets may be of tremendous value in a business, and in a slump sale, it may be difficult to transfer intangibles, particularly the benefit of contracts such as concessions, leases, supply agreements, and so on.

Further, as one sees, the Liquidation regulations have identified (i) sale of ‘corporate debtor’ as a going concern, and (ii) sale of ‘business of corporate debtor’ as going concern as two different modes. As is evident, while the former option is to sell a company ‘in toto’, the latter option calls for identification of distinct undertaking(s) existing with the company and possible sale thereof – the difference is merely of extent and pervasiveness.

As is understood conventionally, when a ‘business’ is sold as a ‘going concern’ – typically the concept involves transfer of assets as well as liabilities. However, conventional GCS in liquidation (especially of insolvent entities) is itself a paradox – as discussed below; therefore, one may have to think beyond conventional parameters to have an effective framework.

Transfer of liability in GCS sale: a paradox in liquidation

GCS may have different forms and manifestations in different context. Under accounting standards, the meaning of a going concern is a concern that is expected to remain alive, at least over the financial year. The presumption is that the concern has neither the intention *nor the necessity of liquidation* or of curtailing materially the scale of operations. That meaning will be completely ousted in case of liquidation- as the concern is, by definition, already dead.

From GST perspective, transfer of business as a going concern (as a whole or an independent part thereof), is being viewed as supply of service and that such supply of service is *exempt from GST*. There have been rulings, both in India and elsewhere, that have highlighted the features of a going concern sale from GST perspective.

The transfer of business as a going concern is a well- known concept in the Income Tax Act, 1961 also, and has been analysed in various tax rulings as well.

Therefore, it is important to understand that the meaning of term takes a different colour in different contexts. And, as may be observed, laws have carved out favourable exemptions in respect of GCS.

The usual meaning of a GCS sale is transfer of the undertaking as is- along with employees, assets and liabilities.

In liquidation GCS, can there be a transfer of employees? By operation of law, the commencement of liquidation results into employment contracts being terminated. The liquidator often does retain

services, may be of some ex-employees as well, but there is no question of an employment contract between the liquidator and such retained staff.

Similarly, the question of liabilities does not arise in case of liquidations, for multiple reasons:

a. Liabilities have become claims – The liquidator cannot and does not know of any liabilities other than claims. The claims may be claims filed by secured creditors- or claims by unsecured creditors.

Additionally, claims may have different rankings. In case of secured claims, a question may arise as to whether the encumbrances which existed on the asset prior to the sale shall pass on with the entity to the acquirer. The liquidator does not have much of the role where the secured creditors decide to realise the security interest all on their own, however, where the security interest is relinquished, there is no question of passing of the encumbrances on the assets of the entity, against the interest of the acquirer.

Thus, the fact that the liabilities have become claims, meaning claims on the liquidation estate, there is no question of the liabilities still fastening with either assets or with any undertaking of the bankrupt entity.

b. Transfer of liabilities to the acquirer will do violence to the scheme of Section 53. Note Section 53 is one of the crucial provisions in the schema of insolvency law. Insolvency law is all about priorities and equitable distributions. If the liabilities pass with one or more undertakings, those liabilities will be paid as per original contracts, whereas liquidation displaces contracts and replaces them with claims on the liquidation

estate.

c. Transfer of liabilities requires consent of the counterparty: If some of the liabilities are separated out, and are to be transferred along with the asset to the buyer, there is a question of consensus of the persons whose claims are involved, because, by law, liabilities are not transferable except with the concurrence of the person to whom they are owed. In the case of [Indu Kakkar v. Haryana State Industrial Development Corporation Ltd. & Anr](#) it was observed as under:

“Assignment by act of parties may cause assignment of rights or of liabilities under a contract. As a rule a party to a contract cannot transfer his liabilities under the contract without consent of the other party. This rule applies both at the Common Law and In Equity (vide para 337 of Halsburys Laws of England, fourth Edition, part 9).”

If the concurrence of the creditors to whom the liabilities are owed is taken, then we are turning the liquidation into a scheme of arrangement – which by itself is an alternative mode anyway.

d. Is transfer of liabilities mandatory or optional? If the transfer of liabilities is an option given to the liquidator, and not mandatorily required for achieving GCS sale, then the Regulations do not seem to be saying so. The IBBI Discussion Paper on Corporate Liquidation Process stipulates as follows:

Indu Kakkar v. Haryana State Industrial Development Corporation Ltd. & Anr.:

“Assignment by act of parties may cause assignment of rights or of liabilities under a contract. As a rule a party to a contract cannot transfer his liabilities under the contract without consent of the other party.”

Concerns on Going Concern

“In case, the GCS is undertaken at the choice of the CoC, the CoC, including secured financial creditors, shall indicate composition of assets and / liabilities to be sold as going concern. In any other case, the Liquidator may have flexibility to package the assets and liabilities as per market practice and offer every option under regulation 32 of the Regulations simultaneously. He will compute value of each option and each combination of options and sell the asset, business or the CD in the manner which gives the highest value. For example, a CD has three assets A, B, and C, and three liabilities X, Y and Z. He may offer for sale, (a) A only, (b) B only, (c) C only, (d) A and B, (e) B and C, (f) A and C, (g) A, B and C, (h) A and X, (i) A and Y, (j) A and Z, (k) A, B and X, and so on. After receipt of bids for each package, he may find that sale of one business comprising A, B and Y, and sale of one asset (C) give the highest value. He may sell these and discharge the liabilities X and Z from the sale proceeds as per section 53 of the Code.”

e. Impracticality of transfer of liabilities in case of a single concern: The transfer of assets along with liabilities seems possible only in case of entities which have multiple verticals. If the entity has only one vertical, the question of the value of assets exceeding the liabilities will never arise in case of bankrupt liquidation. If the entity has multiple businesses, in one or more verticals, the assets exceed the liabilities in terms of value, a GCS sale may shift the liabilities to a new owner, and residual value of the assets may be transferred to the liquidation estate. However, this will be limiting the flexibility of GCS sale to quite an extent.

f. Can the intent of law be achieved by partial transfer of liabilities: Is it the intent of the Regulations that the purpose of GCS sale is achieved if any liability is transferred? If so, then identification of such liabilities becomes a complex formidable task. Once again, unless the purpose is simply to do a cosmetic transfer of liabilities, there will no real benefit of such transfer of liability.

g. Last but not the least, ‘concerns’ are not run on ‘liabilities’, but on ‘assets’. Therefore, making transfer of liabilities as a pre-condition for a GCS will only lead to degradation of marketability of assets which are already stressed. Unlike in case of resolution, there is no order of NCLT in case of liquidation, whereby haircuts may be imposed on creditors. The creditors may make demand for full payment, along with interest (whereas, in case of liquidation, interest stops on commencement of liquidation date), if the liabilities are to be transferred with the assets.

When can Going concern sale be achieved?

The Regulations seem to be saying that the entity must be in running condition. This is a very subjective proposition. If there may be a possibility of restoring the asset and bringing it into running condition, there is no reason why the asset cannot be sold as a going concern, after bringing it to such as situation.

One may take a common life example: a car lying in garage for last 6 month is not a car in running position. However, if I fuel it, and charge its batteries, and carry out some minor repairs, the car is ready to be ignited into a running position. So, will I call it a running car? Of course yes.

In case of plant and machinery also, while in most liquidation cases, the plant may be out of operation for years, but it can be brought back into running condition. There is indeed no justification in obviating a GCS in such cases. Otherwise, it would lead to a practical difficulty as pointed out by the Supreme Court in [Allahabad Bank v. ARC Holding and Anr](#)

Besides the above, there is also a need for clarity as to the applicability of the amended liquidation regulations- whether the regulations will be applicable to the ongoing cases where the Adjudicating Authority has already given necessary directions for going concern sale or will it be applicable to only those companies whose liquidation commence after the enforcement of the amended regulations?

LIQUIDATION SALE AS GOING CONCERN: *The Concern Is Dead, Long Live The Concern!*

- **Vinod Kothari**

Editor's Note: The following is a precursor to the more detailed note titled *Enabling Going Concern Sale* (supra) of the above-note titled *"Enabling Going Concern Sale in Liquidation"*

The amendments to the Liquidation Process Regulations, introduced on 28th March, 2018, have made a seemingly small change to Reg. 33 of the Liquidation Process Regulations, permitting the liquidator to sell the "corporate debtor as a going concern". This seemingly small amendment is obviously inspired by a wholesome objective – to retain the going concern nature of the entity even though the entity has gone into liquidation. However, the amendment may raise lots of questions, and create an overall intrigue, as to what is the meaning of sale of the corporate debtor as a going concern.

This article tries to answer some of these complicated issues.

Impact of liquidator order: cessation of going concern status

One of the significant differences between insolvency and bankruptcy phases of a company is that while the entity is, and is intended to remain, a going concern during resolution, in liquidation, the entity ceases to be a going concern immediately as the liquidation order is passed. Liquidation is the process that entails liquidation, that is, disposal of the assets of the entity. Liquidator does not sit on the task of running the company; his task

is to liquidate. Of course, the law has always empowered the liquidator to carry on the business of the company to the extent required for its beneficial liquidation, but this power has been interpreted as being limited to, or subservient to the objective of liquidation. That is, the liquidator may do only such things, and carry only such activities, as are conducive to the immediate objective - liquidation.

Amendment in Liquidation process regulations

The amendment *vide* 28th March, 2018 notification adds clause (c) to Reg. 32 of the Liquidation Process Regulations. The Regulation, as amended, stands as under:

The liquidator may:

- (a) sell an asset on a standalone basis; or

"THE KING IS DEAD – LONG LIVE THE KING!"

THE MEANING OF THE ADAGE IS THAT THE KING MAY DIE, BUT THE KINGDOM CONTINUES, UNDER THE NEW KING. SIMILARLY, IN GOING CONCERN SALE UNDER LIQUIDATION, THE IDEA IS THAT THE CONCERN MAY SURVIVE AS IS, BUT UNDER A NEW OWNER

- (b) sell
 - (i) the assets in a slump sale,
 - (ii) a set of assets collectively, or
 - (iii) the assets in parcels¹ or”.
- (c) sell the corporate debtor as a going concern.

“If the company is transferred as a going concern, there is no question of disposal of the assets of the company, either by way of a piecemeal sale or a slump sale.”

Note that the existing clauses (a) and (b) refer to sale of the assets of the company. Plainly read, the newly inserted clause (c) refers to sale of the company itself, as a going concern. That seems to mean, if the company is sold as a going concern, the company survives, and therefore, there will be no need for dissolution of the company in terms of sec. 54.

This would almost seem to be the case of a resolution during the insolvency phase: during insolvency, the company mostly survives, and the company undergoes a resolution plan, which gets the seal of approval of the adjudicating authority. Since the company in question was clearly a bankrupt company, meaning a case of irreparable deficit of assets over liabilities, retention of the corporate existence of the company does not make any sense at all, unless there is a compromise or arrangement, whereby the creditors agree on waivers, write-offs, repayment structure, etc.

Also, if the company is transferred as a going concern, there is no question of disposal of the assets of the company, either by way of a piecemeal sale or a slump sale. Therefore, it may be argued that strictly speaking, sec 53 of the Code does not apply. The assets stay in the company, and so do the liabilities, along with all attendant claims, limitations, licenses, permits or business authorizations. The company survives as it was – the ownership of the company is moved by the liquidator to the acquirer.

It is important to understand that the role of the NCLT as the adjudicating authority in liquidation is limited – it does not approve any resolution plan. Therefore, there is, prima facie, no intervention of the NCLT in effecting any waiver of liabilities or deferment thereof. So, the issue is – if the company was in a situation of irreparable deficiency prior to bankruptcy, how does the survival of the company in liquidation proceedings help?

Transfer of business as going concern

Going concern itself is a well-established accounting notion, and one of the fundamental assumptions in preparation of financial statements. “Going concern”, as an accounting notion, is defined in AS 1 as follows:

The enterprise is normally viewed as a Going Concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

The transfer of business as a going concern is a common concept in the world of commerce. De-merger of an undertaking into another undertaking usually happens by transferring the undertaking to a new company on a going concern basis. Section 2 (19AA) (vi) of the Income-tax Act, 1961

Liquidation Sale as Going-Concern

imposes this as a pre-condition to the statutory definition of de-merger. The condition has been interpreted by the Delhi High Court in *Indorama Textile Limited* as meaning if assets and liabilities being transferred constitute a business activity capable of being run independently for a foreseeable future. In *KBD Sugars & Distilleries Ltd., Bangalore vs. Asstt. Commissioner of Income-Tax*, it was held that going concern always means to say 'alive', whether profit-making or not.

Also, the Income tax appellate tribunal (ITAT) held in the above case, for a going concern to mean, that the undertaking constituted a business activity capable of being run independently for the foreseeable future. See also the ruling in *Hindustan Engineering by ITAT, Kolkata*.

In the Central GST Act as well, there is a specific provision for transfer of a business as a going concern – if the transfer of goods happens as a part of a transfer of a business as a going concern, then there is no GST on such a transfer – Item 4 of Schedule II of CGST Act.

Usual pre-conditions of transfer of business as a going concern:

To transfer a business as a going concern, there are certain pre-requisites in absence of which such a transfer would amount to a mere sale or transfer of assets or liabilities. The conditions are:

- Transfer to be carried out by a slump sale, not by itemized sale

That is to say, the sale must be of the assets put together. All such assets which constitute an integral business activity or enterprise must be transferred, and the consideration must be for the entire undertaking as a whole, and must not be for each of the assets individually.

- Transfer of liabilities too

If there are any liabilities relevant to the business or undertaking being transferred, the liabilities must also be transferred.

- Business must be a running business



Figure 17: Usual Preconditions for going concern sale

The idea of a going concern is normally equated with that of a running concern. If the concern in question has long stopped its operations, it is hard to conceive as to how the undertaking could be a going concern.

- Idea must be to run the business

The idea of the acquirer in case of a slump sale is to run the business, and not to dismantle or cannibalise it.

- If employees exist, the employees should also be intended to transferred

One of the major features of going concern sales, as noted in several insolvency proceedings (see next section) is the continuation of employees.

History of going concern sales in winding up

Transfer of entities as a going concern has been a very popular mode of disposal of entities in winding up proceedings. The 1980s saw a spate of industrial closures, and consequential winding up proceedings before the Calcutta High court rulings. It seems quite clear, looking at the observations of the judges who opted for going concern sale in winding up proceedings, that the judge was inspired by the goal of preserving employees. Justice Manjula Bose while delivering her speech in winding up of *AMCO* stated: “as the Court considered the interest of the workers to be of paramount importance and a matter to be considered along with the interest of the Company, inasmuch as it was the hard labour of the workers which was created the Company to exist all these years. Now that the Company faced closure, it would not be right to throw them out on the street, when there is an offer for the Company to run, and an offer made to re-employ all the workers who had been on the payroll...factory should be sold in running condition so that the factory workers should not be thrown out of work and / or employment.”

In another early case before the Calcutta High court where a company was ordered to be sold on going concern basis under liquidation was the *National Tannery Co Ltd. case*. This is an interesting case study of how a committee of management was formed to run the company until its sale on going concern basis, and eventually, how the West Bengal govt. offered to acquire the company on a going concern basis, pay consideration, and also agree to pay the wages of the workmen. See this interesting case study covered in a research paper.

However, while the idea of going concern sales in liquidation was lofty, it sounded quite difficult proposition too, particularly in cases where the entity in question was closed for a long time. The general judicial impression of going-concern sales was that the employees will be passed on to the acquirer, including the closing stock. Several rulings have actually noted that if the entity was shut for some time, it should first be run at least for a day before transfer, and then transferred as a going concern. The impracticality involved in the process has been noted in a Supreme Court ruling in *Allahabad Bank vs ARC Holding and another* in the following words: “But subsequent order directs sale of the entire assets of the company as a ‘going concern’. This means revive the company first to make it operational, re-employ its employees, which would involve huge investment by the prospective buyer, a Herculean task, making execution practically infructuous.”

Liquidation Sale as Going-Concern

In most cases of going-concern sales in winding up proceedings, the acquirer will come with some kind of a compromise settlement with the stakeholders – including workmen. The settlement would be filed for a consent decree before the court.

Going concern transfer under the Code

In light of the above discussion, it will be interesting to find out the purport of going concern transfer, in liquidation proceedings, under the Code.

Evidently, prior to the commencement of liquidation proceedings, resolution has been given a chance, and the same has failed. This is what has pushed the company into liquidation. There already existed the option of slump sale. The slump sale option is with reference to the assets of the company; however, the Liquidation Regulations now permit the liquidator to cause a sale of the company as such, without transferring the assets of the company.

The only potential meaning of this is that the equity shareholding of the company gets transferred, and the acquirer takes over the company, with all liabilities, limitations, licenses, outstandings, assets, entitlements, etc.

Unlike in the case of going-concern transfers in winding up, where the transfer took place under the supervision of the court, the court would give an order, mostly based on a mutual compromise. However, in case of liquidation proceedings, there is as such no intervention of the NCLT – hence, there is, prima facie, no scope for any order of the NCLT giving any phased payment plan, or any forced waiver of the liabilities of the creditors. On the contrary, if the acquirer was to settle all liabilities as they were, that would be counter-intuitive in case of an entity which has failed the going-concern already.

Hence, all eyes will be on the future course of legal proceedings on this issue. If some NCLT takes a view, which, to the humble of the author, is the right view, that the NCLT has the right to pass appropriate orders in case of liquidation proceedings as well, may be using the generic powers in sec. 60 (5) of the Act, there may be a unique possibility of resolution in liquidation!

SCALE-BASED LIQUIDATOR'S FEE

ISSUES AND ANSWERS

-Resolution Services Team, Vinod Kothari & Company

Editor's Note: The provisions for determination of fees of the Liquidator have been laid down in the Liquidation Regulations under reg. 4(2) and 4(3). However, there are several points that need deliberation – there can be various factors which can make the computations extremely complicated and the scale difficult to apply. The issue becomes all the more important as the liquidator is paying the fee to itself and thus has to be extremely cautious while determining the same. Several issues have been discussed herein by way of illustrations for better understanding.

Liquidators under the Liquidation Regulations may be paid either based on a fee fixed by the Committee of Creditors [Reg 4 (2)], or where the Committee has not fixed such fees, based on the scale provided in Reg 4 (3) ["scale-based" or "scalar" fees]. There are several points that arise in respect of computation of liquidator's fees under Reg 4 (3). What makes the issue very sensitive is that the liquidator is paying himself out of the liquidation estate, and therefore, he is treading the very delicate issue of conflict where his duties as a fiduciary might be conflicting with his claim to the fees. Like in every case where a person responsible in a fiduciary capacity is paying to himself, the liquidator has to be extremely careful, so as to avoid even the farthest chance of an allegation of self-dealing.

This write-up tries to get into some very tricky questions about computation of liquidator's fees.

Realisation and distribution – are the two separate?

The foremost question is, are realisation and distribution two separate additives, such that the liquidator is entitled to fees on both realisation and distribution?

"There may be realisation with no corresponding distribution, and there may be distribution, with no connected realisation."

It should be easy to get an affirmative answer to this question – looking at the very language of Reg 4(3).

The Regulation reads: *"..the liquidator shall be entitled to a fee as a percentage of the amount realized net of other liquidation costs, and of the amount distributed, as under ..(emphasis supplied)."*

The Table thereafter provides separate percentages for fees, based on amounts realised, and amount distributed.

The justification for two separate fee components, one based on realisation and one based on distribution, is understandable: there may be realisation with no corresponding distribution, and

Scale-Based Liquidator's Fee: Issues & Answers

there may be distribution, with no connected realisation. "Distribution" obviously has to be read in light of section 53, and therefore, it will mean distribution to stakeholders. The possibility of there being a realisation but no equivalent distribution is when there are amounts paid over to third parties not coming under section 53, such as items not forming part of liquidation estate. There may be security deposits or other third party monies which the liquidator may be required to return. There has been a recent view that even shortfall of amounts pending to be contributed to employee benefit funds also does not form part of liquidation estate. There may be tax payments, such as municipal taxes, which take a part of the sale proceeds of property.

On the other hand, there may be distributions, with no corresponding realisation. This may mostly be the case because of cash or cash equivalents available at the start of the liquidation proceedings.

These moneys may be distributed by the liquidator after settling claims; but one cannot claim that there has been a "realisation", as the amounts were already in liquid form.

Hence, there seems little doubt that there are two separate fee components – one based on realisation of assets, and one based on distribution of the proceeds of such realisation.

Realisation is an inflow; distribution is an outflow. The Regulations seem to have considered realisation as involving more time and effort – hence, there is a higher fee attached with realisation, than with distribution.

Point of time for accrual of the fee – realisation and distribution

In fact, the point of time for fee to be accrued comes also clear from Reg 4 (4). If the proceeds of an asset have been realised, but have not been distributed, the liquidator is entitled to only half of the fee related to realisation. However, if the proceeds have also been distributed, the liquidator shall be entitled to the entire fee on realisation, as well as the fee payable on distribution.

Doing a comparison between the realisation stream is not like comparing the like to like – because of costs and third party payments, there may be at least some realisation which has not been distributed at all. However, this is a conclusion one may arrive towards the end of the liquidation process.

In most real life liquidations, realisations and distributions happen in tranches. There is, obviously, no direct nexus between realisations and distributions. Realisations may happen over time; when liquidators have sufficient liquidity, not required for the purpose of liquidation affairs, the liquidator should cause an interim distribution.

In order to know whether what has been realised has been distributed or not, the only possible test to apply will be cumulative realisations and cumulative distributions. A realisation from an asset may be taken as distributed, if the cumulative realisations till the point of time are at least equal to the cumulative distributions till that point. Of course, there is no concept of partial distribution of sale proceeds – hence, if, looking at the cumulative distributions, it is only a part of the realisation that has been distributed, then it should be presumed that the realisation has not been distributed.

***"Realisation is an inflow;
distribution is an outflow."***

***Hence, there is a higher fee
attached with realisation, than
with distribution.***

“Liquidation costs” and “other liquidation costs”

In case of the realisation scale, the fee is computed on the amount realised, net of “other liquidation costs”. The expression “other” liquidation cost must be taken to mean liquidation costs, other than the fee payable to the liquidator himself. Note that there is no question of deducting any such costs in case of the distribution scale, which is quite obvious, because distribution happens after all relevant costs and outflows have been accounted for.

The meaning of “liquidation costs” comes from Sec 5 (16) of the Code, read with Reg 2 (1) (ea). Section 5 (16) defines the term to mean “any cost incurred by the liquidator during the period of liquidation subject to such regulations, as may be specified by the Board”. As may be seen, the definition is wide enough to include “any cost”.

However, Reg 2 (1) (ea) seems to be doing some delimitation to such wide meaning. The said Regulation gives a comprehensive definition of the term, however, limiting it to 4 components:

- Liquidator’s own fee
- Remuneration payable to professionals, in terms of Reg 7
- Cost incurred by the liquidator in verification and determination of the claim, in terms of Reg 24
- Interest on interim finance, for a maximum period of 12 months from commencement

The first question that comes is – was Reg 2 (1) (ea) actually meaning to delimit the seemingly unlimited ambit of sec. 5 (16)? Reg 2 (1) (ea) was inserted in the statute to ensure that the priority under section 53 (1) (a) is not applicable to all costs incurred by the liquidator but not paid. Hence, it is notable that the language of Reg 2 (1) (ea) is “payable” or “incurred”, rather than paid. That is to say, if the liquidator has engaged professionals for carrying out liquidation functions, but the said professionals could not be paid, the unpaid fee will have the first claim on the priorities listed in section 53.

But could it the idea of Reg 2 (1) (ea) to say that it is only the 4 items of costs that will be deducted from the sale proceeds of assets?

Depending on the facts of the case, there may be numerous types of costs that may be incurred by the liquidator:

1. Costs and expenses to the extent required to keep the business of the corporate debtor going;
2. Costs and expenses required for beneficial liquidation – for example, if there are half-done jobs, the same may have to be completed to get a right on the
3. Costs of insuring the assets
4. Costs of repairing and maintenance of assets

Scale-Based Liquidator's Fee: Issues & Answers

5. Security costs
6. Manpower costs – many assets may require regular upkeep; while the employees may have been dismissed on liquidation orders, some staff may have to be retained on retainership contracts.
7. Municipal and other asset-related taxes
8. Professionals fees –including valuations, auditors, auctioneers, consultants or agents to facilitate a sale

Of the 4 elements mentioned in Reg 2 (1) (ea), the liquidator's fee itself is not a deductible in view of the language of Reg 4 (3). The costs incurred for determination of a claim may include those limited cases where a claim was dismissed, and had to be litigated before the claim could be admitted, or costs incurred for verification of the claim from records of information utility, etc. Interim financing may also not be a common occurrence. That leaves only 1 item of deductible in computing the net realisations under Reg 4 (3) – the fees payable to professionals (discussed at length separately).

However, was that the intent of Reg 4 (3) – to confine the deduction from the sale proceeds only to the professionals' fees, and ignore all other costs?

A useful comparison may be Rule 18.22 of the UK Insolvency Rules, 2016. Here, all bankruptcy expenses are to be deducted in applying the realisation scale, excepting the fee of the receiver, and the expenses in carrying on the business of the insolvent, spent out of the money received in carrying on such business. Assuming that the business of the insolvent was not carried on, all the bankruptcy expenses are deducted, except the liquidator's own fees.

Taking any other interpretation will be unrealistic. Following are some examples:

- An asset will sell for Rs 150 if I incur a repairs cost of Rs 20. If I don't incur the expense, it will sell for Rs 100. So, I decide to incur the expense, and sell the asset for Rs 150. Is it justifiable for me to claim a fee on Rs 150, without deducting the cost of Rs 20 which was responsible for the higher realisation.
- The asset in question is a car. The asset will sell for Rs 110 if the asset is insured, with current tax payments. The asset will sell for Rs 100 if the asset does not have an insurance and road tax receipt. So, I spend Rs 10 on the insurance and road tax. Can I claim the realisation scale on Rs 110, without deducting the insurance and road tax?

In essence, if we limit the expenses to be deducted from the sale proceeds, there may be intricacies of having to distinguish between expenses that have contributed to the sale proceeds and those that have not, expenses that have assisted in the sale process and those have not, etc.

Intuitively, if something is a part of bankruptcy expenses, irrespective of whether it is a professionals' fee or not, the same should be deducted from the realisations.

Therefore, the items which are not deductible from the sale proceeds (i.e. realisations) should actually include only such items which are, properly speaking, not costs. These may include:

- Any taxes on sale such as GST (typically, GST should not be treated as a part of realisation as well).
- Any amounts which were not regarded as forming part of liquidation estate, such as moneys held for third parties, or similar

Professionals' Fees

Section 35(1)(i) enables the liquidator to obtain any professional assistance from any person *or* appoint any professional, in discharge of his duties, obligations and responsibilities. Further, Regulation 7 enables the liquidator to appoint “professionals” to “*to assist him in the discharge of his duties, obligations and functions*” for a reasonable remuneration and the remuneration shall form part of liquidation cost.

Notably, reg. 2(1)(ea) refers to reg. 7 and not section 35(1)(i) – therefore, it might be said that “obtaining professional assistance” and “appointing professionals in discharge of duties, obligations and responsibilities” are not one and same. For instance, if the liquidator obtains a legal opinion – the same would qualify as “professional assistance”.

Now, the duties, obligations and functions of a liquidator are multifarious as described in section 35(1) – ranging from verifying claims to distributing the proceeds; taking the assets into custody, preserving those assets and ultimately selling the assets; instituting/defending suits, prosecution or other legal proceedings in the name of on behalf of the company; and even carrying on the business of the corporate debtor for its beneficial liquidation. Besides, the liquidator has been entrusted with various duties/obligations under the Liquidation Regulations – for instance, arranging for valuations, preparation of various reports, receipts and payments account, etc.

Therefore, as it appears, such professionals who “assist” the liquidator in the functions/duties as above are to be included under regulation 7 and consequently the remuneration paid to them shall be a part of “liquidation cost” under reg. 2(1)(ea). Certain instances of such professionals are –

- merchant bankers appointed for facilitating sale of assets;
- valuers appointed for valuation of assets;
- lawyers/counsels, etc. appointed for representing the liquidator/company in legal proceedings

However, there are several such instances where it might not be possible to clearly distinguish whether the professional was appointed “in discharge of duties/obligations” of liquidator – take for example, auditor appointed for receipts and payments, professionals appointed for drafting sale documents, retainers engaged to carry out beneficial liquidation (whether or not they qualify as “professionals”), etc. In view of the above, determination of reg. 7 costs might be an area of conflict and lead to faulty/uneven computation of liquidator’s fee on realisation. Computation of fee on net realisations (that is, excluding all costs, as discussed above) will possibly avoid such conflicting situations.

Scale-Based Liquidator's Fee: Issues & Answers

How to deduct expenses from realisations?

In case of phased distributions, another issue is – how to deduct expenses from realisations? The expenses are incurred over a period of time. Hence, is it expected that all expenses upto the point of the distribution are deducted from the realisation, or the expenses that pertain to the assets disposed off are to be deducted?

In practice, doing an asset-based allocation of the expenditure will be impractical. Hence, one will to deduct all expenses upto a particular distribution, and then, the expenses from that point onwards may have to be deducted while making the next distribution.

If the view is that expenditure to be deducted from the sale proceeds is all liquidation costs, and that the reference to para 2 (1) (ea) is not relevant to Reg 4 (3), then the easiest way to compute the net realisations will be to start from the distribution, and simply add back the items which are not regarded as “costs” or expenses.

Stress on proper format of liquidator's accounts:

The above discussion also points to the need for standardisation of liquidators' receipts and payments accounts as well. The receipts and payments account not only has to have appropriate groupings of items of inflows and outflows, so as to make intelligible reading, it must also present the sale proceeds, expenses of liquidation, and fees of professionals and the liquidator himself, so as enable the computation of fees.

Conclusion

Seemingly, what is needed is a detailed clarity on regulation 7. Nevertheless, it would be appropriate to consider any cost incurred during liquidation while computing fee on realisation. The same follows a conservative approach, and is recommended because of its reasonability too.

Also, it is suggested that the liquidator's accounts be presented with suitable headings so as to reflect the nature of the expenses paid by the liquidator, alongwith notes, if required.

RELINQUISHMENT OF SECURITY BY SECURED CREDITORS

-Resolution Services Team, Vinod Kothari & Company

Editor's Note: One of the pillars of 'availability of credit' is the rights of secured lenders. The objective of reduction of cost of lending by bringing down the risk premium may be realised only where the secured creditors may effectively encash their collateral rights. While in resolution, letting secured creditors exercise their rights is not an option; during liquidation, secured creditors do get an option to either enforce their security interests outside liquidation or relinquish the same and participate in the collective process of liquidation. The law as of this time, however, remains silent on certain aspects, such as, at what point of time should the secured creditor decide to realise/relinquish? Note that a proposed amendment may tackle the issue by amendment of Regulations.

This note deals with such unanswered issues, in the light to established principles, and judicial precedents.

This Note discusses a significant question in respect of liquidation proceedings under the Code - at what stage does a secured creditor decide whether to relinquish security interest and join the liquidation proceedings, or to enforce security interest outside the liquidation process, and file the claim for the balance amount, if any.

The Note examines the said question, and is, accordingly, structured as follows:

- Background
- Provisions of the IBC
- Provisions of Companies Act, 1956
- Rulings of Courts in India
- Global position

1. Background

Security interest is regarded as "real interest" (right *in rem*) as opposed to "personal interest" (right *in personam*); as such, security interest is the interest in the property itself. Secured lenders may, on default of the personal obligation of the debtor, enforce their rights on the property, and demand the residual debt, if any, from the debtor. This right of the secured debtor is preserved in the situation of winding up/liquidation as well, with the difference there is an appropriation of a *pari-passu* share of workmen's dues.

Thus, IBC, like insolvency laws across jurisdictions, allows the secured creditor the option of either- (a) relinquishing security interest and claiming from the liquidation estate, in which case the ranking of such creditor is the highest among claimants, and *pari passu* with workmen; or (b) enforcing



Relinquishment of Security by Secured Creditors

security interest outside liquidation, in which case, the secured creditor's residual claim, if any, is at 5th level in the waterfall under Section 53, at par with government dues.

The important question is with respect to the stage does a secured creditor is required to exercise the aforesaid options. Below we try to analyse the provisions contained in IBC, with reference to similar provisions in

2 Provisions of IBC

Sub-section (1) of Section 52 provides two alternatives to a secured creditor in liquidation proceedings- (i) relinquish the security interest to the liquidation estate and receive proceeds from the sale of relevant assets by the liquidator in the manner specified in Section 53, or (ii) realise the security interest in the manner specified in Section 52 itself.

The provision, as above, appears to be silent as to the stage one of the two options has to be chosen by the secured creditor. However, if one sees corresponding provisions in the part dealing with individual bankruptcy, the principle becomes clear from Section 172. It states:

“(1) Where a secured creditor realises his security, he may produce proof of the balance due to him.

(2) Where a secured creditor surrenders his security to the bankruptcy trustee for the general benefit of the creditors, he may produce proof of his whole claim.”

The amount of ‘proof’ submitted to the trustee, as such, becomes a determinant or a reference for the trustee to conclude if the secured creditor has surrendered his security or not.

As might be known, such a provision (Section 172) draws inspiration from age-old insolvency laws – the Presidency Towns Insolvency Act, 1909 (Section 48 read with paras 9 & 10 of the second schedule), and the Provincial Insolvency Act, 1920 (Section 47). Such rules, though particularly applicable to individual bankruptcies, were explicitly applicable in corporate insolvent liquidations (Section 529 of the Companies Act, 1956)-see discussion in subsequent paragraphs.

In respect of liquidation of corporate persons, the scheme of the law may be understood from a combined reading of the following:

- The settled scheme of liquidation is that all assets of the Corporate Debtor become part of the liquidation estate, and the claimants make a claim on the liquidation, which, when admitted, will be settled in the priority order mentioned in Section 53.
- In case of assets subject to security interest, only such of the assets become part of the liquidation estate over which the secured creditors have relinquished security interest. This is clear from Section 36(1)(g). That is, if the secured creditor does not relinquish security interest, the asset will not even form part of the liquidation estate.
- Section 52 makes the following clear:
 - Secured creditor(s) have unfettered right to enforce security interest outside liquidation. The liquidation has no role at all in such enforcement, except that he “permits” [Section 52(3)] upon “information” by the secured creditor, and identification of the security interest and evidencing the same [Section 52(2)]. The secured creditor “intimates” liquidation of the

option [Regulation 37] and the liquidator may put up a competing bidder who pays a price than the one obtaining from the private sale by the secured creditor.

- The liquidator has claim on the sale proceeds to the extent of proportionate part of insolvency costs [Section 52(8)]. Vice versa, if there an unrealised amount, the same shall be filed as a claim, and shall rank in terms of Section 53(1)(e).
- It may be argued, based on time-tested principles of Companies Act and reference to provisions of the SARFAESI Act that the *pari passu* share of workmen's dues shall be payable by the secured creditors even when they seek to stay outside liquidation proceedings.

The above discussion makes it clear that the decision by the secured creditors to stay outside liquidation proceedings and enforce security interest by way of a self-help remedy should be exercised early on, and in particular, before filing the claim for which a 30 days' time is given in terms of Section 38. The intuitive basis for this is: the claim of the secured creditor who seeks to enforce security interest is only to the extent of the amount remaining after realisation. Also, since

Section 47 of the Provincial Insolvency Act, 1920:

“(1) Where a secured creditor realises his security, he may prove for the balance due to him, after deducting the net amount realised.

(2) Where a secured creditor relinquishes his security for the general benefit of the creditors, he may prove for his whole debt.”

such asset, on which security interest is to be exercised outside liquidation, will not even form part of the liquidation estate, the liquidator must know of such option at sufficiently early stages. Note that during the CIRP stage, enforcement actions are blocked by moratorium. However, once the CIRP proceedings are over, or 180 (or 270) days are over, the secured creditors are free to proceed for enforcement action, should they choose to.

Filing (called proving, in insolvency law parlance) of a claim is the process whereby the secured creditor makes a claim to be paid out of the liquidation estate. Section 38 permits the secured creditor to file his claim within 30 days. Regulation 37(1) provides that where the secured creditor prefers to enforce security interest outside

liquidation, he would intimate to the liquidator the price at which he intends to sell the asset. It stands to reason to believe that the intimation of the intent to sell, and expected price, should be filed at the very time of filing of claims. It will be counter-intuitive to think of the secured creditor filing claim for the whole of the debt, and still preserving the option to sell outside liquidation, because, in that case, the claim will, in the first place, be only for the residual amount, and also, the secured creditor will have to allow the liquidator to put up a competing buyer.

3. Provisions of Companies Act, 1956

The option to enforce security interest outside winding up is not unique to the Code- the same principle was there under the Companies Act, 1956, and before the Companies Act, 1956, the same principle was extended by way of individual insolvency principles by courts.

Relinquishment of Security by Secured Creditors

Thus, the principle has been recognised in the extant insolvency laws, viz. PTIA, 1909 and PIA, 1920- that a secured creditor has two *alternatives*, viz., to realize the security and to prove for the balance due to him in case on realization of such security he is not able to recover the entire amount due to him. If, however, the secured creditor does not opt to realize his security but relinquishes it for the general benefit of the creditors, then he may prove for his whole debt. The relevant extract of Section 47 of the Provincial Insolvency Act, 1920 is reproduced below:

“(1) Where a secured creditor realises his security, he may prove for the balance due to him, after deducting the net amount realised.

(2) Where a secured creditor relinquishes his security for the general benefit of the creditors, he may prove for his whole debt.”

The principle, as above, prevailed and was observed in winding up of insolvent companies (Section 529 of the Companies Act, 1956). Section 325 of the Companies Act, 2013, which corresponds to Section 529 of the Companies Act, 1956, also contains identical provision as regards applicability of insolvency rules with respect to the estates of persons adjudged insolvent.

4. Rulings of Courts in India

It is relevant to cite the following cases:

- a) One of the most commonly cited rulings on the options of the secured creditor, dating prior to the 1956 Act, is the ruling in [M. K. Ranganathan and Another v. Government Of Madras And Others](#), 1955 AIR 604, 1955 SCR (2) 374. In this case, the Supreme Court quoted Lord Wrenbury in *Food Controller v. Cork*, 1923 Appeal Cases 647, while describing the position of a secured creditor in winding up –

"The phrase 'outside the winding up' is an intelligible phrase if used, as it often is, with reference to a secured creditor, say a mortgagee. The mortgagee of a company in liquidation is in a position to say "the mortgaged property is to the extent of the mortgage my property. It is immaterial to me whether my mortgage is in winding up or not. I remain outside the winding up' and shall enforce my rights as mortgagee". *This is to be contrasted with the case in which such a creditor prefers to assert his right, not as a mortgagee, but as a creditor. He may say 'I will prove in respect of my debt'. If so, he comes into the winding up*".

- b) In [Allahabad Bank v. Canara Bank & Anr](#) (2000) 4 SCC 406, the two-Judge Bench of the Supreme Court discussed these rights of the secured creditors in paragraphs 62, 63, 64 and 65 of the judgment as reported in the SCC, which are extracted below:

“62. Secured creditors fall under two categories. Those who desire to go before the Company Court and those who like to stand outside the winding-up.

63. The first category of secured creditors mentioned above are those who go before the Company Court for dividend by relinquishing their security in accordance with the insolvency rules mentioned in Section 529. The insolvency rules are those contained in

Sections 45 to 50 of the Provincial Insolvency Act. Section 47(2) of that Act states that a secured creditor who wishes to come before the official liquidator has to prove his debt and he can prove his debt only if he relinquishes his security for the benefit of the general body of creditors. In that event, he will rank with the unsecured creditors and has to take his dividend as provided in Section 529(2). Till today, Canara Bank has not made it clear whether it wants to come under this category.

The second class of secured creditors referred to above are those who come under Section 529-A(1)(b) read with proviso (c) to Section 529(1). These are those who opt to stand outside the winding-up to realise their security. Inasmuch as Section 19(19) permits distribution to secured creditors only in accordance with Section 529-A, the said category is the one consisting of creditors who stand outside the winding up. These secured creditors in certain circumstances can come before the Company Court (here, the Tribunal) and claim priority over all other creditors for release of amounts out of the other monies lying in the Company Court (here, the Tribunal). This limited priority is declared in Section 529-A(1) but it is restricted only to the extent specified in clause (b) of Section 529-A(1). The said provision refers to clause (c) of the proviso to Section 529(1) and it is necessary to understand the scope of the said provision.”

c) In Jitendra Nath Singh v. Official Liquidator & Ors, it was held-

“11. The above provision gives different options that are available and can be exercised by a secured creditor. It, however, has to be kept in mind that in terms of section 529 the rules of insolvency shall prevail and be observed but only with regard to debts provable, the valuation of annuities and future and contingent liabilities and the respective rights of secured and unsecured creditors. Where a secured creditor realizes his security, he may prove the balance due to him after deducting the net amount realized; or where a secured creditor relinquishes his security for the general benefit of the creditors, he may prove for whole of his debt. Still, where a secured creditor does not exercise either of these options, he is entitled to have his debt entered in the schedule and would be entitled to receive the dividend in terms of Section 47(3).

Lord Wrenbury in Food Controller v. Cork, 1923:

“The phrase 'outside the winding up' is an intelligible phrase if used, as it often is, with reference to a secured creditor, say a mortgagee. The mortgagee of a company in liquidation is in a position to say "the mortgaged property is to the extent of the mortgage my property.”

Allahabad Bank v. Canara Bank & Anr:

“62. Secured creditors fall under two categories. Those who desire to go before the Company Court and those who like to stand outside the winding-up.

Jitendra Nath Singh v. Official Liquidator & Ors:

The relinquishment of security by a secured creditor certainly requires some conscious act on his part more than the mere filing of a claim in response to a

Relinquishment of Security by Secured Creditors

24. *The relinquishment of security by a secured creditor certainly requires some conscious act on his part more than the mere filing of a claim in response to a public notice issued by the official liquidator. Once the secured creditor takes such further actions like sale of the secured assets through the liquidator and subject to the control of the Company Court in that event, he would be part of the scheme of payment as rationalized under Section 529 and 529A of the Act.*

28. *Equally, it can be stated that a secured creditor who, after institution of a claim but without pursuing the remedy outside the provisions of this Act, files claim before the official liquidator, relinquishes his security and agrees to the distribution of the sale proceeds through the official liquidator, subject to jurisdiction of the Company Court, could always be said to be not 'standing outside the winding up' proceedings.*

Very importantly, this ruling is the ruling of a 3 member Bench, where the following observations of the dissenting Judge were not agreeable to the majority:

“3. Merely submitting of an affidavit or demand by the secured creditor in response to the notice issued by the Official Liquidator inviting claims would not tantamount to effective participation in the winding up proceedings (Ref. ICICI Bank (supra)).

4. Mere institution of a petition by a secured creditor before a court or forum of competent jurisdiction per se will not lead to an inference that the secured creditor has stood outside the winding up proceedings unless it takes some effective steps to pursue those proceedings and realizes its security de hors the specific procedure under the Act.

6. Relinquishment has to be a conscious act on the part of the secured creditor and is incapable of being construed by implication.”

d) In the case of [Canfin Homes Ltd. v. Lloyds Steel Industries Ltd.](#) 2001 (4) BomCR 84, (2001) 106 CompCas 52 Bom, the Bombay High Court observed:

“15. The secured creditor who seeks to prove the whole of his debt in the course of the proceedings of winding up must before he can prove his debt relinquish his security for the benefit of the general body of the creditors. If he surrenders his security for the benefit of the general body of creditors, he may prove the whole of his debt. If the secured creditor has realized his security, he may prove for the balance due to him after deducting the net amount that has been realized. The stage for relinquishing security arises when a secured creditor seeks to prove the whole of his debt in the course of winding up. If, he elects to prove in the course for winding up the whole of the debt due and owing to him, he has to necessarily surrender his security for the benefit of the general body creditors.”

e) The Gujarat High Court, in [Gujarat Steel Tube Employees v. O.L. Of Gujarat Steel Tubes Ltd.](#) 2006 131 CompCas 410 Guj, (2006) 5 CompLJ 452 Guj, 2006 70 SCL 407 Guj, relied on the decision of the Bombay High Court in the case of *Canfin Homes Ltd. v. Lloyds Steel Industries Ltd.* (supra) and observed as follows:

“A secured creditor who seeks to prove the whole of his debt in the course of the winding up proceedings is necessarily required to relinquish the security.”

- f) Similar view was taken by the Andhra Pradesh High Court in [Canara Bank v. Mopeds India Ltd.](#) 2005 124 CompCas 824 AP, 2004 50 SCL 105 AP, wherein it was held-

“Insofar as the secured creditors who move the company Court it was held that secured creditor who wishes to come before the OL has to prove his debt and he can prove his debt only if he relinquishes his security for the benefit of the general body of creditors.”

5. UK Insolvency law

Under rule 14.19 of the UK Insolvency Rules, 2016 [corresponding to rule 4.88 of the UK Insolvency Rules, 1986], a secured creditor has the following options:

- Surrender their security and prove for the whole amount of the debt [R. 14.19(2)];
- Place a value on their security and prove for the balance of his/her debt [R. 14.19(1)(b)];
- Rely entirely on their security and not submit a proof of debt;

Sir R.M. Goode, in his celebrated work, *Principles of Corporate Insolvency Law*, quoting relevant provisions of the Insolvency Rules, 1986, states as follows:

“A secured creditor has a number of options. He can surrender his security and prove for the full amount of the debt due to him, a procedure rarely used since it appears to have no possible advantage; he can value his security in his proof and prove for the balance of the debt; he can realise his security and, if the proceeds are insufficient to cover the amount due, can prove for any deficiency; and he can simply rest on his security without lodging a proof at all.”

Under rule 14.19 of the UK Insolvency Rules, a secured creditor has the following options:

- *Surrender their security and prove for the whole amount of the debt [R. 14.19(2)];*
- *Place a value on their security and prove for the balance of his/her debt [R. 14.19(1)(b)];*
- *Rely entirely on their security and not submit a proof of debt;*

At pg. 168, *ibid*, referring to rule 4.88 of the UK Insolvency Rules, 1986, Goode says, “If he proves for the full debt he is deemed to have surrendered his security”.

On perusal of the relevant provisions and the precedents thereto, it is clear that a secured creditor is deemed to have relinquished its security, and participate in winding up proceedings, if the claim is filed for the whole amount before the liquidator.

Lack of clarity in the law and way forward

The Code is new; liquidation proceedings under the Code are even newer. Secured creditors get 30 days’ time to file their claim. The filing of the claim by the creditors may be intuitively seen as reconciling their amounts with the books of the company, or otherwise, getting the liquidator’s seal

Relinquishment of Security by Secured Creditors

of approval on the total amount claimed. Unfortunately, Section 52 of the Code and Regulation 37(1) do not provide any explicit timelines for the exercise of the option to relinquish. Consequently, several secured creditors may not have been able to connect the filing of the claim with the pre-exercise of the option.

While the need to have clarity in the Regulations is quite obvious, secured creditors need to make their stand on the option under Section 52 clear immediately. Under the scheme of the Code, if the claim for the whole amount would have been admitted, any variation thereof will require the prior approval of the Adjudicating Authority. Therefore, if the claims have been filed and admitted, and the secured creditor still wants to plead lack of clarity of the law and exercise the option to self-enforce the security interest, the secured creditor must obtain approval of the Adjudicating Authority as contemplated in Section 42. Notably, the assets having formed part of the liquidation estate, an option to realise them outside liquidation is not merely an exercise in self-interest of the secured creditor- it impacts all other stakeholder too.

TO RELINQUISH OR NOT TO RELINQUISH: A DISCRETION OF SECURED CREDITORS?

- **Richa Saraf**

Editor's Note: One of the distinguishing features of lending practices in India is that most loans are secured loans. In global lending practice, granting of security interest on assets is limited to asset-backed lending transactions. Floating charges, a UK practice, has come under several significant judicial pronouncements such as *Brumark*, *Cossett*, and *Spectrum*

In India, on the other hand, most lending to industrial companies has been secured lending, and more often than not, the security interest is a floating charge. In the past practice of winding up, the practice that gained popularity was that lenders will not relinquish security interest – they will simply permit the Official Liquidator to sell the asset, thereby converting their charge from charge over the asset to charge over money. There was apparently no strong reason for relinquishment in the past, as the relinquishment of charge will mean the secured creditor will become effectively unsecured.

The Code brings a sea-change in the law: the priority in sec. 53 (1) (b) to be paid from the liquidation estate arises only if the secured creditor has relinquished security interest. This is completely different from how it was under the winding up regime.

Thus, the choices for the secured lender are: sell the asset outside liquidation and claim for the balance money under sec. 53 (1) (e), or relinquish security interest and claim the whole of the money under sec. 53 (1) (b). The secured creditor has to make his choice clearly. He, of course, does not have the option of remaining non-committal.

A security interest is a substantive right of a secured creditor, however, once the corporate debtor is in liquidation, a secured creditor has to take the call on whether the secured creditor wants to join the proceedings by relinquishing security interest or wants to enforce its right and file a claim only for the residual amount.

A secured creditor may enforce, realize, settle, compromise, or deal with the secured assets in accordance with the applicable provisions of law in relation to enforcement of security and apply the proceeds to recover the debts due to him; however, it is pertinent to note that the option to realize, and option not to realise are *mutually exclusive* options. The secured creditor is under duty to select what option he wants to select, on the creditor's own wisdom, doing such analysis, making such forecasts and doing such assessment, as the secured creditor may want to do.

Provisions of Insolvency and Bankruptcy Code:

Sections 52 and 53(1)(b) of the Code are two alternative routes available to a secured creditor. While Section 52 does not explicitly provide for the stage at which the secured creditors have to exercise one of the two options, the corresponding provisions contained in Section 172 of the Code stipulates:

“(1) Where a secured creditor realises his security, he may produce proof of the balance due to him.

Moratorium During Liquidation:

Scope & Effect

(2) Where a secured creditor surrenders his security to the bankruptcy trustee for the general benefit of the creditors, he may produce proof of his whole claim."

As regards the submission of claim for the full value of the asset, a secured creditor who wishes to come before the liquidator has to prove his debt and he can prove his debt, either for the whole of his claim, or, if he chooses to stay outside liquidation, for the amount of the remainder after realization from the sale of the asset. A secured creditor may file his claim for the full amount only if he relinquishes his security for the benefit of the general body of creditors. The creditor cannot thus, state that while it has filed its claim for the entire amount, the creditor has not relinquished his security and still has the option of realization outside liquidation. Further, on reading of Section 36(1)(g) of the Code, it is amply clear that in case of assets subject to security interest, only such of the assets become part of the liquidation estate over which the secured creditors have relinquished security interest.

If the creditor decides to enforce security interest outside liquidation utilizing the option given in Section 52, it is mandatory under the law for the creditor to notify of such an intent to the liquidator, as required under Regulation 37(1) of the IBBI (Liquidation Process) Regulations, 2016; There is no role that the liquidator has in the secured creditor choosing one of the two rights that the secured creditor has. In fact, the liquidator comes into picture, insofar as the secured asset is concerned, only if and to the extent the security interest has been relinquished, because it is only then that the asset forms part of liquidation estate. However, the creditor cannot wait for months altogether, and contend that it has not relinquished security interest. The creditor does not have any right to stall liquidation proceedings.

Precedents:

The extant Section 52 of the Insolvency and Bankruptcy Code, 2016 and the erstwhile Section 529 of the Companies Act, 1956 has been derived from Section 47 of The Provincial Insolvency Act, 1920, which stipulates-

"47. Secured creditors.- (1) Where a secured creditor realises his security, he may prove for the balance due to him, after deducting the net amount realised.

(2) Where a secured creditor relinquishes his security for the general benefit of the creditors, he may prove for his whole debt."

On perusal of the aforesaid provision, it is evident that a right was available to the secured creditor, under Section 47 of the Insolvency Act, and has a similar option under the present regime to realize the security and to prove for the balance due to him in case on realization of such security he is not able to recover the entire amount due to him. If, however, the secured creditor does not opt to realize his security but relinquishes it for the general benefit of the creditors, then he may prove for his whole debt. This has been the position in India and elsewhere in the world in case of secured creditors, and remains unchanged under the Code.

The company courts in various rulings have already pointed out the stage at which a secured creditor is required to exercise its options. *"The stage for relinquishing security arises when a*

Section 172 of the Code stipulates:

"(1) Where a secured creditor realises his security, he may produce proof for the balance due to him.

(2) Where a secured creditor surrenders his security to the bankruptcy trustee for the general benefit of the creditors, he may produce proof of his whole claim."

secured creditor seeks to prove the whole of his debt in the course of winding up. If, he elects to prove in the course for winding up the whole of the debt due and owing to him, he has to necessarily surrender his security for the benefit of the general body creditors.” In this regard, it is also relevant to cite the following cases:

- a) One of the most commonly cited rulings on the options of the secured creditor, dating prior to the 1956 Act, is the ruling in [M. K. Ranganathan and Anr. v. Government of Madras and Ors](#) 1955 AIR 604, 1955 SCR (2) 374. In this case, the Supreme Court quoted Lord Wrenbury in *Food Controller v. Cork*, 1923 Appeal Cases 647, while describing the position of a secured creditor in winding up-

“The phrase ‘outside the winding up’ is an intelligible phrase if used, as it often is, with reference to a secured creditor, say a mortgagee. The mortgagee of a company in liquidation is in a position to say “the mortgaged property is to the extent of the mortgage my property. It is immaterial to me whether my mortgage is in winding up or not. I remain outside the winding up’ and shall enforce my rights as mortgagee”. This is to be contrasted with the case in which such a creditor prefers to assert his right, not as a mortgagee, but as a creditor. He may say ‘I will prove in respect of my debt’. If so, he comes into the winding up”.

- b) In [Allahabad Bank v. Canara Bank & Anr](#) (2000) 4 SCC 406, the two-Judge Bench of the Supreme Court discussed these rights of the secured creditors in paragraphs 62, 63, 64 and 65 of the judgment as reported in the SCC, which are extracted herein below:

“62. Secured creditors fall under two categories. Those who desire to go before the Company Court and those who like to stand outside the winding- up.

63. The first category of secured creditors mentioned above are those who go before the Company Court for dividend by relinquishing their security in accordance with the insolvency rules mentioned in Section 529. The insolvency rules are those contained in Sections 45 to 50 of the Provincial Insolvency Act. Section 47(2) of that Act states that a secured creditor who wishes to come before the official liquidator has to prove his debt and he can prove his debt only if he relinquishes his security for the benefit of the general body of creditors. In that event, he will rank with the unsecured creditors and has to take his dividend as provided in Section 529(2).”

- c) In [Jitendra Nath Singh v. Official Liquidator & Ors.](#), it was held-

*“11. The above provision gives different options that are available and can be exercised by a secured creditor. It, however, has to be kept in mind that in terms of section 529 the rules of insolvency shall prevail and be observed but only with regard to debts provable, the valuation of annuities and future and contingent liabilities and the respective rights of secured and unsecured creditors. Where a secured creditor realizes his security, he may prove the balance due to him after deducting the net amount realized; or where a secured creditor relinquishes his security for the general benefit of the creditors, he may prove for whole of his debt. Still, where a secured creditor does not exercise either of these options, he is entitled to have his debt entered in the schedule and would be entitled to receive the dividend in terms of Section 47(3).****

**Moratorium During Liquidation:
Scope & Effect**

Cafin Homes Ltd. v. Lloyds Steel Industries Ltd

“A secured creditor who seeks to prove the whole of his debt in the course of the winding up proceedings is necessarily required to relinquish the security.”

Canara Bank v. Mopeds India Ltd:

“Insofar as the secured creditors who move the company Court it was held that secured creditor who

****24. The relinquishment of security by a secured creditor certainly requires some conscious act on his part more than the mere filing of a claim in response to a public notice issued by the official liquidator. Once the secured creditor takes such further actions like sale of the secured assets through the liquidator and subject to the control of the Company Court in that event, he would be part of the scheme of payment as rationalized under Section 529 and 529A of the Act. ****

****28. Equally, it can be stated that a secured creditor who, after institution of a claim but without pursuing the remedy outside the provisions of this Act, files claim before the official liquidator, relinquishes his security and agrees to the distribution of the sale proceeds through the official liquidator, subject to jurisdiction of the Company Court, could always be said to be not ‘standing outside the winding up’ proceedings.”*

- d) In the case of [Cafin Homes Ltd. v. Lloyds Steel Industries Ltd](#). 2001 (4) BomCR 84, 2001 106 CompCas 52 Bom, the Bombay High Court observed:

“15. The secured creditor who seeks to prove the whole of his debt in the course of the proceedings of winding up must before he can prove his debt relinquish his security for the benefit of the general body of the creditors. If he surrenders his security for the benefit of the general body of creditors, he may prove the whole of his debt. If the secured creditor has realized his security, he may prove for the balance due to him after deducting the net amount that has been realized. The stage for relinquishing security arises when a secured creditor seeks to prove the whole of his debt in the course of winding up. If, he elects to prove in the course for winding up the whole of the debt due and owing to him, he has to necessarily surrender his security for the benefit of the general body creditors.”

- e) The Gujarat High Court, in [Gujarat Steel Tube Employees v. O.L. Of Gujarat Steel Tubes Ltd](#). 2006 131 CompCas 410 Guj, (2006) 5 CompLJ 452 Guj, 2006 70 SCL 407 Guj, relied on the decision of the Bombay High Court in the case of Cafin Homes Ltd. v. Lloyds Steel Industries Ltd. 106 Company Cases 52, and observed as follows:

“A secured creditor who seeks to prove the whole of his debt in the course of the winding up proceedings is necessarily required to relinquish the security.”

- f) Similar view was taken by the Andhra Pradesh High Court in [Canara Bank v. Mopeds India Ltd](#). 2005 124 CompCas 824 AP, 2004 50 SCL 105 AP, wherein it was held-

“Insofar as the secured creditors who move the company Court it was held that secured creditor who wishes to come before the OL has to prove his debt and he can prove his debt only if he relinquishes his security for the benefit of the general body of creditors.”

Global position:

Under Rule 14.19 of the [UK Insolvency Rules, 2016](#) [corresponding to Rule 4.88 of the UK Insolvency Rules, 1986], a secured creditor has the following options:

- Surrender their security and prove for the whole amount of the debt [R. 14.19(2)];
- Place a value on their security and prove for the balance of his/her debt [R. 14.19(1)(b)];
- Rely entirely on their security and not submit a proof of debt;

Sir R.M. Goode, in his celebrated work, Principles of Corporate Insolvency Law, quoting relevant provisions of the Insolvency Rules, 1986, states as follows:

“A secured creditor has a number of options. He can surrender his security and prove for the full amount of the debt due to him, a procedure rarely used since it appears to have no possible advantage; he can value his security in his proof and prove for the balance of the debt; he can realise his security and, if the proceeds are insufficient to cover the amount due, can prove for any deficiency; and he can simply rest on his security without lodging a proof at all.”

At pg. 168, *ibid*, referring to rule 4.88 of the UK Insolvency Rules, 1986, Goode says, *“If he proves for the full debt he is deemed to have surrendered his security”*.

It is a time tested principle of insolvency laws that the secured creditor has the option to either realise his security or relinquish his security. Also, on perusal of the relevant provisions and the precedents thereto, if the secured creditor relinquishes his security, like any other unsecured creditor, he is entitled to prove the debt due to him and receive dividends out of the assets of the company in the winding up proceedings; and if the secured creditor opts to realize his security, he is entitled to realize his security in a proceeding other than the winding up proceeding. Furthermore, it is clear that a secured creditor is deemed to have relinquished its security, and participate in winding up proceedings, if the claim is filed for the whole amount before the liquidator.

Update

In light of the dilemma w.r.t. such relinquishment, the Draft IBBI (Liquidation Process) (Amendment) Regulations, 2019, provide that if the secured creditor does not provide an explicit relinquishment within 60 days of Liquidation Commencement Date, it shall be a deemed relinquishment.

The Draft Regulation, however, does not provide as to what shall constitute as “proper relinquishment” and has left the same to be decided upon by an Advisory Committee

MORATORIUM DURING LIQUIDATION: SCOPE AND EFFECT

- **Richa Saraf**

Editor's Note: "Moratorium", as is discussed earlier, entails 'calm period' during which parties can negotiate. The sweep of moratorium is far-reaching during resolution as it prohibits even secured creditors to initiate enforcement actions against the assets of the corporate debtor. Section 33 contains provisions similar to section 14, envisaging stay on suits/proceedings during liquidation. However, the reach of 'stay' during section 33 is different from the effect of section 14.

In this article, the author has made an effort to discuss the idea of moratorium, its ambit and effect on the liquidation proceedings under the Code.

What is a moratorium?

The term has been defined in Merriam Webster Dictionary to mean "legally authorized period of delay in the performance of a legal obligation or the payment of a debt; a waiting period set by an authority; or a suspension of activity.

In Cambridge Dictionary, moratorium refers to period of time during which a particular activity is stopped.

In the Code, Section 33(5) of the Insolvency and Bankruptcy Code, 2016 ("IBC") stipulates *"Subject to section 52, when a liquidation order has been passed, no suit or other legal proceeding shall be instituted by or against the corporate debtor:*

Provided that a suit or other legal proceeding may be instituted by the liquidator, on behalf of the corporate debtor, with the prior approval of the Adjudicating Authority."

It is a general notion that moratorium exists only at the time of corporate insolvency resolution process, the article discusses whether moratorium exists during liquidation as well. Further, based on precedents, the author has also tried to explain the exclusions and inclusions in the term "other legal proceedings" as mentioned in Section 33(5) of IBC.

Moratorium on Institution or Continuation of Suits?

1. The understanding, based on the interpretation of Section 33, is that there is no moratorium on continuation of suits. In case the liquidator wants to institute a fresh suit or legal proceeding, he will require specific permission from the adjudicating authority, in accordance with Section 33(5) of IBC, however, the liquidator can continue to pursue or defend an already existing proceeding, without seeking any permission from the adjudicating authority, pursuant to the powers conferred upon him under Section 35(1)(k) of IBC. Here, it will be relevant to draw reference from the parent Companies Act which puts a stay not only on institution of "suit or other legal proceeding", but also on its continuation.

In fact, in the parent Companies Act, 1956, Section 446(2) conferred an exclusive jurisdiction on the winding up court in all matters pertaining to the company before the court. Section 60(5) of IBC is akin to the provisions contained in Section 446(2)(d). The relevant extract is reproduced below:

“Notwithstanding anything contained in any other law for the time being in force, NCLT have jurisdiction to entertain, or dispose of: (a) any application or proceeding by or against the corporate debtor;... (c) any question of priorities... arising out of or in relation to the insolvency resolution or liquidation proceedings of the corporate debtor”.

There are several court rulings which have analyzed the relevance of this provision— that the winding up court has **holistic powers** in respect of the company under winding up, so that all matters that may affect the company under liquidation may be dealt with by the court. It can thus, be contended that age old laws have been developed with an intention to prohibit institution as **well as continuation** of suits or legal proceedings during liquidation.

In the book **Law Relating to Insolvency & Bankruptcy Code, 2016**⁵⁴, this issue was discussed and it has been clarified that:

Unlike clause (a) of sub-section (1) of section 14, sub-section (5) of section 33 does not include the word ‘continued’, which apparently implies that suits or proceedings that were instituted prior to the insolvency commencement date may be continued during the liquidation proceedings. However, the [notes to clauses](#) clearly state that the “liquidation order shall result in a moratorium on the initiation **or continuation** of any suit or legal proceeding by or against the corporate debtor”. In view of the author, absence of the word ‘continued’ is merely a drafting glitch- since allowing the continuation of pending suits or proceedings will hamper smooth conduct of liquidation proceedings. Hence, the provision shall be read as, “. . . no suit or other legal proceeding shall be instituted **or continued** by or against the corporate debtor:”

In Companies Act, 1956 and 2013, approval of court was required for suits by or against the corporate debtor, but under the IBC, there is no provision for seeking leave by the other party and only the liquidator can institute legal proceedings on behalf of the corporate debtor by seeking prior approval of the adjudicating authority. The very object of Section 60(5) of IBC is to prevent multiplicity of suits in multiple fora, and therefore, it will be quite illogical to have several forums determining matters which may impinge on the assets or liabilities of the company under liquidation. There are several rulings which have discussed the intent of the moratorium. One significant ruling is *Central Bank of India v. Elmot Engineering Co.*, 1994 AIR 2358; 1994 SCC (4) 159, wherein the Hon’ble Supreme Court cited the following para from Palmer’s Company Precedents, Part 11, 17thEdn., page 302:

Central Bank of India v. Elmot Engineering Co

“When a winding-up order is made, the Court, acting by its officer the Official Receiver lays its hand upon the assets and says, no creditor or claimant must touch these assets or take proceedings by way of action, execution or attachment pending the distribution by the Court in due course of administration. This protection is indispensable equally in winding-up and in bankruptcy to prevent a scramble for the assets, but it is not always enough. ”

⁵⁴2016 Edition, by Sikha Bansal and Vinod Kothari.

Moratorium During Liquidation:

Scope & Effect

“When a winding-up order is made, the Court, acting by its officer the Official Receiver lays its hand upon the assets and says, no creditor or claimant must touch these assets or take proceedings by way of action, execution or attachment pending the distribution by the Court in due course of administration. This protection is indispensable equally in winding-up and in bankruptcy to prevent a scramble for the assets, but it is not always enough. An even-handed justice requires that the Court should have power to intervene at an early stage for the protection of the assets, and this power is given by this section.”

The Apex Court, thus, explained the intent of the section:

“This section aims at safeguarding the assets of a company in winding-up against wasteful or expensive litigation as far as matters which could be expeditiously and cheaply decided by the company court are concerned. In granting leave under this section, the court always takes into consideration whether the company is likely to be exposed to unnecessary litigation and cost.”

Proceedings not covered under the ambit of moratorium:

– Tax proceedings:

Tax proceedings will have to be classified into two categories: pre-assessment and post-assessment proceedings. While assessment proceedings are considered to be outside the purview of moratorium, proceedings for recovery of tax would fall within the ambit of moratorium. This distinction may seem to be unfair, however, in the proceedings under the [income tax act](#) and some other analogous acts, for example under sales tax, excise etc., the proceedings for determination of the rights and liabilities of the companies and the other persons may have to be determined initially by authorities which have been specially created under the specific statute, and when it comes to recovery of dues, the winding up court should come into picture. The reason is that the legislature intended that the assets of the company in liquidation should be dealt with at one place by the NCLT who would be in the best position to distribute the funds of the companies equitably.

See [Life Insurance Corporation of India v. Asia Udyog \(P\) Ltd.](#), 1984 55 CompCas 187 Delhi, 1984 145 ITR 520 Delhi and in Official Liquidator, [Golcha Properties Private Ltd. \(In Liquidation\) v. Income-Tax Officer and Ors.](#)[1974] 44 CompCas 144 (Raj); [1974] 94 ITR 11 (Raj); 1972 WLN 563.

While the tax authorities may continue the assessment proceedings to determine the quantum of their claim, however, they cannot proceed with execution, distress or recovery. Statutory authorities are included under the definition of “operational creditors” [Section 5(20) of IBC], and accordingly, they will have to file their claim with the liquidator for recovery of their dues in the requisite form. The liquidator will verify their claim, and make payment only in accordance with the priority laid down under Section 53 of IBC.

For pre-assessment proceedings, the liquidator has to continue to represent the company. In this regard, it is relevant to cite the case of [Tika Ram and Sons \(Private\) Ltd. v. Commissioner of Income-Tax](#) [1964] 51 ITR 403 (All), where Allahabad High Court made the following observations:

“Income-tax proceedings are certainly not such proceedings which the High Court under [Section 446](#) could possibly entertain and make the assessment itself nor could it transfer any such assessment pending before the Income-tax Officer to its own record.

.....For these reasons I would hold that assessment proceedings do not fall within the scope of “other legal proceedings” and do not automatically come to a stop the moment the company goes into liquidation.....

.....the company in liquidation is still an assessee, and income-tax proceedings up to the stage of assessment do not fall within the scope of the words “other legal proceedings” as used in [Section 446](#) of the Companies Act, 1956.”

For recovery of dues, the exclusive jurisdiction vests with the NCLT, and statutory authorities cannot encroach upon the same. See [DamjiValji Shah v. Life Insurance Corporation of India](#), [1965] 35 Comp. Cas. 755; [1965] 3 S.C.R. 665, 673 (S.C.), [S. V. Kondaskar, Official Liquidator, and Liquidator of the Colaba Land and Mills Co. Ltd. v. V. M. Deshpande, Income-tax Officer](#), [1972] 83 I.T.R. 685, 699; 42 Comp.Cas. 168, 181 (S.C.).

In this regard, reference may be drawn to [Circular No. 1053/02/2017-CX](#) issued by Central Board of Excise and Customs dated 10th March 2017, which clearly lays down that the dues under IBC shall have priority over Central Excise dues. Also, it is mentioned that when cases are pending before BIFR/ OL/ appropriate authority under IBC, then recovery measures shall not be resorted to and further, in such cases public counsel should be advised to file affidavits for first charge under Section 11E of Central Excise Act, 1944 informing the quantum of confirmed demand to BIFR/ OL/DRT/IBC Authorities.

– **Jurisdiction of Writ Courts:**

On perusal of the provisions contained in the earlier act, it may be noted that an exemption was granted to cases pending before High Courts or Supreme Court, but no such exemption has been provided for under the IBC. The issue was discussed in [Canara Bank v. Deccan Chronicle Holdings Limited, \[CA \(AT\) Insol No. 147 of 2017\]](#). The appellant (i.e. the creditor) submitted that the adjudicating authority cannot exclude any court from the purview of moratorium for the purpose of recovery of amount or execution of any judgement or decree, including the proceeding, if any, pending before the High Courts and the Supreme Court of India against a corporate debtor.

The NCLAT acknowledged that clause (a) of Section 14(1) specifically does not exclude any Court, including the High Courts or even the Apex Court. However, the Hon’ble Bench there are certain constitutional provisions which must be considered. There is no provision to file any money suit or suit for recovery before the Supreme Court except under Article 131 of the Constitution; some High Courts have original jurisdiction to entertain the suits, which may include money suit or suit for recovery of money. However, the writ jurisdiction conferred on the Supreme Court and the High Court under Article 32 and Article 226 of Constitution of India, being a constitutional power, cannot be curtailed by any provision of an Act or court. Therefore, ‘moratorium’ will not affect any suit or case pending under Article 32 or 226. However, so far as suit, if filed before any High Court under original jurisdiction which is a money suit or suit for recovery, against the corporate debtor such suit will be covered by the bar imposed under Section 33(5).

Moratorium During Liquidation: Scope & Effect

– **Criminal Proceedings:**

In criminal proceedings, particularly in the proceedings under Section 138 of the Negotiable Instruments Act, 1881, the directors or officers in default, as the case may be, are generally held personally liable, as against the civil liability of the company. The company and its directors cannot shirk their criminal liability merely on the ground that the company was already wound up and the liquidator had taken charge of the affairs of the company.

Upholding the principle laid down by the Kerala High Court in [Jose Antony Kakkad v. Official Liquidator 2000 Comp Cas 811](#), in [Counter Point Advt. P. Ltd., Rep. by its Director, Mr. Naresh Purushotham v. Harita Finance Limited, Rep. by its Special Legal Assistant, Miss. Gulzar Sayeeda \[2006\] 133 CompCas 435 \(Mad\); 2006 Cri LJ 2289; 2006 \(2\) CTC 501](#), the Madras High Court observed that:

“Though the words ‘legal proceedings’ in Section 446 of the Companies Act is wide enough to be taken in criminal proceedings also, such criminal proceedings must be in relation to the assets of the company. Criminal proceedings which are not in respect of the assets of the company but which end in the conviction or acquittal of the accused, cannot be stayed under Section 446 of the Companies Act. Proceedings under Section 138 of the Negotiable Instruments Act, 1881, can end only in the conviction or acquittal of the accused in the case and no recovery of any amount covered by the dishonoured cheques can be made in the criminal proceedings. As the proceedings under Section 138 of the Negotiable Instruments Act are not in respect of the assets of the company, the proceedings pending in the criminal Courts cannot be stayed under Section 446 of the Companies Act.”

Again, in *M/s. Indorama Synthetics (I) Ltd v. State of Maharashtra and Anr.*, having regard to the earlier decisions, and in consonance with the spirit, purpose and object of the provisions of Section 446(1) of the Companies Act and Section 138 of the Negotiable Instruments Act, similar view was taken by the Bombay High Court. Applying the ratio, it can be safely concluded that the expression “suit or other proceedings” does not include criminal complaints filed under Section 138 of the Negotiable Instruments Act.

• **Proceedings notified by the Central Government:**

Section 35(6) stipulates that the provisions of sub-section (5) shall not apply to legal proceedings in relation to such transactions as may be notified by the Central Government in consultation with any financial sector regulator, however, no such legal proceedings has been notified till date.

TAX AUTHORITIES LEFT HIGH & DRY IN IBC CASES

- **Sikha Bansal**

Editor's Note: *Moratorium u/s 14 of IBC applies to all recovery proceedings against the corporate debtor. However, can its impact be stretched to tax assessment proceedings? The Supreme Court upheld a Delhi High Court ruling imposing bar on Income Tax Department in making appeals against the orders of the Income Tax Appellate Tribunal. This piece is a brief critique on the precedent.*

In insolvency, there is a dilemma between preserving the insolvent debtor's business and protecting the rights of creditors. This is taken care of by imposing stay on any adversarial proceedings against the debtor, and simultaneously allowing the creditors to file their claims before the insolvency practitioner for due consideration in reorganisation plans. Given the basis, the law and the judiciary shall ensure that the protection of the debtor shall be balanced against rights of the creditors and *vice-versa*.

In recent case of [Pr. Commissioner Of Income Tax v. Monnet Ispat And Energy Ltd.](#), the Supreme Court (SC) upheld the [decision of the Delhi High Court](#) (Delhi HC) which ruled that the moratorium under section 14 of the Insolvency and Bankruptcy Code, 2016 (IBC) 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 corporate insolvency resolution process (CIRP).

The Delhi HC had noted (but, not SC) that the moratorium continues till the completion of CIRP or until NCLT approves the resolution plan or passes an order for liquidation of the debtor, whichever is earlier. As such, the Delhi HC had disposed of the appeals by the Income Tax Department *with liberty to revive them subject to the further orders of NCLT.* This stand of Delhi HC was held to be "correct in law" by SC.

With due respect to the observations of the judiciary, it may be noted that there is a natural difference between assessment and recovery proceedings. There may be a scenario where the tax authority might be left with no opportunity to "revive" the appeals.

Assessment versus recovery proceedings

Income tax liability is first determined by the assessing officer.

The appellate machinery consists of commissioners, Income Tax Appellate Tribunals, High Courts and then the Supreme Court. Appeal to High Courts and the Supreme Court can be made only where the case involves questions of law.

Whether such appeals are restrained by section 14 of the IBC, would need a two-fold consideration - *first*, the sweep of the moratorium under section 14; and, *secondly*, the nature of the appellate proceedings and whether as such, these proceedings come within the ambit of section 14.

"The Delhi HC in Power Grid Corporation of India Ltd. Jyoti Structures Ltd. ruled that the moratorium provisions would apply to "debt recovery actions" against the corporate debtor"

Tax Authorities Left High & Dry in IBC Cases

The moratorium is intended to restrain proceedings which are in the nature of debt-recovery, and cannot be extended to merely assessment proceedings which have no adverse impact on the assets of the debtor during CIRP. The Delhi HC itself, in *Power Grid Corporation of India Ltd. v. Jyoti Structures Ltd.* ruled that the moratorium provisions would apply to “debt recovery actions” against the corporate debtor.

The assessment proceedings are only aimed at giving finality to the assessment, which *per se*, is a preliminary step, and may or may not lead to a recovery against the debtor, which is what IBC actually bars.

Once the assessment proceedings conclude, the determined tax liability shall stand subjected to the resolution plan under IBC. It is obvious that unless there is an assessment, a creditor’s right to file a claim cannot be served. The tax-authorities can only become a creditor when the assessment is made and not before. As such, where the assessment itself is in dispute, there is no impending recovery against the debtor. At the outset, even disputed claims are to be considered in the resolution plan.

A widely known provision comparable to section 14 of IBC was section 22 of the Sick Industrial Companies Act (SICA), where the courts have held that the provision would not extend to proceedings not eroding into the assets or paid up capital of the company. Similarly, in the context of section 446 of the Companies Act, 1956, it had been held that a company, even in liquidation, remains an assessee and income-tax proceedings upto the stage of assessment do not fall in the scope of the words “legal proceedings”.

“Revival” of appeal proceedings – a misnomer?

The moratorium remains operational until the expiry of the CIRP period or until NCLT passes an order approving resolution plan or an order for liquidation, whichever is earlier. While the Delhi HC gave *liberty* to revive the appeals subject to further orders of the NCLT, it is doubtful whether the liberty can be exercised at all.

During CIRP, the resolution plan, if drawn up, may not consider the tax liability at all, which was the subject-matter of the purported appeal, being decided by ITAT. Given this, an interesting question which would arise is whether the tax authorities can proceed to make an appeal against the acquirer coming under the resolution plan.

Alternatively, if the debtor goes into liquidation, the moratorium would still continue under section 33. As such, it would not be possible to revive the appeals.

No way ahead?

The stand taken by judiciary might actually lead to a permanent prohibition on the tax authorities to make the appeals. While the spirit of section 14 has to be protected in all conditions, it should not serve as a dead-end to creditors seeking remedy for determination of their dues.

Know More...

In the matter of [Pr. Director General of Income Tax v. Synergies Dooray Automotive Limited & Ors](#), the Hon’ble NCLAT, held that ‘Income Tax Department of the Central Government’ and the ‘Sales Tax Department(s) of the State Government’ and ‘local authority’, who are entitled for dues arising out of the existing law are ‘Operational Creditor’ within the meaning of Section 5(20) of the ‘I&B Code.

PROOF OF CLAIM IN LIQUIDATION: WHETHER DISPENSABLE?

- **Sikha Bansal**

Editor's Note: Collation of claims is one of the basic tasks which a resolution professional/liquidator has to perform. The claims form the basis of payouts in resolution plan or distribution in liquidation, The law lays down detailed procedure for each class of stakeholders for submission of proof of claims. The claimants are required to submit their claims in accordance with the CIRP Regulations/Liquidation Regulations along with facts substantiating their claim; however, whether such proof of claim is mandatory, forms an interesting question. Find below, the answer to this question, its analysis and our view on the same.

In [SBS Transpole Logistic Pvt. Ltd. v. M.M. Cargo Container Line Pvt. Ltd. & Ors.](#) [CA 152/2018 in CP (IB) 204(ND)/2017] before National Company Law Tribunal, New Delhi Bench ("NCLT"), the applicant's claim was not entertained in the resolution process and was filed after commencement of liquidation proceedings. The liquidator resisted entertaining the claim on the ground that after liquidation proceedings have commenced, he cannot include the claim unless permitted by the adjudicating authority. The applicant prayed for inclusion of claim to be considered in the process of liquidation.

The NCLT noted that the claim of the applicant was reflected in the balance sheet of the corporate debtor. The Code mandates the resolution professional to collect all the claims and therefore, it would be the duty of the liquidator to entertain and ascertain all claims whether or not filed by the claimant. Until the period that the liquidation assets are distributed, a verified claim should not be summarily rejected. It is only after distribution of assets that no further claim can be entertained. Hence, the liquidator was directed to entertain the claim.

The case sets, humbly, sets an erroneous principle. Most humbly, the ruling fails to appreciate the following:

1. Proof of debt: whether mandatory or merely procedural

Both the terms 'proof' and 'provable' are of technical import in the language of the law of insolvency. A creditor proves its debt when it lodges a proof in a mode as prescribed by the statute and having done that its debt is proved as per the requirements of the law [[GovindPrasad v. Pawan Kumar](#) (1944) 46 BOMLR 306]. Proof of debt is basically the document by which the parties seek to establish their claim.

Regulation 12 of the Insolvency and Bankruptcy Board of India (Liquidation Process) Regulations, 2016 (the "Regulations") requires that the public announcement shall "call upon the stakeholders to submit their claims as on the liquidation commencement date; and provide the last date for submission of claim, which shall be thirty days from the liquidation commencement date". In

Proof of Claim in Liquidation: Whether Dispensable?

furtherance of this, regulation 16 requires that a person who claims to be a stakeholder shall prove its claim for debt or dues to it, including interest, if any, as on the liquidation commencement date.

As is evident, filing of a proof of debt is therefore a mandatory requirement. The view is strengthened by an exclusive carve-out for workmen and employees under regulation 19(4), by virtue of which the liquidator may admit the claims of a workman or an employee on the basis of the books of account of the corporate debtor if such workman or employee has not made a claim. Such specific relaxation for a particular class of stakeholders speaks for the compulsory nature of such requirement for other class(es) of stakeholders.

Therefore, the mere presence of the debt in the books of accounts of the corporate debtor, is not evidential enough for the claim to be considered and admitted by the liquidator. Undoubtedly, the liquidator is mandated to “verify claims of all the creditors”; however, a claim which has not been submitted cannot be verified.

It must be noted that the Code treats the corporate insolvency resolution process and the liquidation process as two separate stages, and proof of claim is to be filed separately at each stage.

The liquidator cannot solely rely on the balance sheet of the corporate debtor to “ascertain” such claims, as required by the NCLT. Doing so would completely undermine the requirement of “proof of claim” as envisaged under the Code and the Regulations which lay down detailed procedures and timelines for submission of proofs. Proof of claim assumes significance under the liquidation process given the limited assets of the debtor available for disbursement.

On a conservative side, it is open to the liquidator to “provide” for such claims (which have not been submitted) until the assets of the liquidation estate are distributed; however, making such provision, in any manner, does not constitute “admission” of the claim, per se. A claim which has not been filed, cannot be admitted; and a claim which is not admitted, cannot be paid/repaid.

2. Proving of Claims: Resolution vs Liquidation

In the instant case, the liquidator resisted entertaining the claim on the ground that after liquidation proceedings have commenced, he cannot include the claim unless permitted by the adjudicating authority.

However, nothing in the Code bars a person who has not filed a claim in resolution from filing a claim during liquidation. The intervention of adjudicating authority is required only where the claim is filed after the last date for submission of claims. No specific approval of the adjudicating authority is required where the claim was not filed during resolution but is filed during liquidation within the specified time frame.

It must be noted that the Code treats the corporate insolvency resolution process and the liquidation process as two separate stages, and proof of claim is to be filed separately at each stage. In the resolution phase, the submission of claims and verification thereof is with respect to determining the eligibility to be a member of the committee of creditors and rights arising as such; whereas under the liquidation process, the objective is to determine the total amount of dues and priority thereof to be paid out of the liquidation estate.

As such, a claim which was not submitted during resolution, but was first submitted during liquidation cannot be summarily rejected on the ground that it was not submitted during resolution.

3. Time limit for filing claims

As regards the liquidation process, section 38(1) of the Code expressly specifies the time period of 30 days from the date of commencement of the liquidation process for receipt and collation of the claims of creditors by the liquidator. Thus, pursuant to this section read with regulation 12(2)(b) of the Regulations, the authority of the liquidator to accept the claims cannot extend beyond this prescribed time limit.

It must be noted that section 38(1) does not imply that the claimant shall be deprived of its right to recover its claim in case of delayed submission of claim. By virtue of section 42 of the Code, remedy has been provided by way of appeal against the rejection of claim by the liquidator within 14 days of the receipt of the decision of the liquidator. A joint reading of sections 38(1) and 42 implies that the delayed submission of claim can be admitted by the liquidator only when directed to do so by the adjudicating authority on appeal under section 42. See, [UCO Bank v. Nicco Corporation Limited \(in liquidation\)](#) [CA (IB) No. 31/KB/2018 in CP (IB) No. 03/KB/2017, Order dated 14.02.2018].

The NCLT ruling in *SBS Transpole* will, therefore, have the effect of rendering section 38(1) of the Code and regulation 12(2)(b) of the Regulations meaningless.

4. Admission of claims pending distribution of assets

The NCLT observes that until such period that the liquidation assets are distributed, a verified claim should not be summarily rejected. It is only after distribution of assets that no further claim can be entertained. The observation holds true, provided the claim is submitted and admitted in accordance with the provisions and the principles as discussed above. The author in the post titled, "[Latecomers in Liquidation: Entitlements and Penalties](#)", has dealt with the issue of late claims of creditors in detail.

The discussion as above makes it clear that proof of claims is an indispensable part of the resolution and liquidation process and mere presence of the debt in the books of the corporate debtor cannot be taken as a basis, unless expressly provided for.

LATECOMERS IN LIQUIDATION – ENTITLEMENTS AND PENALTIES

- **Sikha Bansal**

Editor's Note: 'Proof of claim' is a technical requirement in resolution/liquidation proceedings. A creditor claiming to be so, has to file a proof stating requisite details of the claim and the same has to be filed within a stipulated time. What happens to a creditor who arrives late? Is it possible for a late creditor to participate in the proceedings? Will the creditor receive a share in the funds already distributed, or will he lose it for all time to come?

The article seeks to answer these questions, with the help of illustrations.

The Code provides for resolution of corporate debtors and then liquidation, where the insolvency proceedings fail. Liquidation of a company entails settlement of claims of creditors in the staking order of their priorities. Hence, the task of collection, collation, verification, admission and rejection of claims by the liquidator constitutes a major function in the liquidation process. The function becomes all the more crucial when the company under liquidation is an insolvent entity. The competing stakeholders put their claims against insufficient assets. The laws regulating liquidation generally mandate the stakeholders to furnish their claims within a specified time limit. However, it might be possible in several cases that a creditor fails to furnish his proof of debt within the time so stipulated. Issues generally do not arise when there had been no distributions before the filing of proof by the creditor. Concerns would be there when an interim distribution had already been made. Also, the issue does not come up during resolution process, since the proofs are invited for the purpose of determining eligibility as a member of the committee of creditors and voting in meetings thereof⁵⁵.

In this context, questions which may come up are –

1. Is it possible for a creditor to submit claims after the maximum time period allowed for submission of claims?
2. If the creditor is allowed to submit belated claim, and an interim distribution had been made before receipt of his claim, will the creditor get his share which he would have received from the distribution so made?
3. If answer to the above is yes, what would be the impact on the distributions already made?

⁵⁵ According to regulation 12 of the CIRP Regulations, 2016, a creditor, who failed to submit proof of claim within the time stipulated in the public announcement, may submit such proof to the interim resolution professional or the resolution professional, as the case may be, till the approval of a resolution plan by the committee. Where the creditor is a financial creditor, it shall be included in the committee from the date of admission of such claim.

The article below attempts to study the questions in the context of the Code read with the regulations framed thereunder, viz. the CIRP Regulations and the Liquidation Process Regulations

What the Code says

Sections 33 to 54 of the Code deal with the liquidation of the corporate debtor arising out of a failed attempt to resolve the insolvency of the corporate debtor. The liquidator is appointed to conduct the process of liquidation and is thus required under the law to receive and collate the claims of the creditors and distribute the realizations in accordance with the priority laid down under section 53. Section 38 of the Code provides that the liquidator shall receive or collect the claims of creditors within a period of 30 days from the date of the commencement of the liquidation process. Also, according to regulation 12 of the Liquidation Regulations, 2016, the last date for submission of claims shall be 30 days from the liquidation commencement date. The Liquidation Regulations, 2016 do not dwell upon the consequences of delayed filing of proofs by creditors.

Certain provisions are contained in the CIRP Regulations, 2016 – as required under regulation 12 (2), a creditor shall submit proof of claim on or before the time stipulated in the public announcement. However, a creditor who failed to submit proof of claim within the time so stipulated, may furnish such proof till the approval of a resolution plan by the committee of creditors. The provision is not of much help in the liquidation scenario.

Noteworthy is section 177 of the Code which provides for entitlements and penalties of and for the creditor who does not prove his debt before the declaration of dividend. It states

“(1) A creditor who has not proved his debt *before the declaration of any dividend* is not entitled to disturb, by reason that he has not participated in it, the distribution of that dividend or any other dividend declared before his debt was proved, but—

(a) when he has proved the debt, he shall be entitled to be paid any dividend or dividends which he has failed to receive, out of any money for the time being available for the payment of any further dividend; and

(b) any dividend or dividends payable to him shall be paid before that money is applied to the payment of any such further dividend.”

The provision contained in section 177 as stated above has been traditionally present in laws like the Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920 and then in the Companies Act, 1956 – see the discussion that follows.

Here, note that the word “dividend” is being used so as to refer to a share of the distributable proceeds of the assets of the bankrupt/insolvent corporate debtor. The view is evident from a reading of various provisions of the Code – see sections 171 (7) whereunder a creditor may receive dividends in manner prescribed; and section 174 which states that the bankruptcy trustee may declare and distribute interim dividend *among the creditors*.

A point which should be noted as evident from the provisions above is that there is nothing in the Code or the regulations made thereunder which altogether exclude a creditor from submitting claims post the last date for submission. However, the entitlement of a creditor, who comes late, to

Latecomers in Liquidation

distributions already made shall be determined taking into consideration principles settled over time.

The Insolvency Act, 1986 and the Bankruptcy Act (Chapter 20), Singapore

According to section 153 of the Insolvency Act, 1986 of UK, the court may fix a time or times within which creditors are to prove their debts or claims or to be excluded from the benefit of any distribution made before those debts are proved. However, rule 14.40 of the UK Insolvency Rules 2016 also provides for entitlement of creditors delaying proofs. It may be reproduced as –

“14.40.—(1) A creditor is not entitled to disturb the payment of any dividend or making of any distribution because—

(a) the amount claimed in the creditor’s proof is increased after payment of the dividend;

(b) in an administration, a creditors’ voluntary winding up or a winding up by the court the creditor did not prove for a debt before the declaration of the dividend; or

(c) in a members’ voluntary winding up, the creditor did not prove for a debt before the last date for proving or increases the claim in proof after that date.

(2) However *the creditor is entitled to be paid a dividend or receive a distribution which the creditor has failed to receive out of any money for the time being available for the payment of a further dividend or making a further distribution.*

(3) *Such a dividend must be paid or distribution made before that money is applied to the payment of any further dividend or making of any further distribution.*

(4) If, after a creditor’s proof has been admitted, the proof is withdrawn or excluded, or the amount of it is reduced, the creditor is liable to repay to the office-holder, for the credit of the insolvency proceedings, any amount overpaid by way of dividend.”

As regards “dividend” and “distribution”, section 65 of the UK Insolvency Act allows the administrator to make a distribution to a creditor of the company. Rule 14.27 of the UK Insolvency Rules provide for declaration and distribution of dividends among the creditors in respect of the debts which they have proved. “Dividend”, in relation to a members’ voluntary winding up, includes a distribution.

Section 118 of the Bankruptcy Act of Singapore too has the same provisions as regards claims of unsatisfied creditors.

Erstwhile & Contemporary Laws

The Presidency Towns Insolvency Act, 1909 & the Provincial Insolvency Act, 1920 – These were the longest living insolvency laws in the country and survived till the advent of the Code. Section 72 of the PTIA, 1909 and section 63 of the PIA, 1920 contain provisions similar to Rule 178 of the Companies (Court) Rules, 1959 – see below.

The Companies Act, 1956 read with the Companies (Court) Rules, 1959 – Section 474 of the Companies Act, 1956 provided that the court may fix a time or times within which creditors are to

prove their debts or claims, or to be excluded from the benefit of any distribution made before those debts or claims are proved.

Rules 177 and 178 of the Companies (Court) Rules, 1959 are relevant. Rule 177 says,

“R.177. Procedure on failure to prove the debt within the time fixed - If any creditor fails to file proof of his debt with the Liquidator within the time specified in the advertisement referred to in Rule 148, such creditor may apply to the Court for relief, and the Court may, thereupon, adjudicate upon the debt or direct the Liquidator to do so.”

Further, rule 178 says,

“R.178. Right of creditor who has not proved debt before declaration of dividend - Any creditor who has not proved his debt before the declaration of any dividend or dividends shall be entitled to be paid *out of any money for the time being in the hands of the Liquidator available for distribution of dividend, any dividend or dividends which he may have failed to receive before that money is applied to the payment of any future dividend or dividends, but he shall not be entitled to disturb the distribution of any dividend declared before his debt was proved by reason that he has not participated therein.*”

Judicial Precedents

The provisions as enunciated in the Companies Act, 1956 were comprehensively discussed in [Ganeshilal Gupta v. Bharatpur Oil Mills through Official Liquidator](#) [1972 WLN 68]. The court observed that

“there has been a long delay in filing the proof, but the claim is within the period of limitation prescribed by the Limitation Act, the only consequence of the delay will be that prescribed by Section 474 of the Companies Act according to which a creditor, who does not prove his debt or claim within the time fixed by the court, *has to be excluded from the benefit of any distribution made before his debt or claim is proved.*”

However, in view of rules 177 and 178 of the Court Rules, 1959, it is also clear that the creditor is “. . . entitled to be paid *out of any money for the time being in the hands of the Liquidator available for distribution of dividend. The scheme of the law therefore does not prescribe any other penalty in the case of a belated claim.*”

The court relied on the decision made in *In re General Rolling Stock Company* 1871 (7) Ch. Appeal 646, wherein the court held,

“. . . the rule is that everybody who had a subsisting claim at the time of the adjudication, the insolvency, the creation of the trust for creditors, or the administration decree, as the case may be, is entitled to participate in the assets, and that the Statute of Limitations does not run against this claim, but, as long as assets remain unadministered he is at liberty to come in and prove his claim, not disturbing any former dividend. ***Therefore so long as justice can be done to a creditor without disturbing the dividend already declared or paid, there is no reason why he should be prevented from getting his dividend.*** . . . I therefore direct the Official Liquidator to admit the applicant's claim without further proof and *pay her the*

Latecomers in Liquidation

dividend due to her if he can do so without disturbing the previous dividend and if he has funds enough in his hands."

The court also relied on *In re Metcalfe* 1879 (13) Ch. D. 236, where it was held that that a creditor may come in as long as there are undistributed assets still available, and he is entitled to prove, not disturbing the previous dividends. The view has also been followed in *In re Kit Hill Tunnel* 1880 (16) Ch. D. 590.

In *Buckley on Companies Act*, 13th edition, it has been stated,

"A creditor may come in and prove at any time before the company is dissolved; the penalty of not coming in before the day fixed by the Court is not exclusion altogether, but exclusion from the *benefit of any distribution made before proof.*"

Reference was also made to the decisions in *Isack Jesudasen Pillai v. Divan Bahadur Ramsamy Chhetty* ILR 1904 Mad. 496 which appears to have been based on the decision in *General Rolling Stock Company (supra)*, and to *T.R. Rajakumari v. Motion Picture Producers Combine Ltd.* AIR 1942 Mad. 349. Same view has been expressed in Palmer's Winding up, Part II at p. 483:

"As by the Act the assets are impressed with a trust in favour of all the creditors, the Court will make no difficulty in admitting proofs after the expiration of the time fixed. No mischief can be done to other creditors by reason of the delay or laches of any creditor, since, if he delays beyond the proper time, **he must take his chance of what assets he can find for payment of his debt, not disturbing any former dividend.**"

It is thus a well settled proposition of the law, a creditor may come in and prove his debt at any time before the final distribution of the assets, however, within the time prescribed under the limitation law, but he cannot disturb any dividend which has already been paid.

The rules that emerge

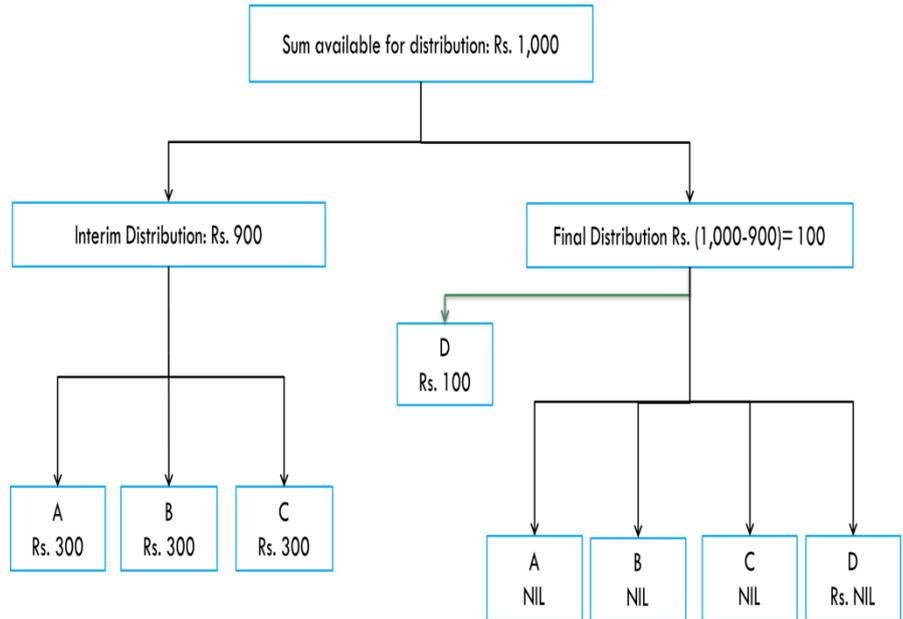
The foregoing discussion makes the following clear –

- (i) A creditor who delays filing of proof of debt is not barred from proving altogether.
- (ii) The creditor may come in any time before the final distribution of dividend.
- (iii) The debt must not be time-barred; i.e. the proof must be lodged within the time allowed under the limitation law.
- (iv) Where a distribution had been made prior to the creditor lodging delayed proof, he is *not entitled to disturb such distribution*, because he had not participated in it.
- (v) However, the creditor *is entitled to the sums he has failed to receive.*
- (vi) Such sum shall be paid to the creditor out of the money, for the time being in the hands of the liquidator, available for distribution as dividend.
- (vii) The money in the hands of the liquidator shall *first be applied to pay the creditor and then applied to the payment of any future dividend or dividends.*

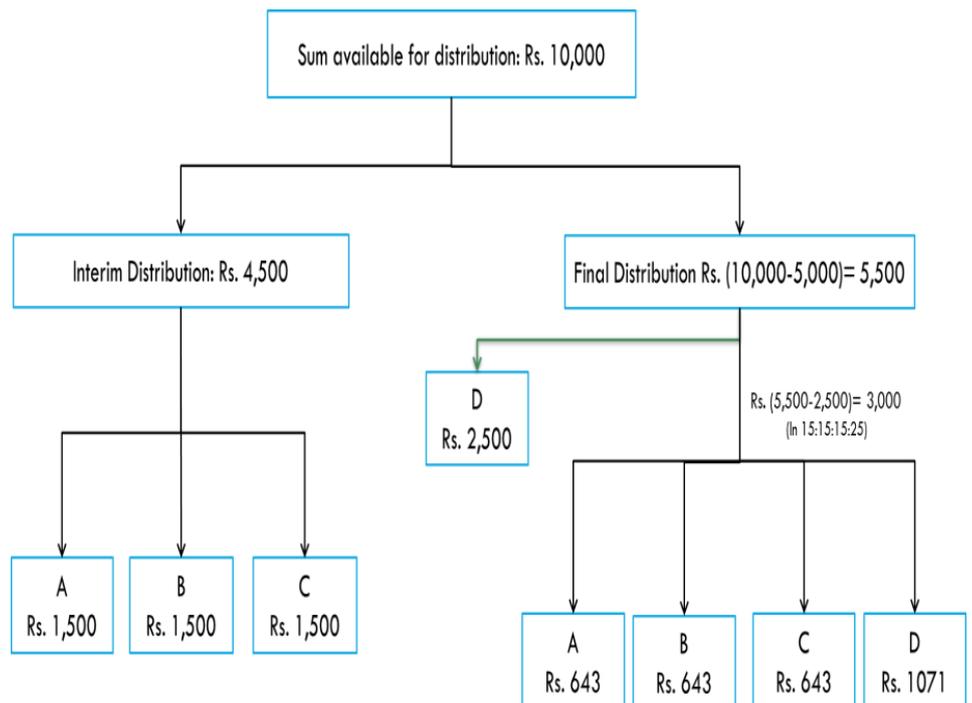
Illustrations

Let us take some illustrations to clarify the rules above.

Example 1: A, B, C (assuming that they share the same priority level) lodge claims of Rs. 3000 each before the liquidator. The liquidator has Rs. 10000 (Ten Thousand) in hand available for distribution. He makes an interim distribution at the rate of 50% of creditors' claims. Therefore, A, B, C will receive Rs. 1500 each. The money left in the hands of the liquidator is Rs. (10000-1500*3), i.e. Rs. 5,500. The liquidator, after some time, proposes to make another distribution for full and final settlement of the creditors. Now, D, another creditor comes in and claims Rs. 5000 as due from the company. During the interim distribution, he failed to receive Rs. 2500 (i.e. 50% of Rs. 2500). The money in the hands of the liquidator is Rs. 5,500 for the time being. Therefore, D shall be paid Rs. 2500, and then the liquidator shall make the final distribution to A, B, C, D from Rs. (5500-2500), i.e. Rs. 3,000. Money amounting to Rs. 3000 payable to A, B, C, D would be in the ratio 1500:1500:1500:2500. Therefore, A, B, C will receive Rs. 643 each and D will receive Rs. 1071. From calculations, it will be noted that each of these four creditors has received 71% of their claims. The creditor D did not disturb the distributions made to A, B, C; however, he got equivalent proportion of his dues from the liquidation estate.



Example 2: A, B, C (assuming that they share the same priority level) lodge claims of Rs. 3000 each before the liquidator. The liquidator has Rs. 1000 (One Thousand only) in hand available for distribution. He makes an interim distribution at the rate of 10% of creditors' claims. Therefore, A, B, C will receive Rs. 300 each. The money left in the hands of the liquidator is Rs. (1000-300*3), i.e. Rs. 100. The



Latecomers in Liquidation

liquidator, after some time, proposes to make another distribution for full and final settlement of the creditors. Now, D, another creditor comes in and claims Rs. 4000 as due from the company. During the interim distribution, he failed to receive Rs. 400 (i.e. 10% of Rs. 4000). The money in the hands of the liquidator is only Rs. 100 for the time being. Therefore, D shall be paid Rs. 100, and no money is left to be paid to A, B, and C. In total, A, B, C has received Rs. 300 each and D has received Rs. 100. From calculations, it will be noted that A, B, C has received 10% of their claims, while D has received merely 2.5% of his claim. The creditor D cannot claim for the deficiency since he was late in participating in the distributions.

Conclusion

The provision contained in rule 178 of the Court Rules, 1959 or section 177 of the Code shall not be read so as to deprive the creditor of his share in the distribution already made. He is entitled to the same, subject to the condition that he does not disturb the distribution made. The creditors who filed their proofs in time will not suffer at the hands of the creditor who came late. Therefore, the creditor who comes late will have to contend himself with the money available after the distribution – he cannot seek re-inclusion of the moneys distributed in the liquidation estate. However, at the same time, it must be accepted that a creditor's delay cannot promote other creditors' entitlements just because a creditor was late in filing his proof must not let other creditors receive more than what they ought to have received had all the creditors filed their claims in time. Therefore, there is no prejudice against the creditors including the one who comes late.

As such, the latecomer creditor will get the dividend which he failed to receive, subject to availability of funds in the hands of the liquidator. His penalty for coming late, in effect, is that he will be running with the risk of insufficient assets which may get distributed totally if the delay is prolonged. Also, the creditor will be losing on the time value of money which he could have received at the time the distribution was made.

PRIORITY OF TAX DUES IN LIQUIDATION

- **Kasturi Chowdhury**

Editor's Note: IBC, as explicitly laid down in the Preamble itself, seeks to alter the priority of government dues in insolvent resolution/liquidation proceedings. The intent has been made clear in the reports of BLRC. Now, taxing statutes confer power on the authorities to 'attach' properties of the assessee in default – does it amount to a 'security' in favour of the taxing authority, thus scaling up the priority of such dues? The Andhra Pradesh High Court has ruled that the 'encumbrance' created over properties by such taxing laws do not amount to a 'security' and does not confer the status of a secured creditor to the taxing authorities.

In the article below, we have discussed the provisions of the Code vis-à-vis the Income Tax Act while analysing the said ruling.

The manner of distribution of the assets of a company during liquidation is fraught with ambiguity and settlement of such claims arising out of it has inconvenienced the parties concerned since the advent of the Insolvency and Bankruptcy Code, 2016 ("Code"). In a recent ruling, the judgement of the Hon'ble High Court of Hyderabad showed the path to be followed when there arose such conflict regarding priority of settling the dues of the Income Tax authority during liquidation of a Company.

This article essentially deals with the provisions of the Code in juxtaposition to the Income Tax Act, 1961 deliberating upon the judgement of the Hon'ble High Court in the matter of [Leo Edibles & Fats Ltd. Vs. The Tax Recovery Officer \(Central\) IT Dept.](#) (WRIT PETITION No.8560 OF 2018)

Facts of the Case:

Leo Edibles & Fats Limited, the petitioner in the present case, filed a writ petition with the Hyderabad High Court, against the action of the Sub-Registrar, Erragadda, Hyderabad, in refusing to register its purchase of immovable property, in the liquidation proceedings of VNR Infrastructures Limited ("VNR"), since the Income Tax Department claimed charge over such immovable property, pursuant to an earlier notice of attachment for non-payment of tax by the corporate debtor, VNR.

Pursuant to the liquidation order of VNR, passed by the National Company Law Tribunal, Hyderabad, the liquidator formed a liquidation estate. Subsequently, the assets of VNR was sold through e-auction, wherein the petitioner was declared as the highest bidder for one of the properties. The petitioner had deposited 25 percent of the total amount due as consideration and was also issued a letter of sale by the liquidator, calling upon it to deposit the balance sale consideration within fifteen

Leo Edibles & Fats Ltd. Vs. The Tax Recovery Officer (Central) IT Dept.:

- Petitioner filed a writ petition with the Hyderabad High Court, against the action of the Sub-Registrar, Erragadda, Hyderabad
- Income Tax Department claimed charge over such immovable property pursuant to an earlier notice of attachment for non-payment of tax by the corporate debtor

Priority of Tax Dues in Liquidation

days. However, at this point, the petitioner came to know that the property purchased by it was subjected to attachment by the IT Department and therefore, the said petition was moved by the petitioner.

The court had passed an interim order to the effect that the petitioner company should deposit the balance sale consideration in respect of the auction, however, the liquidator was instructed not to disburse any of the amounts pending further orders.

The High Court directed the sub-registrar to register sale of the property in favour of the petitioner and instructed the IT Department to submit its claim before the liquidator, who may consider it, in accordance with the priorities set by Section 53 of the Code.

Relevant Provisions of Law:

Income Tax Act, 1961:

Section 178 of the Income Tax Act which lays down the mannerism in which the Income Tax Department may recover the amount which, in the opinion of the Assessing Officer, would be sufficient to provide for any tax which is payable by the company under liquidation. Sub-section (6) of Section 178 further provides the following:

“The provisions of this section shall have effect notwithstanding anything to the contrary contained in any other law for the time being in force”

Insolvency and Bankruptcy Code, 2016:

1. Amendment in the IT Act:

Section 247 of the Code read along with the Third Schedule amends the Income Tax Act, 1961 with the following direction:

“In sub-section (6) of section 178, after the words “for the time being in force”, the words and figures “except the provisions of the Insolvency and Bankruptcy Code, 2016” shall be inserted.”

2. Non-obstante clause:

Section 238 states that “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.” Therefore, the Code clearly overrides the IT Act.

3. Principles of Distribution:

Section 53(1) of the Code lays down the following order of priority in which the proceeds from the sale of the liquidation assets shall be distributed:

1. IRP costs and liquidation costs
2. Workmen’s due for the period of twenty-four months preceding the liquidation commencement date and debts owed to a Secured Creditor

3. Wages and any unpaid dues owed to employees other than workmen
4. Financial debts owed to unsecured creditors
5. any amount due to the Central Government and the State Government including the amount to be received on account of the Consolidated Fund of India and the Consolidated Fund of a State, if any, in respect of the whole or any part of the period of two years preceding the liquidation commencement date
6. any remaining debts and dues
7. preference shareholders, if any
8. equity shareholders or partners, as the case may be.

The Income-tax Department is clearly not a secured creditor and the debt owed to the Dept. is in the nature of dues that clearly adds to the consolidated fund of the state and thus, should be settled as per the waterfall structure mentioned in Section 53(1)(v).

4. Effect of Moratorium:

As per Section 14 of the Code, the order of the NCLT for initiation of liquidation of the Corporate Debtor would result in a moratorium on the initiation or continuation of legal proceedings by or against the corporate debtor thereby making the contention of the IT department, that the Code did not apply to them in relation to the said property, and the argument that the attachment order predated the initiation of liquidation can certainly not be regarded as valid.

5. Attachment on Liquidation Estate:

Section 36 of the Code states that for the purposes of liquidation, the liquidator shall form an estate of the assets mentioned in sub-section (3), which will be called the liquidation estate in relation to the corporate debtor. Further, Section 36(3)(b) of the Code provides that the liquidation estate assets may or may not be in possession of the corporate debtor, including but not limited to encumbered assets. Therefore, even if the order of attachment constitutes an encumbrance on the property, it still does not have the effect of taking it out of the purview of Section 36(3)(b) of the Code or put a bar on completion of the sale.

Precedents Followed:

In [*Ananta Mills Ltd. \(In Liquidation\) V/S. City Deputy Collector, Ahmedabad*](#), [(1972) 42 Company cases 476] the Gujarat High Court observed that the purpose of attachment appeared to be to prevent private alienations of the property but the attaching-creditor does not acquire, by merely levying attachment, any interest in the property.

In [*Prem Lal Dhar vs. Official Assignee*](#) [(1897) ILR 25 Cal. 179 (P.C.)], the Hon'ble Court considered the effect of attachment prior to the commencement of winding-up proceedings and whether such attachment could continue on the property even in the hands of the purchaser, who bought the property through the official liquidator free of all encumbrances. The court in the said matter held that such attachment of the properties of a company, which was subsequently ordered to be wound

Priority of Tax Dues in Liquidation

up, without any further action being taken would be of no consequence or effect against the official liquidator and the property could be disposed of by the official liquidator, since such attachment merely prohibits private alienation by the person whose property is attached but creates no interest in such property.

In the case of [Dena Bank vs. Bhikabhai Prabhudas Parekh & Co. & Ors. \[\(2000\) 5 SCC 694\]](#), it was held that the Crown's preferential right to recovery of debts, over other creditors is confined to ordinary or unsecured creditors and further in the case of [Stock Exchange, Bombay vs. V.S. Kandalgaonkar](#), [CIVIL APPEAL NO.4354 of 2003], the Supreme Court put at rest the ongoing controversy by observing that there is priority of rights of secured creditors over the rights of income tax department.

Conclusion:

The framework for insolvency and bankruptcy Code was proposed with the objective of consolidating and amending the laws relating to reorganisation, and insolvency resolution of corporate persons in a time bound manner for maximization of the value of assets of such persons and to promote entrepreneurship, availability of credit while balancing the interests of all the stakeholders, including alteration in the priority of payment of Government dues. However, certain ambivalences existing in the interpretation of the framework resulted in undue delays in resolution. The thorough interpretation and detailed analysis by the Hon'ble High Court not only settles the long-standing dilemma regarding the ascertainment of the nature of crown debts and the supremacy of the Code over the Income Tax Act, it further clarifies that the interest of secured creditors prevail over crown debts.

INCLUSION OF ASSETS TAKEN ON LEASE IN THE LIQUIDATION ESTATE OF THE LESSEE

- Anita Baid

Editor's Note: Forming a liquidation estate is a preliminary step in the liquidation process and involves 'identification' of assets which would form a part of the estate. An interesting case would be to identify whether an asset taken on financial lease where corporate debtor is a lessee shall be included in the liquidation estate. The treatment of 'financial lessor' will accordingly be determined. This article makes an effort to understand this issue.

The lifeline of any entity is dependent upon the assets that are used for carrying out its operations. These assets can either be owned by the entity or taken on lease. As the ownership involves huge capital outflow, entities either purchase the asset by entering into a financial transaction with the lending entity or acquires the asset on lease.

With a rise in these financial transactions, there has also been a corresponding growth in financial defaults and hence there was a strong need for implementing a disciplined insolvency and bankruptcy legislation to address the default issue. Eventually, the laws relating to restructuring and insolvency of corporate persons, partnership firms and individual firms were consolidated and amended by IBC. The IBC intends to promote availability of credit and improve the ease of doing business.

The IBC provides for an institutional framework where the lenders and other stakeholders of a stressed firm try to revive it before its taken to liquidation. The intention is to save the stressed firms by way of restructuring and preserve the valuable assets and the fundamental existence of such stressed firms. However, subsequent to the implementation of IBC it has been observed that, in the resolution process there are always chances where the promoters of the corporate debtor will hesitate to co-operate with the RP and thus, in such an event there are plausible chances that the corporate debtor may face liquidation.

**Two types of leases –
Financial lease;
and
Operating lease.**

Once the corporate debtor enters into liquidation, the liquidator is required to determine the assets of the corporate debtor available for sale and subsequently distribute the sale proceeds among various creditors. One of the issues that the liquidator faces is with respect to the treatment of assets taken on lease as a part of the liquidation estate. In this article we intent to discuss the provisions of law to determine whether the assets taken on financial lease by the corporate debtor would form a part of its liquidation estate or not.

Inclusion of Assets Taken on Lease in the Liquidation Estate of The Lessee

Concept of lease

Lease is a form of bailment where the Lessor transfers the right to use an asset to the Lessee against periodic cashflows. There are two type of leases – a) Financial lease and b) Operating lease. Legally there is no difference between the two, in both the cases, the legal title of the asset remains with the lessor through out the lease tenure. However, for all other purposes retention of asset based risks and rewards acts as the differentiating factor.

In case of a financial lease, substantially all risks and rewards are transferred to the lessee by the lessor, therefore, the lessee steps into the shoe of the owner of the asset for all practical purposes. However, in case of an operating lease the lessor retains the risks and rewards associated with the assets.

Financial lease

Financial lease provides an alternative to borrowing and is a mode of obtaining finance. Here, all major risks and awards of ownership are transferred from the lessor to the lessee. The lengthy lease period provides use of the asset by the lessee for almost whole economic life of the asset. The lessor merely finances the acquisition of the asset and retains the title over it. Usually, the ownership is transferred from the lessor to the lessee at the end of the lease. However, the same is subject to the terms agreed between the parties to the lease.

Operating lease

Unlike financial leases, the risks and rewards pertaining to the ownership of the asset are retained by the lessor himself in case of operating leases. The intent in operating leases is not of providing a mere financing facility to the lessee but to hire out the asset. The title of ownership of the asset is that of the lessor. In essence, operating leases truly focuses on usage of the asset rather than ownership, for the lessee.

However, here it is important to understand that the nature of a financial lease is admittedly a financial assistance and is akin to loan transactions. There have been several judicial pronouncements where it has been substantiated that financial leases are akin to loan. In the case of [*Association of Leasing and Financial Services Company v/s Union of India*](#), paragraph 20 and 21 of the judgment clearly brings out the fact that financial leasing and hire purchase transactions are a mode of long term funding. In case of [*Asea Brown Baveri Ltd v/s Industrial Finance Corporation of India*](#), the judgment brings fore the fact that financial lease is nothing but loans in disguise. In other words the lessor in case of a financial lease is also a creditor for the lessee.

In order to succeed in initiating corporate insolvency resolution process against a debtor, it is *sine qua non* to prove that the creditor falls within the ambit and scope of the definition of either 'Financial Creditor' or 'Operational Creditor'.

Treatment of lease transactions under the IBC

Financial Creditor and Financial Debt

A financial creditor is defined under Section 5(7) of the IBC as-

"financial creditor" means any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred".

In order to ascertain whether a person is a financial creditor, the debt owed to such a person must fall within the ambit a 'Financial Debt' as under Section 5(8) of the IBC. Further, a financial debt is defined under Section 5(8) of the IBC:

"financial debt" means a debt alongwith interest, if any, which is disbursed against the consideration for the time value of money and includes—

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(d) the amount of any liability in respect of any lease or hire purchase contract which is deemed as a finance or capital lease under the Indian Accounting Standards or such other accounting standards as may be prescribed;

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In case of operating lease, the lessor retains the ownership along with all the risks and rewards associated with the asset and the asset is capitalized in the books of the lessor. Hence, there is no doubt on the ownership or title of the asset being vested with the lessor. However, the treatment is different in case of financial lease. In a financial lease, the lessor recognizes only its investment in the lease transaction, which is similar to the treatment of the loan transaction. The asset is capitalized in the books of the lessee and a corresponding liability is created to recognize the liability towards the lease rentals.

Therefore, it may be noted that a financial lease transaction, in all practicalities, is no different from a loan transaction and the IBC also does not differentiate between a loan transaction and a financial lease transaction, as the definition of financial debt specifically includes finance lease.

Under IBC, a financial creditor which is a secured creditor always sits at the top of the priority list for payment upon realization. This gives rise to the question whether a financial lessor, who is also a financial creditor, can be treated as a secured creditor for the purpose of IBC, which has been examined at length below.

Inclusion of Assets Taken on Lease in the Liquidation Estate of The Lessee

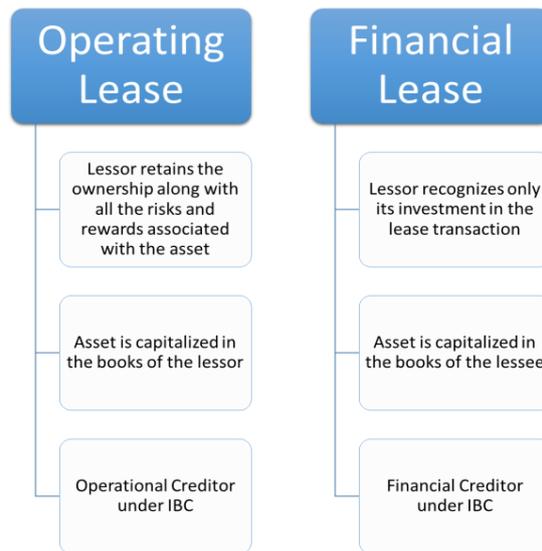


Figure 18: Difference between Operating and Financial Lease

Secured Creditor and Security Interest

Under IBC, the definition of secured creditor states that:

(30) "secured creditor" means a creditor in favour of whom security interest is created;

Further, security interest has been defined to mean the following:

*(31) "security interest" means **right, title or interest or a claim to property**, created in favour of, or provided for a secured creditor by a transaction which secures payment or performance of an obligation and includes mortgage, charge, hypothecation, assignment and encumbrance or any other agreement or arrangement securing payment or performance of any obligation of any person: Provided that security interest shall not include a performance guarantee;*

A secured creditor is someone who has created a security interest on the property of the lessee. In a normal loan transaction carrying a collateral, the borrower creates a security interest on the property in favour of the lender. This can be in the form of mortgage, hypothecation, pledge etc. However, in case of a lease transaction such is not the case as the lessor continues to be the owner of the property through out the lease tenure.

Therefore, arises a question – whether financial lessor can be treated as secured creditor for the purpose of IBC, more importantly whether the interest of a financial lessor be treated as security interest for the purpose of IBC as the answer to the first question would depend on the answer to the second one.

In case of a financial lease the legal ownership of the asset vests with the lessor. It is only at the end of the tenure that the lessee has an option to effectuate transfer of ownership in its favour. During the tenure of the lease, the asset is not held by the lessee and hence it cannot be said that a security

interest is created on the asset in favour of the lessor. As the lessor being the legal owner of the asset has all the rights over the asset, without any particular assignment of right in its favour.

Since, a financial lessor does not hold any security interest on the property, therefore, it cannot be treated as secured creditor of the lessee, despite being a financial creditor. However, in that case, the rights of the of the financial lessor will be way superior than other secured creditors of the company, because, the rights of a secured creditor under section 52 is limited to either enforcement or relinquishment of the security interest. Whereas, a financial lessor is the legal owner of the asset and has all the rights to sell or dispose off the asset in any manner as it may deem necessary even before a secured creditor exercises its rights under the aforesaid section upon liquidation of the lessee.

However, a financial lessor will be free to dispose off the asset only if it does not form part of the lessee's liquidation estate. The scope of liquidation estate has been laid down under section 36 of the IBC and the same has been discussed at length below:

Liquidation Estate

Under IBC, NCLT can order for liquidation under Section 33 of the IBC if no resolution plan has been submitted to it before the expiry of the corporate resolution insolvency process period, or if it rejects a plan because it does not comply with the provisions of the IBC. The liquidation of a corporate debtor involves the selling of its assets piecemeal and the distribution of the sale proceeds among its various creditors.

For the purposes of liquidation, the liquidator shall form an estate of assets which shall be called "Liquidation Estate". Section 36 is the relevant section dealing with the inclusions and exclusions-

36. (1) For the purposes of liquidation, the liquidator shall form an estate of the assets mentioned in sub-section (3), which will be called the liquidation estate in relation to the corporate debtor.

(2) The liquidator shall hold the liquidation estate as a fiduciary for the benefit of all the creditors.

(3) Subject to sub-section (4), the liquidation estate shall comprise all liquidation estate assets which shall include the following:—

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(4) The following shall not be included in the liquidation estate assets and shall not be used for recovery in the liquidation:—

(a) assets owned by a third party which are in possession of the corporate debtor, including—

a. assets held in trust for any third party;

b. bailment contracts;

**Inclusion of Assets Taken on Lease
in the Liquidation Estate of The Lessee**

- c. *all sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund;*
- d. ***other contractual arrangements which do not stipulate transfer of title but only use of the assets; and***
- e. *such other assets as may be notified by the Central Government in consultation with any financial sector regulator;*

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Usually under a lease arrangement, the ownership of the asset rest with the lessor and only the right to use the asset is transferred to the lessee. A lease transaction usually does not by itself result into a transfer of title. However, in certain cases of financial lease, the lease contract may provide for an option to buy the asset with the lessee.

Any financial lease transaction shall result into an automatic transfer of asset after a period of time to the lessee, if it has been pre-decided at the time of the execution of the lease agreement itself that title of ownership is sure to change hands at the end of the lease term. In such a situation, where the lessee is given an option to buy the asset at the end of the lease tenure at a nominal price at which there is reasonable certainty that the lessee will exercise the option to purchase asset, it would be regarded as an automatic transfer of the property.

In a hire purchase transaction, the entire cost of asset along with the expected rate of return of the financier is collected from the customer and an option is given to the customer to buy the asset at a nominal price, normally, as low as Re. 1 or such. In such cases of hire purchase, since the entire amount is recovered from the customer during the tenure of the transaction, the option to buy at a nominal price is not a real option, as the probability of the customer not exercising the option is nil. Therefore, in a hire purchase transaction, there is a certainty that the title of the goods will pass on to the customer at the end of the tenure.

Here, it is important to note that the option to purchase at the end of the lease term must be real and the lessee must not be compelled to exercise the option. For instance, in case the option price is very nominal, like hire-purchase transactions, it will be irrational to assume that the lessee will not exercise the option. The option in such a case remains just a formality since the lessee shall otherwise lose the entire rentals paid if the option is not exercised, therefore, the principles of common wisdom indicate that exercising such an option is certain.

Further, to determine the nominality of the option price, one should compare it with the expected market value or residual value of the asset at the end of the lease term. The determination of nominality is a case specific matter that is ascertained based on prudence and applicable market practice.

One of the factors influencing the thin line of difference between a lease and hire purchase transaction is the certainty of exercising the option. Given that the option price is very nominal, it will be irrational to assume that after paying all the rentals the lessee will not exercise the option to purchase at a nominal price. However, if the option is not nominal but a bargain price, the uncertainty still remains. Here, the option at a bargain price or a nominal price must not be regarded

as the same, since in case of the former, it will be at the sole discretion of the lessee to either exercise the option, however, for the latter it becomes certain. Accordingly, a lease transaction with an option to purchase at a bargain price shall not be regarded as a hire purchase transaction provided that the price is not nominal and the uncertainty remains.

Moreover, for an asset to be excluded from the liquidation estate the option to purchase the asset at the end of the lease term must be such that it defies common wisdom that the transfer will be effectuated that is to say it should not result in automatic transfer. To sum it up one may conclude that under the IBC law, such leased assets which do not stipulate automatic transfer of title but only right to use is transferred, shall be excluded from the liquidation estate of the lessee. The asset taken on hire purchase and those taken on lease with reasonable certainty that the ownership shall be transferred after the expiry of the lease term, shall accordingly be included in the calculation of liquidation estate of the lessee.

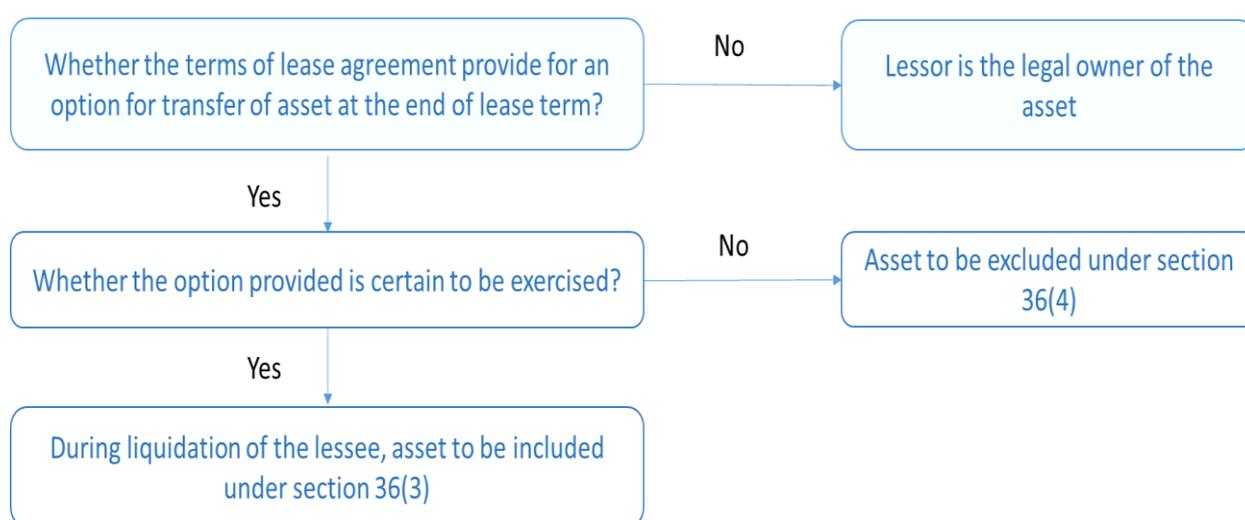


Figure 19: Treatment of Assets under Lease

Conclusion

The liquidation of a corporate debtor is the last step to end the existence of the corporate debtor. In order to effectuate the liquidation process, the liquidator is required to determine the liquidation estate of the corporate debtor. In case of a financial lease, the inclusion of the asset taken on lease would be dependent on the terms of the leasing arrangement-

- In case the lessor provides an option to buy the asset at the end of the lease tenure at a price which does not stipulate automatic transfer or reflect reasonable certainty of lessee exercising the option, the lessor will be treated superior to the secured financial creditor. The leased asset will accordingly be excluded from the liquidation estate under section 36 (4).
- On the other hand, in case the lessor provides an option to buy the asset at the end of the lease tenure at a price at which there is reasonable certainty that the lessee shall exercise the option to buy the asset or the automatic transfer of the asset is stipulated, then the leased asset shall be deemed to be a part of the liquidation estate of the lessee.

CAN LIQUIDATOR'S OUTREACH GRAB GUARANTORS ASSETS

- **Sikha Bansal**

Editor's Note: *Guarantee contracts are an extremely common phenomenon and is found in almost every company, more commonly amongst group companies. While under contract laws, the liability of guarantor is co-extensive with that of the principal debtor, issue arose as to whether it is possible to include the assets of the (personal) guarantor in the liquidation of the corporate debtor. In one of the cases, it was ruled that the assets of the guarantor can be subjected to liquidation.*

Later, the ruling was reversed by Hon'ble NCLAT. The analysis by our colleague contains important point of law, and has been retained despite the NCLT ruling having been over-ridden.

In [Punjab National Bank v. Vindhya Vasini Industries Limited](#), [C.P. (IB)-1170(MB)] the issue before the NCLT, Mumbai Bench was whether a property belonging to the guarantor of the corporate debtor can be liquidated in the liquidation proceedings of the corporate debtor. The NCLT referred to section 60(2) of the Code and held that the assets of the guarantor can be subjected to liquidation by virtue of the said section. The rationale given by the NCLT was that the financial debt in question was intricately linked with the property of the guarantor mortgaged under the same loan agreement on the basis of which the financial debt in question was sanctioned and hence cannot be segregated in the process of liquidation proceedings.

With due respect to the decision of the NCLT, the author opines that while it is open for the creditors to proceed against the guarantor's assets independently and simultaneously, the NCLT's reliance on section 60(2) of the Code to support its ruling is altogether misplaced. The legislative intent behind section 60(2) is to ensure that there is a common forum for dealing with the insolvency resolution, liquidation process and bankruptcy of the corporate debtor and its personal guarantors, as the case may be. However, in the instant case, no question arose as to the insolvency or bankruptcy of the personal guarantor. Based on the loan agreement alone by way of which the properties of the guarantor were mortgaged to obtain the financial debt, the NCLT held that the liquidator is entitled to liquidate the assets of the guarantor too.

Given the context, the following may be noted as regards a guarantor's assets vis-à-vis proceedings under the Code:

1. Scope/intent of section 60 (2) of the Code

Section 60 of the Code provides for jurisdiction of NCLT. Sub-section (2) provides that where a corporate insolvency resolution process or liquidation proceeding of a corporate debtor is pending before a NCLT, an application relating to the insolvency resolution or liquidation or bankruptcy of a corporate guarantor or personal guarantor, as the case may be, of such corporate debtor shall be filed before the same NCLT.

The NCLT, in the instant case, remarked:

. . . to avoid such high percentage of sacrifice, it is necessary to take decision in favour of the financial creditor to initiate liquidation proceedings against a guarantor as well who had mortgaged the property and on that guarantee the loan in question was granted. The debt in question is intricately linked with the property mortgaged hence cannot be segregated in the process of liquidation proceedings. . . As a result, the assets of the guarantor can be subjected to liquidation by invoking the jurisdiction prescribed u/s 60(2) of the Code.

In the opinion of the authors, the purport of section 60(2) is to provide a common forum for proceedings under the Code in respect of the corporate debtor and in respect of the guarantors (personal or corporate). The section does not intend to cover segregated recovery proceedings against the assets of the guarantors, like invocation of guarantee, and commingling the guarantor's assets with the assets comprised in the liquidation estate of the corporate debtor.

Hence, references to the above section in the instant case were completely irrelevant. There were no insolvency resolution/bankruptcy proceedings against the guarantor. There was no application for initiation of bankruptcy proceedings against the guarantor either. Simultaneously, it may be noted that the provisions of the Code relating to insolvency resolution/bankruptcy of individuals have not been enforced as yet. The above holds true whether or not the guarantee is extended under the same loan agreement under which the debt was advanced.

2. Guarantor's assets during resolution: drawing the analogy

The guarantor's assets are not protected by the moratorium provisions of section 14 of the Code, as already made explicit by way of amendments made by the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2018 to section 14 of the Code. The provisions of moratorium during corporate insolvency resolution process period shall not apply to a surety in a contract of guarantee to a corporate debtor. Therefore, the creditor can proceed against the assets of the surety (i.e. the guarantor) while the corporate insolvency resolution process is continuing in respect of the corporate debtor.

Prior to the said Ordinance, there were conflicting views of the National Company Law Appellate Tribunal ("NCLAT") and the High Court on the subject. See, [Alpha and Omega Diagnostics \(India\) Ltd. v. Asset Reconstruction Company of India](#) [Company Appeal (AT) (Insolvency) No. 116/2017]; [Schweitzer Systemtek India Private Limited v. Phoenix ARC Private Limited](#) [Company Appeal (AT) (Insolvency) No. 129/2017]; [Sanjeev Shriya v. State Bank of India](#) [2017 (9) ADJ 723]; [State Bank of India v. V. Ramakrishnan and Veeson Energy Systems](#) [Company Appeal (AT) (Insolvency) No. 213/2017].

The Insolvency Law Committee (ILRC), in its Report, had referred to section 128 of the Indian Contract Act, 1872 which establishes the co-extensiveness of the liability of the surety to that of the principal debtor. Thus, the creditor is entitled to proceed against either the principal borrower or surety or both in any order, unless a contrary stipulation has been made in the contract. It further noted that the assets of the surety are separate from those of the corporate debtor, and that the availability of remedy with the creditor against both the surety and the corporate debtor in a contract of guarantee is the basis for extending loans in most cases. In view

Voluntary Liquidation Regulations-

Last But Not The Least

of this, the ILRC recommended exclusion of the assets of the guarantor from the applicability of moratorium, which has been incorporated by the Ordinance as above.

By extending the same reasoning to the liquidation proceedings, it can be stated that a loan agreement, incorporating guarantee as a collateral, confers no power on the liquidator to liquidate the assets of the guarantor and any interpretation inconsistent with this would contravene the settled principle of contract law.

The above situation is evident of the fact that the assets of the guarantor do not form part of the assets of the corporate debtor (see below), and the creditors have a separate independent recourse against the guarantor, outside the liquidation proceedings.

3. Not a component of liquidation estate

As regards the formation of liquidation estate for recovery, sub-sections (3) and (4) of section 36 of the Code enlist the assets which would fall or not fall, respectively, within the liquidation estate of the corporate debtor. The assets of guarantor are nowhere included in section 36(3). Moreover, there is express exclusion under sub-section (4) of personal assets of any shareholder or partner of a corporate debtor from the liquidation estate unless such assets are held on account of avoidance transactions. It follows that the guarantor's assets can only be put into the liquidation estate where the assets form a subject matter of vulnerable transactions, dealt with under sections 43 to 51 of the Code.

4. Can NCLT exercise its inherent powers to order the liquidation of the assets of the guarantor?

Rule 11 of the National Company Law Tribunal Rules, 2016 reads:

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.

However, the inherent powers are not limitless. In *Ram Chand and Sons Sugar Mills v. Kanhayalal*, the Supreme Court held that the Court would not exercise its inherent power under section 151 of the CPC if it was inconsistent with the powers expressly or impliedly conferred by other provisions of the Code. Thus, the adjudicating authority cannot override the substantive provisions of the Code or be inconsistent with the express rights or entitlements under the Code while exercising its inherent powers.

The above analysis shows that the adjudicating authority cannot direct the liquidator to liquidate the assets of the guarantor of the corporate debtor. In the instant case, the creditors under the liquidation proceedings and the creditors under the guarantee contract were one and the same; therefore, the act of putting the guarantor's assets in the liquidation pool will only be a matter of convenience for the creditors. Therefore, NCLT's order in the case should be seen as peculiar to the facts and circumstances of the case and shall not be taken as a precedent.

DECISIONS OF INSOLVENCY PROFESSIONAL SCOPE OF JUDICIAL REVIEW

- **Sikha Bansal**

Editor's Note: *In the course of insolvency or bankruptcy proceedings, the insolvency office-holders have to take various decisions – while some of the decisions are taken with the sanction of a body of creditors, and some with prior approval of the judicial authorities, in many other cases, the office-holder has to rely on his own prudence and take decisions, prominently as liquidators.*

In scenarios as liquidation, where there is "insufficiency", decisions taken by the office-holder may be prone to challenges by creditors (secured/unsecured), other stakeholders and even competing buyers for assets. However, the pertinent questions are – What kind of challenges are at all maintainable? Who, at all, can be said to be "aggrieved" by such decision-making? What are the grounds on which this decision-making may be challenged in judicial/quasi-judicial proceedings? When will the courts intervene or not intervene with such decisions? The jurisprudence is rich with rulings from insolvency laws of various countries over the decades, which the author discusses in this Paper.

In course of his conduct of insolvency or bankruptcy proceedings, the insolvency officeholder has to take various decisions. Some of these decisions are taken with the sanction of a creditors' body, such as the Committee of Creditors (CoC). Some are taken with the explicit permission of the judicial or adjudicatory body. However, there are lots of decisions which are taken by the officeholder himself. What are the grounds on which this decision-making may be challenged in judicial/quasi-judicial proceedings? The jurisprudence on this is rich with rulings from insolvency laws of various countries over the decades, as also the general principles of judicial review coming from administrative law.

The relevance of this article, in Indian context, is the fact that the involvement of practising professionals as insolvency officeholders, particularly, liquidators, is quite new, and therefore, decision-making by these professionals may be relatively more aggressive, less inclusive, and therefore, prone to challenges by creditors and other stakeholders. As the actions and decisions of these professionals are taken before legal forums, it may be necessary to see the evolution of the law around this topic from global jurisdictions.

The discussion, therefore, delves on the following –

- An overview of the provisions in India and corresponding/comparable provisions in other jurisdictions talking about the powers/duties of the office-holders in different roles they might assume under concerned laws.
- Potential situations which generally require/may require exercise of power of decision-making and fetters to such powers, as corollary.
- Right to challenge the decisions – whether such a right exists and if so, who has this right?
- Circumstances when the courts would or would not intervene.

Decisions of Insolvency Professional: Scope of Judicial Review

Decision-making powers/duties of office-holders

Decision-making is as much a duty as a power, as envisaged in laws across jurisdictions.

In India, under the Insolvency and Bankruptcy Code, 2016 (“Code”), while during resolution, the board is under animated suspension, liquidation entails statutory discharge of officers of the entity; thereby requiring, in both circumstances, the office-holder to step into the role of decision-making. The office-holder cannot NOT decide. However, such decision-making has been subjected to approval of the CoC during resolution, and to directions of the adjudicating authority (“NCLT”) during liquidation.

Note that there is a clear difference between the two phases which the office-holder serves – unlike resolution proceedings where the role of the insolvency professional is mainly that of a facilitator, working under the directions of the CoC, the liquidator is largely on his own and *has to* take several decisions in course of proceedings, thereby functioning in a “quasi-judicial” capacity⁵⁶. See, illustratively, sections 20, 23, 25, 28 (in respect of resolution professional), and sections 35, 39, 40, 41 (in respect of liquidators)⁵⁷.

Also, there is a noticeable difference between the position of a liquidator under voluntary winding up, and that under winding up by court. In case of voluntary liquidation, the liquidator is appointed by the shareholders. In case of winding up by court, the liquidator is seen as an officer of the court. The liquidator is, therefore, in a more vulnerable position when it comes to challenge to the decisions taken by the office-holder.

Under the UK Insolvency Act, 1986, the powers of the liquidator are enumerated in Schedule 4, read with sections 165-170 – specifically, section 167 provides for powers of liquidators in a winding up by court. Similar powers/duties are seen in laws of other countries too – for example, section 477 of the Corporations Act of Australia, and sections 144-145 of the Insolvency, Restructuring and Dissolution Act, 2018 of Singapore.

Generally speaking, the liquidators have to *decide* in the following illustrative cases –

- day-to-day management of assets of the entity, especially, when the entity is still to be maintained as a “going concern”;
- acceptance/rejection of claims;
- whether to bring any action/legal proceeding in the name of the entity;
- whether to settle disputed claims of the entity against third parties, including by way of conciliation, out-of-court settlements, or to continue litigate otherwise;
- whether to assign a cause of action;
- manner of disposal of the assets – whether on slump-sale, piecemeal or in parcels;
- whether to raise money requisite by creating further security on assets;
- whether to hold or to distribute the sums realised;

⁵⁶Hon’ble Supreme Court in [Swiss Ribbons Pvt. Ltd. v. Union of India & Others](#), WP (Civil) No. 99 of 2018, paras 60-61.

⁵⁷Interestingly, section 42 uses the expression “appeal” against the decision of liquidator, thereby emphasizing the role of liquidator as a quasi-judicial authority.

- whether to enter into compromise/arrangement with creditors/class of creditors, or members/class of members;
- whether to disclaim certain properties/contracts – this will involve determination of whether the property/contract is onerous;
- whether a certain transaction is vulnerable to be categorised into preferential, undervalued, extortionate, or fraudulent or as wrongful trading or fraudulent trading;

and the list is endless – there are plethora of circumstances where the liquidator is/might be required to take a stand.

Judicial Review of Office-holder's acts or decisions: Provisions of Law

The key questions of law on judicial review of liquidators' actions or decisions may be several:

- Is there a right of challenging liquidator's decisions or actions?
- Who can bring the challenge?
- Under what circumstances will the court usually interfere?

Generally speaking, while granting wide discretionary powers to the office-holders, the law also imposes certain fetters on such powers, thereby modulating their roles, and reducing the chances of conflict between the office-holder and the stakeholders.

Evidently, *refer* section 28 which requires the resolution professional to take prior approval of the CoC before undertaking any of the actions listed thereunder. Similarly, section 35 starts with “*Subject to the directions of the Adjudicating authority . . .*” while laying down general powers and duties of the liquidator. From being subject to “sanction” of the court to being subject to “directions” of the tribunal, the provisions relating to exercise of powers of the liquidator has evolved over time⁵⁸.

The second half of section 35 – that is, sub-section (2) – is equally important. It *empowers* the liquidator to consult *any of the stakeholders entitled to distribution* of proceeds under section 53. The proviso clarifies that such consultation is *not binding* on the liquidator.

Besides, section 60 of the Code vests on the NCLT generic powers to determine any question of law/facts, as arising in relation to proceedings of the corporate debtor under the Code.

Similarly, sections 167 and 168 of the UK Insolvency Act, 1986 make provision for judicial intervention. By virtue of sub-section (1) of section 167, in case of a company being wound up by the court, the liquidator may exercise any of the powers specified in Parts 1 to 3 of [Schedule 4](#), which inter-alia include power to bring/defend action, to carry on the business for beneficial liquidation, to sell any of the properties of the company by public auction or private contract with power to transfer the whole of it to any person or to sell the same in parcels, to raise security, to distribute, etc. However, at the same time, sub-section (3) of section 167 provides as follows –

⁵⁸Section 35 of the Code is akin to section 290 of the Companies Act, 2013, which in turn, is in contrast to section 457 of the Companies Act, 1956. The latter subjected the powers of the liquidator to “sanction” of the court. Section 458, however, enabled the liquidator to exercise discretion where the court, by order, provides that the powers can be exercised without such sanction. In any case, the exercise of such powers shall be “subject to control” of the court. Besides, *refer* section 460, 463-465 of the Companies Act, 1956.

Decisions of Insolvency Professional: Scope of Judicial Review

“(3)The exercise by the liquidator in a winding up by the court of the powers conferred by this section *is subject to the control of the court, and any creditor or contributory may apply to the court with respect to any exercise or proposed exercise of any of those powers.*”

Section 168 of the UK Insolvency Act provides supplementary powers to the liquidator. The liquidator *may seek a decision* on any matter from the company's creditors or contributories; and *must seek a decision* on a matter, if requested to do so by 1/10th in value of creditors, or 1/10th in value of the contributories. Sub-section (3) entitles the liquidator to apply to the court in prescribed manner, for directions in relation to any particular matter arising in the winding up. Sub-sections (4) and (5) provide as follows –

“(4)Subject to the provisions of this Act, the liquidator *shall use his own discretion in the management of the assets and their distribution among the creditors.*

(5)If *any person* is aggrieved by an act or decision of the liquidator, that person may apply to the court; and *the court may confirm, reverse or modify the act or decision* complained of, and make such order in the case as it thinks just.”

The fetters, as above, serve two crucial functions – first, these put a control on the use of discretion by the office-holder, and secondly, these spread the responsibility too. However, it must be noted that such intervention or control, as the case may be, has its own limitations. The courts have, time and again, declined to intervene in the acts/decisions of the liquidators unless *the act/decision was something so unreasonable and absurd that no reasonable man would have done it* – see discussions below.

Judicial Review of actions of Office-Holders: Judicial Precedents

In [Re Edenote Ltd; Tottenham Hotspur PLC v. Ryman](#) [1996] 2 BCLC 389, [1996] EWCA Civ 1349 is a classic case concerning the subject. Certain important aspects as discussed in this ruling are –

- (i) The Court, comparing the role of a liquidator to that of a *prudent businessman*, called for inapplicability of commonly referred Wednesbury test (see *Associated Provincial Picture Houses Ltd. v. Wednesbury Corp.* [1948] 1 KB 223) while judging the acts/decisions of liquidators, as follows –

“. . . it is unnecessary, rather it may be confusing, to introduce into the court's control of the acts and decisions of liquidators the language of its control of administrative action. In the latter case the court is usually concerned with the supervision of public servants performing statutory functions; in the former *with the supervision of persons who must, in most of what they do, act as prudent businessmen. In general there seems to be something unrealistic in judging the propriety of the acts and decisions of a businessman by asking whether he took into account something he ought not to have taken into account or failed to take into account something he ought to have taken into account.*”

- (ii) However, it approved of the test that the court will only interfere with the act of a liquidator if he has done something so utterly unreasonable and absurd that no reasonable man would have done it⁵⁹ –

“it is certainly possible for a liquidator to do something so utterly unreasonable and absurd that no reasonable man would have done it, simply by selling an asset of the company without taking into account the possibility that a third party might well have made a better offer than he to whom it was sold.”

- (iii) As to “reasonability”, the Court emphasised on the importance of being properly advised –

“A reasonable liquidator must be taken to be one who is properly advised. If support be needed for that proposition, it can be found in *Re Hans Place Ltd.* [1993] BCLC 768, 778I, where Mr John McDonnell QC is recorded as having submitted that the court can only reverse a decision of a liquidator under section 168(5) *where it is satisfied that it was taken in some way mala fide or “was so perverse as to demonstrate that no liquidator properly advised could have taken it.”* . . . *Very often a liquidator will not need advice before he acts. Here he clearly did.*”

- (iv) Section 167(3) provides, first, that the exercise of the liquidator's powers is subject to the “control” of the court and, secondly, that any creditor or contributory may apply to the court with respect not only to any “proposed exercise” but also to any “exercise” of any of those powers. It is therefore plain that the court can control a past exercise of the powers and can, if appropriate, undo a transaction to which it has led. In any event, the notion that creditors and contributories should be able to seek the directions of the court in an uncontroversial way is a curious one. As to who is a “person aggrieved”, the Court remarked, “It is neither necessary nor desirable to attempt a classification of those who may be persons aggrieved by an act or decision of a liquidator in a compulsory winding up. On the footing that the claims of secured creditors have been or will be satisfied, it is perfectly clear that unless and until there proves to be a surplus available for contributories (a most improbable event) “persons aggrieved” must include the company's unsecured creditors. If the liquidator disposes of an asset of the company at an undervalue, *their interests are prejudiced* and each of them can claim to be a person aggrieved by his act.” [emphasis ours]

The *Edenote* ruling (*supra*) has been cited and relied upon by an array of rulings, for instance, in [Abbey Forwarding Limited and Hone and others](#) [2010] EWHC 1644 (Ch), stating that the “test is a high one”.

⁵⁹The Court also went into the question of removal of the liquidator. The Court observes, “At [1995] 2 BCLC 268B, Sir John Vinelott said that the decision in *Keypak* was founded on and usefully illustrated the general principle that a liquidator must act in the interests of the general body of creditors and should not continue in office if in the circumstances the creditors no longer had confidence in his ability to realise the assets of the company to their best advantage and to pursue claims with due diligence. Again, I respectfully agree. *But there is an important qualification, which is indeed accepted by Mr Heslop. The creditors' loss of confidence must be reasonable.* Moreover, the court does not lightly remove its own officer and will, amongst other considerations, pay a due regard to the impact of a removal on his professional standing and reputation.” [emphasis ours]

Decisions of Insolvency Professional: Scope of Judicial Review

In an Australian case, [*Wentworth Metals Group Pty Ltd v Leigh and Owen \(as liquidators of Bonython Metals Group Pty Ltd\): In the matter of Bonython Metals Group Pty Ltd \(In liq\)*](#) [2013] FCA 349, the Federal Court of Australia discussed relevant legal principles in the context of section 1321 of the Corporations Act, 2001 of Australia. The Federal Court relied on a catena of decisions⁶⁰ wherein it has been upheld that “the power of a court under s 1321 and its predecessors to review a discretionary decision of a liquidator has generally been said to be confined to circumstances where the liquidator was *acting unreasonably or in bad faith*”, and that “The courts have generally been reluctant to interfere with decisions of liquidators where, as here, *their actions attract the benefit of the business judgment rule* under s 180(2)⁶¹ of the Act.”

Commenting upon the limitation of the judicial intervention in the decisions/acts of office-holders, the Federal Court, quoted [*ASIC v Forrestview Nominees Pty Ltd \(Receivers and Managers Appointed\)*](#) [2006] FCA 1530, wherein it was held,

“Where an appeal is brought against a discretionary or evaluative decision of receivers and managers, and *particular decisions involving qualitative judgment, the scope for curial intervention is necessarily confined.*”, as also held in *Duffy v Super Centre Development Corporation Ltd* [1967] 1 NSW 382 as follows –

“To the extent to which he makes decisions from time to time, they are in effect made under the authority of the Court itself, and they are subject to review and control by the Court should a proper case be made out requiring such intervention. Whilst this Court does, therefore, have an ultimate control over the day-to-day

⁶⁰*Re Mineral Securities Australia Ltd (in liq)* [1973] 2 NSWLR 207 at 230–231; *UTSA Pty Ltd (in liq) v Ultra Tune Australia Pty Ltd* [1997] 1 VR 667 at 696; (1996) 21 ACSR 251 at 281; *Re Burnells Pty Ltd (In liq)* [1979] Qd R 440 at 441; *Re Tyndall* (1977) 17 ALR 182 at 185; *Re Jay-O-Bees Pty Ltd (in liq)* (2004) 50 ACSR 565 ; [2004] NSWSC 818

⁶¹The **Business Judgement Rule** is propounded in section 180 (2) of the Corporations Act, 2001, as follows –

“(2) A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:

- (a) make the judgment in good faith for a proper purpose; and
- (b) do not have a material personal interest in the subject matter of the judgment; and
- (c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- (d) rationally believe that the judgment is in the best interests of the corporation.

The director’s or officer’s belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

Note: This subsection only operates in relation to duties under this section and their equivalent duties at common law or in equity (including the duty of care that arises under the common law principles governing liability for negligence)—it does not operate in relation to duties under any other provision of this Act or under any other laws.

(3) In this section:

business judgment means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.”

actions of a receiver and manager, *it is a control which is not in my view to be too freely exercised*. If, of course, there can be shown to be some defect in the manner in which the receiver and manager is conducting his duties – *a defect arising out of some want of good faith or out of some erroneous approach in law or in principle* – then that is clearly a ground on which the Court would entertain an application by one of the interested parties for appropriate directions or some other form of remedial order. Where, however, *the challenge made is that there has been an absence of prudence and wisdom in the receiver's decisions, a far heavier onus rests upon the party who seeks to challenge the decision in question. The Court will not concern itself with minor and ordinary decisions that he may have made: it must be shown that there is a decision of real significance in the affairs of the company and as to which there are real and substantial grounds for questioning its correctness before the Court will embark upon an investigation of what, if any, directions ought to be given.*" [emphasis ours]

The Federal Court also quoted from *Forrestview Nominees(supra)* that, "It is sufficient to say that at the very least the person bringing an appeal under s 1321 in these circumstances must demonstrate that the decision is informed by some error of law or significant factual error or is otherwise so unreasonable, in the circumstances, that it should not be allowed to stand. The content of those somewhat ambulatory considerations will be informed by the significance of the decision to the affairs of the company."

The Federal Court of Australia, also noted that *it is important not to lose sight of the standard of conduct expected of liquidators, particularly where matters of commercial or business judgment are involved*, as observed in *In the matter of St Gregory's Armenian School (in liq)* [2012] NSWSC 1215 at [33] –

"In evaluating the conduct of a liquidator, it is important to remember that a liquidator is required to make practical commercial judgments. Much of a liquidator's decision-making involves the application of business acumen. That a decision is not fully reasoned or supported by the fullest investigation does not mean that it should be second-guessed by the Court."

Author Remarks

With great powers, comes great responsibility – however, the corollary is also true. It becomes counter-intuitive to expect fulfilment of responsibilities without vesting adequate authority/powers and "freedom to decide".

The office-holders have been vested with powers that ought to be exercised reasonably by following ordinary rules of skill, care, and diligence. The courts do not see such cases with a "keen eye" where the office-holder has acted reasonably and in a manner as a person of ordinary business prudence would act. If each act/decision of the office-holder is questioned on non-serious grounds or grounds not falling in the category of "unreasonableness", the same would cause a serious damage to the professional infrastructure of the concerned laws.

VOLUNTARY LIQUIDATION REGULATIONS- LAST BUT NOT THE LEAST

- **Sikha Bansal**

Editor's Note: IBC not only provides for insolvency resolution and liquidation of solvent entities, it also covers voluntary liquidation of solvent entities.

The provisions of voluntary winding up have been removed from the Companies Act, 2013 and are now governed by the IBC, 2016. Ministry of Corporate Affairs vide notification dated 30th March, 2017 notified Section 59 of the Insolvency and Bankruptcy Code, 2016 which is relating to Voluntary Liquidation of Corporate persons. On the very next day, the Insolvency and Bankruptcy Board of India (IBBI) vide its notification dated 31st March 2017, notified the [Insolvency and Bankruptcy Board of India \(Voluntary Liquidation Process\) Regulations, 2017](#) which came into effect from 1st April 2017. This note, written soon after the promulgation of the voluntary liquidation regulations, discusses relevant provisions in brief.

IBBI, vide Notification No. IBBI/2016-17/GN/REG010 dated March 31, 2017 has issued the VL Regulations pursuant to section 59 of the Code and has appointed April 1, 2017 as the date on which the VL Regulations shall come into force.

The Ministry of Corporate Affairs vide Notification No. S.O. 1005(E) dated March 30, 2017 has notified April 1, 2017 as the date on which the following sections of the Code came into force:

1. Section 59 – Voluntary liquidation of corporate persons;
2. Section 209 – 215 (both inclusive) – Information utilities;
3. Sub-section (1) of section 216 – Rights and obligations of persons submitting financial information;
4. Section 234 – Agreements with foreign countries; and
5. Section 235 – Letter of request to a country outside India in certain cases.

The discussion below summarises the history of voluntary liquidation provisions in India and takes note of important provisions of the Code and the VL Regulations.

Voluntary Liquidation – Why “Voluntary”?

Voluntary liquidation, as it suggests, is liquidation of a corporate entity at the instance of its members. It is like private liquidation proceeding where the court's intervention is minimised. Voluntary liquidation is opted for several reasons, e.g. when the entity has been formed for a particular purpose and the purpose has been fulfilled; or where the articles provide that the entity shall be liquidated on the happening of an event and the event has happened; or where it is unable to carry on the business.

Law relating to Voluntary Liquidation – Then & Now

Liquidation of corporate entities (compulsory as well as voluntary) has been a subject matter covered under the Companies Acts prevalent from time to time and the provisions have evolved over time.

Part VII of the Companies Act, 1956 was prominently influenced by the provisions of the UK Companies Act, 1948 and provided for the following modes of winding up –

- (i) Compulsory winding up by the court;
- (ii) Voluntary winding up, classified into –
 - 1. Members' voluntary winding up
 - 2. Creditors' voluntary winding up
- (iii) Voluntary winding up subject to supervision of court

Voluntary winding up subject to supervision of the court became redundant – hardly any matter was referred in the category, and it was opined that compulsory winding up would take care of the same [Para 4.3 of the Eradi Committee Report. The provisions were omitted *vide* the Companies (Second) Amendment Act, 2002. And obviously, this mode of winding up was out of the scene in the Companies Act, 2013. Regarding voluntary winding up, while the Companies Act, 1956 distinguished between a members' voluntary winding up and a creditors' voluntary winding up; the Companies Act, 2013 merged the provisions – under the voluntary winding up option, both a declaration of solvency, as also creditors' resolution, were made mandatory. Therefore, companies finding it difficult to make a declaration of solvency (i.e. insolvent companies), were being left with the sole option of compulsory winding up for being unable to pay debts, as the route of creditors' winding up was no more available to them. All this while, the winding up provisions of the Companies Act, 2013 were not enforced.

In the early 2015, the Bankruptcy Law Reform Committee (BLRC) submitted its Interim Report where it stated,

“Reforming the insolvency system will have some benefits for liquidation of solvent companies as well. Many shareholder-agreements for investment transactions (involving foreign and domestic investors) in Indian companies provide for voluntary liquidation of the company as one of the exit alternatives for the investors or as a consequence of a termination event (termination events are grounds on the basis of which a shareholder agreement can be terminated by all or any of the parties). The ability of shareholders to cause the liquidation of a company in the event of breach of obligations by the other shareholders can serve as a disciplining mechanism for all the shareholders (and the management). However, the effectiveness of such a remedy depends on the efficacy of the liquidation regime. If the liquidation regime is efficient, it can go a long way in promoting

Bankruptcy Law Reform Committee:

“ The ability of shareholders to cause the liquidation of a company in the event of breach of obligations by the other shareholders can serve as a disciplining mechanism for all the shareholders (and the management). However, the effectiveness of such a remedy depends on the efficacy of the liquidation regime. If the liquidation regime is efficient, it can go a long way in promoting investor confidence by giving strength to such liquidation provisions in shareholder-agreements “

Voluntary Liquidation Regulations-

Last But Not The Least

investor confidence by giving strength to such liquidation provisions in shareholder-agreements. Such efficiency could also help commercial certainty on the occurrence of a liquidation event (by enabling parties to weigh legal risks in advance and price them into contracts accordingly).”

Subsequently, in its Final Report, the BLRC recommended that the proposed Code will also provide for voluntary liquidation of corporate persons who have not defaulted on any debt. Where a firm has not defaulted on any debt (or where a firm has no debt), it may make any application to be liquidated voluntarily in such manner as may be specified by the Board.

Consequently, the Code, which has been enacted with the main objective of providing a rescue mechanism for insolvent corporate persons (including liquidation thereof) also deals with voluntary liquidation of solvent corporate persons. Interesting is to note that sections 484 to 520 of the Companies Act, 1956 dealt with voluntary winding up and there were 20 sections (sections 304 to 323) in the Companies Act, 2013 dedicated especially to voluntary winding up (besides the general provisions relating to every type of winding up). Surprisingly, the Code, while dealing with voluntary liquidation of corporate persons (i.e. not only companies, but also limited liability partnerships and other bodies corporate), wraps up the voluntary liquidation provisions under a single section, i.e. section 59.

Voluntary Liquidation under section 59

An overview of section 59 has been provided in the following points –

1. Section 59 deals with voluntary winding up of corporate persons; therefore, financial service providers (excluded from the definition of corporate person) cannot avail this route. However, according to section 227, the Central Government may, if it considers necessary, in consultation with the appropriate financial sector regulators, notify financial service providers or categories of financial service providers for the purpose of their insolvency and liquidation proceedings, which may be conducted under this Code, in such manner as may be prescribed.
2. It is not necessary that the corporate person must owe a “debt” – reference is to “corporate persons” and not “corporate debtors”.
3. Two pre-conditions for initiating voluntary liquidation under section 59 are –
 - (i) the corporate person intends to liquidate itself voluntarily; and
 - (ii) the corporate person has not committed any default.
4. Sub-section (2) of section 59 requires that the voluntary liquidation of a corporate person shall be carried out in accordance with the conditions and requirements specified by the IBBI. The VL Regulations have been issued pursuant to this provision.
5. Where the corporate person is a company, the following procedure must be observed –
 - (i) Majority of the directors of the company shall make a declaration of solvency verified by an affidavit.

- (ii) The declaration shall be accompanied by audited financial statements and records of business operations, and a report of the valuation of assets.
- (iii) Within 4 weeks of declaration, shareholders' approval shall be obtained by ordinary or special resolution, as the case may.
- (iv) Where the company owes debt to any person, creditors' approval is also required. The approval shall be obtained from creditors representing at least 2/3rd in value of the debt of the company.
- (v) The company shall notify the Registrar of Companies and the IBBI of such resolution(s).
- (vi) Once the affairs of the company are being fully wound up, application shall be made to the adjudicating authority (i.e. the NCLT) for the dissolution of the corporate person. The corporate person shall be deemed to be dissolved from the date of the order of the adjudicating authority.

6. Note that –

- (i) The voluntary liquidation shall commence from the date of passing the shareholders' resolution, subject to the creditors' approval.
- (ii) The shareholders shall appoint an insolvency professional to act as liquidator for the purpose of conducting the voluntary liquidation proceedings.
- (iii) The provisions of sections 35 to 53 (relating to liquidation under the Code in respect of insolvent entities) shall apply to voluntary liquidation proceedings for corporate persons with such modifications as may be necessary. These provisions are listed below –
 - (a) section 35 – powers and duties of liquidator;
 - (b) section 36 – formation of liquidation estate, inclusions in and exclusions therefrom;
 - (c) section 37 – power of liquidator to access information systems;
 - (d) sections 38 to 42 – consolidation, verification, admission/rejection of claims; determination of value of claims; application against the decision of the liquidator;
 - (e) sections 43 to 51 – provisions relating to avoidable transactions, namely, preferential transactions, undervalued transactions, transactions defrauding creditors, extortionate credit transactions;
 - (f) section 52 – rights of secured creditors in liquidation proceedings; and
 - (g) section 53 – distribution of assets, priority of payment of debts.

The VL Regulations

A brief summary of the VL Regulations has been given as below:

- **Liquidation commencement date** – Liquidation commencement date has been defined under section 5 (17) of the Code to mean *the date on which the proceedings for liquidation commence in accordance with section 33 or section 59, as the case may be*. As stated under section 59 (5), voluntary liquidation shall be deemed to have commenced from the date of passing the shareholders’ resolution, subject to the creditor’s approval. Similarly, as stated under regulation 3 (3) of the VL regulations, the voluntary liquidation proceedings in respect of the corporate person (other than a company) shall be taken to commence from the date on which the partners, or contributories (as the case may be) resolve as such, subject to the creditors’ approval.
- **Voluntary liquidation of a corporate person other than a company:** Note that sub-section (2) of section 59 requires the Board to specify procedures and conditions for voluntary liquidation of corporate persons, while sub-section (3) provides some detailing as regards voluntary liquidation of a company. Regulation 2 of the VL Regulations lay down similar criteria (as under sub-section (3) of section 59) to be met in case of voluntary liquidation of a corporate person other than a company.
- **“Special majority” of partners** – Section 59 requires special resolution of the shareholders for voluntarily liquidating the company in some cases – sub-section (3) (c) (i); and the regulations, in respect of a corporate person other than a company, requires special majority of partners/contributories. Though the meaning of the term “special resolution” can be easily deciphered from the Companies Act, 2013; however, what constitutes “special majority” of partners/contributories has not been defined under the VL Regulations.
- **Approval of creditors** – Creditors’ approval is also a requirement for the commencement of voluntary liquidation proceedings. It is possible that the creditors refuse to approve such resolution or refuse to accept the liquidator nominated by the shareholders. Approval of creditors’ being a pre-condition in case a company owes a debt, it is opined that the only option left with the company is to move an application under section 271 of the Co Act, 2013.
- **Remuneration of the liquidator** – The Code requires the shareholders to appoint an insolvency professional to act as liquidator. However, unlike the provisions relating to remuneration of the liquidator under the Liquidation Regulations, 2016, there is no prescription as to the manner in which the remuneration of the liquidator shall be determined. The Liquidation Regulations (reg. 4) allow the committee of creditors to determine the remuneration in some cases; while in other cases, the liquidator’s fee is a function of the amount realized net of other liquidation costs, the amount distributed, and the time period within which the amounts are realised and distributed. In the case of voluntary liquidator, the VL regulations require that the remuneration shall be fixed by the shareholders/partners/contributories (as the case may be) under the same resolution as passed under section 59 (3) (c) or regulation 3 (1) (c). Hence, there is no mathematical

formula for computation of liquidator's fee as in case of liquidation of insolvent companies, which is understandable.

- **Eligibility for appointment as liquidator** – The eligibility conditions are the same as those for a resolution professional under the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations) and the liquidator under the Liquidation Regulations. Basic criterion is “independent of corporate debtor”.
- **Liquidator to step down on conflict of interests** – Regulation 6 (4) of the VL Regulations requires the liquidator to step down from acting as a liquidator in two cases –
 - If the insolvency professional entity of which he is director/ partner represents other stakeholder in the same liquidation proceeding; or
 - Any other director/ partner of such insolvency professional entity represents any other stakeholder in the same liquidation proceeding.
- **Public announcement of liquidation** – The public announcement of voluntary liquidation shall be made by the liquidator within 5 days of his appointment. The time limit is same under the Liquidation Regulations. However, in case of insolvency resolution, the public announcement shall be made within three days of the appointment of interim resolution professional.
- **Claims** – Chapter V of the VL Regulations provide for the manner of submission of claims by creditors (including workmen and employees and secured creditors), determination of amount of claims, foreign currency claims, mutual credits ad set-off, verification of claims, etc.
- **Realisation of assets** – Note that the VL Regulations allow the liquidator to value and sell the assets of the corporate person in the manner and mode approved by the corporate person. The provisions are stricter and more specific under the Liquidation Regulations.
- **Reporting requirements** – Pursuant to regulation 8, a liquidator is required to prepare and submit viz., preliminary report, annual status report, minutes of consultations with stakeholders and final report.
- **Preliminary report:**
 - **Submission of preliminary report** – within 45 days from the liquidation commencement date.
 - **Content of the report** – the preliminary report shall provide details of following –
 - » the capital structure of the corporate persons;
 - » estimates of its assets and liabilities as on liquidation commencement date based on the books of the corporate persons;

Voluntary Liquidation Regulations-

Last But Not The Least

- » intention to make any further inquiry in to any matter relating to the promotion, formation or failure of the corporate person or the conduct of the business;
 - » the proposed plan of action for carrying out the liquidation, including the timeline within which he proposes to carry it out and the estimated liquidation costs.
- **Annual status report:**
- » If liquidation process continues for more than 12 months
 - » Status report shall indicate progress in liquidation and shall *inter alia* include the following –
 - ✓ settlement of list of stakeholders,
 - ✓ details of any assets that remains to be sold and realized,
 - ✓ distribution made to the stakeholders, and
 - ✓ distribution of unsold assets made to the stakeholders;
 - ✓ developments in any material litigation, by or against the corporate person;
 - ✓ filing of, and developments in applications for avoidance of transactions in accordance with Chapter III of Part II of the Code and
 - ✓ enclose audited accounts of the liquidation.
- **Minutes of consultations with stakeholders:**
- » The stakeholders shall extend all assistance and cooperation to the liquidator to complete the liquidation of the corporate person;
 - » Any consultation with the stakeholders shall be recorded.
- **Final report:**
- » When to prepare – on completion of the liquidation process
 - » Final report shall consist of –
 - ✓ audited accounts of the liquidation, showing receipts and payments pertaining to liquidation since the liquidation commencement date; and
 - ✓ a statement demonstrating that-
 - ✓ the assets of the corporate person has been disposed of;
 - ✓ the debt of the corporate person has been discharged to the satisfaction of the creditors;

- ✓ no litigation is pending against the corporate person or sufficient provision has been made to meet the obligations arising from any pending litigation.
 - ✓ a sale statement in respect of all assets containing –
 - ✓ the realized value;
 - ✓ cost of realization, if any;
 - ✓ the manner and mode of sale;
 - ✓ an explanation for the shortfall, if the value realized is less than the value assigned by the registered valuer in the report of the valuation of assets under section 59(3)(b)(ii) or Regulation 3(1)(b)(ii), as the case may be;
 - ✓ the person to whom the sale is made; and
 - ✓ any other relevant details of the sale
 - ✓ Final report shall be sent to? – the Registrar, the Board and the Adjudicating Authority.
- **Time period for completion of liquidation** – Regulation 37 of the VL Regulations requires that liquidator shall endeavor to complete the liquidation process of the corporate person within 12 months from the liquidation commencement date. In case the process continues beyond, the liquidation shall call meeting(s) of contributories at intervals specific. The time period suggested under the Liquidation Regulations is 2 years.
 - **Rights of members *inter-se* in case of distribution** – Sections 304 to 323 of the Companies Act, 2013 have been omitted; however, an important part missed in section 59 and the VL regulations is the provision relating to distribution of property of company among the members according to their rights and interests in the company. While in case of an insolvent company, the possibility of shareholders getting a surplus might be bleak; such a provision is of crucial importance in case of liquidation of a solvent company.
 - **Suspension of liquidation** – There is a provision under regulation 40 which states that where the liquidator detects insolvency, he shall make an application to the adjudicating authority to suspend the process of liquidation and pass any such orders as it deems fit.
 - **Dissolution of corporate persons** – On affairs of the corporate persons being completely wound up, the liquidator shall make an application to the Adjudicating Authority for dissolution of corporate persons. The Corporate persons shall be dissolved from the date of order and a copy of the same shall be forwarded to the authority within a period of fourteen days with which such corporate persons is registered.

Transfer of pending proceedings

Rule 4 of the Companies (Transfer of Pending Proceedings) Rules, 2016 provide that “All applications and petitions relating to voluntary winding up of companies pending before a High Court on the date

Voluntary Liquidation Regulations-

Last But Not The Least

of commencement of this rule, shall continue with and dealt with by the High Court in accordance with provisions of the Act". Note that the date of commencement of Rule 4 is 1st April, 2017.

Therefore, the voluntary winding up proceedings pending as on 1st April, 2017 will not get transferred to NCLT, and will be dealt with by the High Court in accordance with the provisions of the Act, 1956, as shown below:

Consequences of shifting voluntary winding up provisions to the Code

Para 16 of the Eleventh Schedule of the Code [pursuant to Clause 255] to the Code calls for omission of Sections 304 to 323 of the Companies Act, 2013 dealing with voluntary winding up provisions. Therefore, the Companies Act, 2013 now have only one mode of winding up – winding up by the NCLT. However, only the insolvency professionals have been allowed to act as liquidators in these modes of winding up, whether by NCLT under the Companies Act, 2013 or winding up of insolvent companies under the Code, or voluntary liquidation of corporate persons under the Code.



SECTION V: PREFERENTIAL, WRONGFUL & FRAUDULENT TRANSACTIONS

Preferential, Wrongful & Fraudulent Transactions

Editor's Note

Sections 43 to 51 of the Code contain provisions dealing with 4 types of transactions, which may collectively be called “vulnerable transactions”. Additionally, section 66 (1) and 66 (2) deals with the power of the Adjudicating Authority to make contribution orders in respect of fraudulent conduct of business, and wrongful conduct of business, respectively.

Both – the proceedings against vulnerable transactions, and proceedings for contribution orders, are meant for swelling the liquidation estate. Unlike what might appear to be the case, the intent of the RP or liquidator in initiating these proceedings is not penal – prosecution is a different aspect altogether. The clear intent of each of these proceedings is to bring back into the company or liquidation estate money/assets that may have gone beyond the reach of the company/liquidator.

Sections 43 to 51, and section 66 differ in their scope and purport. Sections 43 to 51 are mostly about transactions, and therefore, the remedy generally will be reversal of the impact of successfully assailed transactions. Section 66 (1) and (2) both deal with the general conduct of business – an isolated or specific transaction is not the subject matter of this section. Section 66 is, in a manner of speaking, a dent on the principle of separation of legal personality or limited liability. By virtue of section 66 (1), if the conduct of business has been fraudulent, it may lead to contribution orders against any person who is responsible for the same. The scope of section 66 (1) is not limited to directors. While this remains to be tested, but it may be felt that if the creation of holding/subsidiary layers is also a clever design, done deliberately to insulate the assets or operations of a corporate debtor, section 66 (1) may even be triggered to invoke “group liability” or “substantive consolidation” – a concept which is discussed in one of the chapters in this book.

Section 66 (2), as a distinct ground of challenge, is against the continuation of business by a beleaguered company, where the board of directors is clearly aware that there is no hope for revival. In such cases, the directors will be liable to make contribution for the aggravation of losses, and thereby, the depletion of assets of lenders/creditors. This also is, therefore, an exception to the principle of limited liability.

Both sections 66 (1) and (2) are inspired by UK Insolvency Act [sections 213 and 214 respectively], and have been inserted after strong recommendations of the Cork Committee. Both the sections do not have parallels in winding up provisions.

Sections 43 and 45 deal with preferential and undervalued transactions, respectively. A transaction is preferential, irrespective of being for good value. Preference is usually by preferring one over the other. That is, if someone is put to unjust advantage over others, there is a case of preference. This may be due to a payment, security, terms of borrowing, or the like. Undervalued transactions, on the other hand, result into unjust enrichment at the cost of the company.

Section 423 of the UK Law

Section 49 of the Indian law corresponds to 423 of the UK Insolvency Act. The UK provision has received very interesting comments in several UK rulings. Here is one:

“Section 423 plays an important role in insolvency law. It can moreover apply even though the debtor is not in a formal insolvency ... Section [423] is a carefully calibrated section forming part of a carefully calibrated group of sections.” [IRC v Hashmi [\[2002\] 2 BCLC 489](#)]

Section 49, though, refers to section 45 in terms of its scope, but is not the same as section 45. The distinctive feature in section 49 is “deliberate” action. Hence, transactions deliberately entered into for keeping the assets of the company beyond the reach of creditors, or generally, to adversely affect the interests of claimants, can be assailed under this section. Section 49 is inspired by section 423 of the UK Act. The BLRC has specifically discussed wilful defaults, and has recommended

that the claw-back period applicable to actions under sections 43, 45 and 49, should not be applicable where there is a deliberate or fraudulent intent.

While the history of winding up laws in India has rich jurisprudence dealing with vulnerable transactions, the provisions of the sections cited above have mostly been inspired by UK law have almost analogous language. Therefore, there is substantial advantage in learning from the case law under the UK law under the corresponding provisions.

DISCERNING THE REACH OF AVOIDANCE PROCEEDINGS:

An Analysis of IDBI Limited v. Jaypee Infratech Limited

- **Sikha Bansal**

Editor's Notes: *The Code calls upon the Resolution Professional/ Liquidator, as the case may be, to bring to the knowledge to the Adjudicating Authority, transactions of preferential, undervalue, extortionate, fraudulent, or unlawful nature, if any, identified during the course of CIRP or liquidation. Considering the huge sums involved in these transactions, provisions for the same, in IBC as well as on a global scale, is of utmost importance.*

The following articles covers discussion on one of the rulings concerning vulnerable transactions.

In [IDBI Limited v. Jaypee Infratech Limited](#) [CA No. 26/2018 in CP No. (IB)77/ALD/2017, Order dated 16.05.2018], the NCLT, Allahabad Bench, dealt with a crucial aspect of insolvency proceedings, that is, vulnerable transactions. The resolution professional (RP) of the Corporate Debtor filed application in relation to a mortgage of an immovable property belonging to the Corporate Debtor to secure the debt of a related party (that is, the holding company of the Corporate Debtor). The RP sought the following directions, *inter alia*, so as to declare the transaction as preferential, undervalued and "fraudulent and wrongful" under the Code

A. Forms of Vulnerable Transactions

The Code talks about four forms of vulnerable transactions, three of them as relevant to the context being – preferential transactions, undervalued transactions, and transactions defrauding creditors. Note that there might be overlaps in between such transactions, i.e. a transaction can be preferential, undervalued, and fraudulent at the same time.

Here it is relevant to note that the words "transaction" and "transfer" are omnibus expressions. In "[Security Interests as Preferential Transactions](#)", the author has discussed how and under what circumstances a security interest can/cannot be treated as preferential transaction – the views are reflected in the observations made in *Jaypee Infratech (supra)*.



Further, section 66 holds the promoters/directors personally liable for carrying out the business of the corporate debtor with an intent to defraud creditors of the corporate debtor or for any fraudulent purpose.

B. The Ruling in Jaypee Infratech

The facts of *Jaypee Infratech case (supra)* can be outlined as below –

The holding company was also the principal contractor of the Corporate Debtor. The RP alleged that the directors of the Corporate Debtor mortgaged unencumbered land owned by it to secure one of the debts of the holding company. Questions which arose for consideration are, *inter-alia* –

- (i) whether impugned transactions were carried out with an intent to defraud creditors of the Corporate Debtor or for any fraudulent purpose [section 66];
- (ii) whether impugned transactions are preferential transactions [section 43] or undervalued transaction [section 45];
- (iii) whether look-back period shall be 1 year or 2 years.

The questions may be discussed as follows, alongwith the deliberations of NCLT –

(i) Whether the transaction was a preferential transaction:

It may be noted that in view of the conditions specified under section 43 (2), the debt, the creditor, and the assets – all should belong to the corporate debtor. In this case, the lender in favour of whom the mortgage was created was not the creditor of the Corporate Debtor, but it was the creditor of the holding company. Therefore, the provisions of section 43 are not directly attracted in this case.

However, NCLT noted that *the holding company is also one of the operational creditors of the Corporate Debtor*. Section 43(2) requires that the transfer should be for the benefit of a creditor of the corporate debtor. Hence, this being a deeming provision, applies in case of impugned transaction. The holding company, which is a creditor of the Corporate Debtor, is put in a beneficial position, than it would have been in the event of distribution of assets made in accordance with section 53.

The stand taken by NCLT implies that once the Corporate Debtor has granted security interest in favour of its holding company, it has the effect of reducing the direct liability of the holding company towards the transferee lender. So, the holding company which is also one creditor, is being an indirect beneficiary here.

(ii) Whether the relief of “ordinary course of business” available:

The provisions of the Code carve out exceptions for transactions entered into ordinary course of business from being challenged as avoidable transactions. For example, section 43 (3) (a) excludes “a transfer made in the ordinary course of the business or financial affairs of the corporate debtor or the transferee”.

NCLT held that the transaction of creating a security interest by way of mortgage in favour of lenders of a third party, on the unencumbered land of the Corporate Debtor without any consideration or counter guarantee, cannot be treated as transfer in the ordinary course of business or financial affairs of the corporate debtor. The exclusion clause cannot be interpreted that the ordinary course of business also includes transferee’s ordinary business because transferee can never do transfer himself. The impugned transfer did not benefit either the business or the finances of the Corporate Debtor in any way. Such transfer is for the benefit of the related party, therefore cannot be excluded under section 43 (3). The word “transfer made” itself indicates that it relates to the transferor and not the transferee. Therefore, the ordinary course of business of transferee bank will not exclude the transactions from the purview of preferential transactions.

Discerning the Reach of Avoidance Proceedings

(iii) Whether the transaction was an undervalued transaction:

The alleged transaction has been made without any consideration to the Corporate Debtor. Therefore, the transaction was said to be covered under section 45 (1) of the Code, and will be treated as undervalued. The arguments as to collateral security being common practice in banking industry and reciprocity in the relationship the holding and the Corporate Debtor were rejected by the NCLT.

(iv) Whether look-back period will be 1 year or 2 years:

It was argued that the relevant sections of the Code [sections 43,45,60(5),66] came into effect as on 01.12.2016. Therefore, the limitation period of 1 year/2 years will apply only to transactions made on or after 01.12.2016 and not beyond that date. NCLT rejected the contention stating that the retrospective effect of such provisions is imbibed in the legislation itself. The look-back period is to be determined with reference to the insolvency commencement date and not the date when the Code came into effect. Therefore, in this case, since the beneficiary is a related party, the look-back period would be 2 years from the insolvency commencement date.

Here, the ruling of *Levit v. Ingersoll Rand*, 874 F.2d 1186 F.2d (7th Cir. 1989) might be relevant. The court held that look-back period shall be determined on the basis of the ultimate beneficiary of the transaction, that is, whether the beneficiary is an outside creditor or an inside creditor.

The author would also like to reiterate that since the transaction has already been classified as one defrauding creditors (see below) by the NCLT, there was no need of delving into the question of lookback period. Reason being – no look-back period has been specified for fraudulent transactions. Where a fraudulent transaction is also a preference transaction, there shall be no need of putting the limits of “look-back period”.

(v) On question whether the transaction was to defraud creditors:

The NCLT noted that the Corporate Debtor was facing financial crunch and its account was declared NPA. The Joint Lenders Forum lenders advised the Corporate Debtor to not to create any mortgage/charge on any asset/land parcel without approval from the lenders of the Corporate Debtors. However, NCLT noted that the impugned transactions were done not only without the consent of JLF but also contrary to the decision of JLF.

Berkey v. Third Avenue R. Co.,

“the corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterized as an ‘alias’ or a ‘dummy.’ All this is well enough if the picturesqueness of the epithets does not lead us to forget that the essential term to be defined is the act of operation.”

C. The Doctrine of Alter Ego

Though NCLT did not delve into the concept, yet it might be relevant to discuss the same here.

A corporate has a separate legal existence. However, “alter ego” is the doctrine that treats a corporation and those who own its stock to be identical⁶². When a corporation has been so dominated by an individual or another corporation and its separate entity so ignored that it primarily transacts the dominator's business instead of its own and can be called the other's alter ego, the corporate form may be disregarded to achieve an equitable result. See, *Passalacqua Bldrs. v. Resnick Developers S.*, 933 F.2d 131; *Gartner v. Snyder*, 607 F.2d 582; *Directors Guild v. Garrison Prods.*, 733 F.Supp. 755) quoted in *Austin Powder Co. v. McCullough*, 216 AD 2d 825, 827 [1995], *Sampselly. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941), *Cappuccitti v. Gulf Indus. Products, Inc.*, 222 S.W.3d 468, In *Klein v. Sporting Goods, Inc.*, 772 S.W.2d 173, Court of Appeals of Texas (14th Dist.), *Iridium India Telecom Ltd. V Motorola Incorporation and Other*, (2011) 1 SCC 74, [Criminal Appeal No. 688 of 2005].

More often than not, the doctrine of alter ego will be invoked in cases involving fraudulent transactions, that is, where there is a deliberate intent on the part of the debtor to give away its assets to or for the benefit of its alter ego or vice versa.

In *Berkey v. Third Avenue R. Co.*, 244 N.Y. 84, it was said that “the corporate entity will be ignored when the parent corporation operates a business through a subsidiary which is characterized as an ‘alias’ or a ‘dummy.’ All this is well enough if the picturesqueness of the epithets does not lead us to forget that the essential term to be defined is the act of operation. *Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent.* Where control is less than this, we are remitted to the tests of honesty and justice.”

D. Concluding Remarks

The *Jaypee Infratech case (supra)* sets a precedent as regards avoidance proceedings under the Code. It decodes the depth and the reach of preferential transactions. It would be interesting to see what lies ahead, and whether the applicability/non-applicability of the doctrine of “alter ego” is at all considered in this case.

⁶²The Law Dictionary.

A NOTE ON FRAUDULENT TRADING AND WRONGFUL TRADING

-Resolution Team Services, Vinod Kothari & Company

Editor's Note: *An entity may slip into insolvency for multiple reasons. While technological obsolescence, bad business decisions are unavoidable/natural reasons; for a sound business environment, it is incumbent to curb cases of fraud and negligence – where the insolvency was perpetuated knowingly or as a result of lack of due care. Notably, these two aspects may sound synonymous but are different in nature. Insolvency laws across the globe provide for strict action against fraudulent and wrongful trading. Following is an extensive note, encompassing the various aspects of such transactions, laws dealing with them and its impact.*

Introduction

On examination of a Corporate Debtor's transactions during the process of liquidation, the most commonly used types of vulnerable transactions liquidator are Preferential Transactions (Section 43), Undervalued Transactions (Section 45), Transactions to defraud creditors (Section 49) and Extortionate Credit Transactions (Section 50), as provided under the Insolvency and Bankruptcy Code, 2016. However, one of the most potent and efficient tools for holding directors liable for their misconduct under Section 66 is ignored and underused. Section 66 of the Code provides for fraudulent trading under sub-section 1 and wrongful trading under sub-section 2.

The introduction of separate provisions for fraudulent trading and wrongful trading was one of the most significant turning points in the history of insolvency laws in both UK and Indian jurisdictions.

This note examines fraudulent trading and wrongful trading as provided under UK Legislations as well as Section 66 of the Code, while looking into the intent of such provisions and history of director's liability to contribute to assets of a corporate debtor, to highlight its importance and efficiency in being used as a tool to enforce director's liability.

United Kingdom Laws

The concepts of fraudulent trading and wrongful trading in India were derived from the provisions in the [UK Insolvency Act 1986](#). Hence, it is necessary to examine the background and intent with which such provisions were introduced in the UK Laws.

Directors were always protected under the cloak of limited liability and hence, there was a high possibility of 'indifference and lack of concern' on their part, especially in times of financial distress. High monitoring costs and informational asymmetries disallowed creditors from keeping a check on such actions, which when combined with the abuse of limited liability, ultimately led to market failure.

Cork Committee Report

The Report of the Insolvency Law Review Committee, *Insolvency Law and Practice* (“The Cork Report”) was of the opinion that the provisions of fraudulent trading under Section 332 of the Companies Act 1948 had significant inadequacies in dealing with irresponsible trading. While there was always a liability imposed on directors who had the intention to defraud creditors, the Committee preferred the inclusion of a provision which held directors liable for mere failure to take steps in minimizing creditor losses on anticipation of insolvency.

Concerned with the lack of protection for unsecured creditors, the Cork committee sought for a “radical extension” in civil liability for directors whose fraudulent, reckless and negligent actions during financial distress, affected the interest of creditors. The Committee wanted a legislation which would ensure company directors to satisfy themselves about the company’s ability to discharge its liabilities.

While the Government agreed to tighten the reins on directors’ activities in its paper titled “A Revised Framework for Insolvency Law”⁶³, it did not take up the recommendations of the Cork Report entirely.

Subsequently, provisions were inserted for “fraudulent trading” under Section 213 and “wrongful trading” under section 214 of the Insolvency Act 1986

UK INSOLVENCY ACT 1986

1. Fraudulent Trading- Section 213

Section 213 allows for the court, on the application of the liquidator, to order for any persons to make contributions to the company’s assets if were knowingly parties to the fraudulent trading of business with the intention to defraud creditors. The various aspects of this section, as interpreted in judicial decisions are as follows:

1.1. Dishonest Intention

*The most relevant component of fraudulent trading is "blind-eye" knowledge. The elements of this type of knowledge were accurately described in the speech of Lord Scott of Foscote, in Manifest Shipping Company Limited v. UniPolaris Company Limited.*⁶⁴

“Blind-eye knowledge requires, in my opinion, a suspicion that the relevant facts do exist and a deliberate decision to avoid confirming that they exist. But a warning

⁶³Cmnd 9175

⁶⁴[2003] 1 AC 469.

Elements of Fraudulent Trading

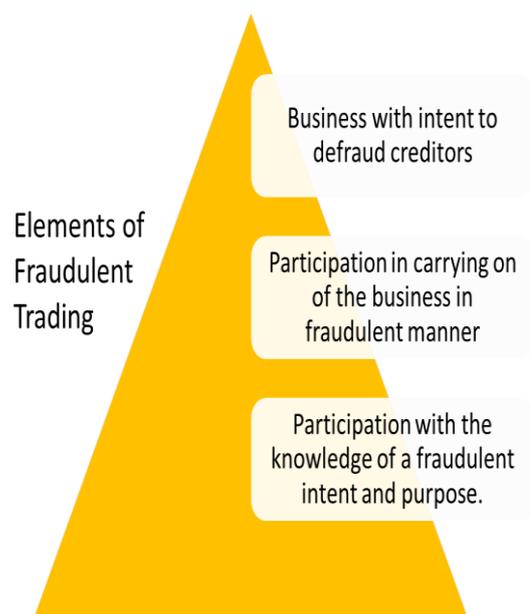


Figure 20: Elements of Fraudulent Trading

A Note on Fraudulent and Wronfgul Trading

should be sounded. Suspicion is a word that can be used to describe a state-of-mind that may, at one extreme, be no more than a vague feeling of unease and, at the other extreme, reflect a firm belief in the existence of the relevant facts. In my opinion, in order for there to be blind-eye knowledge, the suspicion must be firmly grounded and targeted on specific facts. The deliberate decision must be a decision to avoid obtaining confirmation of facts in whose existence the individual has good reason to believe.”

The Judge held that the pre-requisite for “dishonesty” under Section 213 does not have high thresholds. In *Morris v. Bank of America*, the court held that the extraordinary nature of the transactions and the paucity of the paperwork are a few things that the court checks to conclude dishonesty⁶⁵ References to “fraudulent” in the legislation connotes “actual dishonesty involving, according to current notions of fair trading amongst commercial men, real moral blame.” In the case of *Morphitis v. Bernasconi*,⁶⁶ the court held that dishonesty is incurring company debt by those in charge, with the knowledge that it will not be repaid, or there is a substantial and unreasonable risk of default. The requirement of dishonesty presents the problem of evidence and proof.

1.2. No criminal liability under Section 213

The predecessor provisions of Section 213 were Section 275 of the Companies Act, 1929 and Section

The “Blinds’ Eye Test”:

Conduct regarded as dishonest by the standards of reasonable and honest people will be treated as dishonest, even if the defendant genuinely believed that such conduct would not be so regarded

332 of the Companies Act, 1948. These sections combined both compensatory and penal provisions.

They were naturally regarded as penal legislation and, as such, were strictly construed so as to give the person charged, the benefit of the doubt.

Morris v. Bank of India:

“outsider” companies can be made liable under section 213, provided that it is established they were “knowingly” parties to the fraudulent trading.

The position is different under the 1986 Act. Section 213 is not a penal provision. It only covers civil liability to pay compensation in cases where the company which traded fraudulently is being wound up. The purpose of Section 213 is to enable the liquidator to recover compensation from those who have knowingly assisted the fraudulent conduct of a company's business.

In the case of *Re Patrick and Lyon Maugham*, it was held that the jurisdiction of the court was confined in civil cases to declaring that past or present directors, including shadow directors of the company, who had carried on its business with intent to defraud creditors, should be personally responsible for all or any of the

⁶⁵ [2001] BCLC 771.

⁶⁶[2001] 2 BCLC 1.

debts or other liabilities of the company as the court may direct.

1.3. Corporate knowledge

In *Bank of India v. Christopher Morris*⁶⁷, the court analysed the circumstances in which an individual's knowledge of fraud is to be treated as corporate knowledge for the purposes of Section 213. It is not a simple matter of identifying the person who authorised the transaction in accordance with the system of authorisation operated by the company in question. The scheme of delegation of authority might provide only an incomplete picture of what was done and may not be sufficient for attribution of corporate knowledge. The company cannot be liable for the activities of an individual when it itself is the victim of such wrong. Usually, the illegal act of a company officer's is attributable to the company, however, it is not so when a company is making a claim against its directors. The directors owe a duty to the company and the conduct of directors is different from that of the company.

1.4. Liability of Outsiders

Section 332 of the 1948 Act extended liability beyond past or present directors of the company carrying on its business fraudulently to any persons, including other companies, who were knowingly parties to that fraudulent trading.

In *Morris v. Bank of India*, the court held that "outsider" companies can be made liable under section 213, provided that it is established they were "knowingly" parties to the fraudulent trading. A creditor may also be liable under the section⁶⁸ Both types of liability extends beyond the company which actually carried on its business with intent to defraud creditors, to its directors and to "outsiders" who are individuals and corporate third parties who have knowingly been parties to the fraudulent trading in question.

1.5. Defences

In case of *Etivia S.A. & Anor v. Bilta (UK) Limited (in liq)*⁶⁹ the issue was whether the corporate debtor could bring a claim against the fraudulent directors as it itself had been a party to the illegal acts through its directors and shareholders. The UK Supreme Court held that a director cannot use his dishonesty as a defence.

2. Wrongful Trading- Section 214

Section 214 attaches a personal liability on the director of a company to contribute to the company's assets if:

1. The company has gone into liquidation and
2. The director at that time, knowing or having ought to conclude that there was no reasonable prospect of avoiding liquidation proceedings, did not take steps with a view of minimizing the potential loss to the company's creditors

⁶⁷[2005] EWC AC iv 693.

⁶⁸ [2004] 2 BCLC 236.

⁶⁹[2015] UKSC 23.

A Note on Fraudulent and Wrongful Trading

Section 214 was introduced with the intent to enhance ‘transparency and trust’ in UK business, with specific focus on expanding the scope of civil liability of directors for their misconduct.

This was also an attempt to prevent directors from externalizing the cost of their company’s debts and placing the risk of further trading on the creditors. As opposed to fraudulent trading, the civil liability for wrongful trading was imposed only on “insiders” ie. the directors of the company, including shadow directors.

Section 214 imposes a personal unlimited liability on a director of an insolvency company who is found to have indulged in callous, negligent and reckless continuation of trade during times when they knew or ought to have known that there was no prospect for the company to avoid the liquidation process. The rule under this section is widely used as an important device for the protection of creditors. The directors are assessed against the general knowledge, skill and experience that may be reasonably expected out of a ‘reasonably diligent person’ acting in the capacity of a director.

This provision seeks to remedy the market failure caused through its compensatory and deterrence aspects, in pursuance of Cork’s idea. Although the liability is *ex post* in nature, ie. the liability to compensate is imposed only after the incident takes place, Cork believed in the *ex- ante* benefits in encouraging better management of the assets of a company in financial distress. This provision, however, can be imposed only by a liquidator and only when a company has entered insolvent liquidation. One of the defences available to a director is to show that he took every step possible with the primary purpose to minimize the potential loss that could have been caused to the company’s creditors.

Section 214 imposes a personal unlimited liability on a director of an insolvency company who is found to have indulged in callous, negligent and reckless continuation of trade during times when they knew or ought to have known that there was no prospect for the company to avoid the liquidation process.

INDIAN PROVISIONS

Companies Act, 1956

Prior to the commencement of the Code, courts used the provisions of Section 542 and section 543 of the Companies Act 1956, where courts have ordered for directors to compensate for the consequences of their wrongful or fraudulent acts in various instances.

It was held in [Official Liquidator, Supreme Bank Ltd v. P.A. Tendolkar](#) (1973) 43 Comp Cas382, (1973) 1 SCC 602:

“The director cannot shut his eyes to what must be obvious to everyone who examines the affairs of the company even superficially. If he does so, he could be held liable for dereliction of duties undertaken by him and compelled to make good the losses incurred by the company due to his neglect even if he is not shown guilty of participating in the commission of fraud. It is enough if his negligence is of such a character as to enable frauds to be committed and losses thereby incurred by the company.”

In [*Official Liquidator v. Ram Swaroop*](#)⁷⁰ charges of misfeasance and fraudulent trading were made out against the party under Section 542 of the Companies Act, 1956. The court held that the directors occupied a fiduciary position and the proceedings under Section 542 can be of civil nature and hence, they were liable to compensate the company.

In [*Hypine Carbons Limited v. J.C. Bhatia*](#)⁷¹ the court held that mere failure to initiate legal steps against the debtors of the company would not make the directors liable in the recovery of amounts, unless it was proved that they had fraudulent intentions.

In *Official Liquidator v. Shri DD. Sinha and ors* 2015 (2) WLC (Raj) 18, it was held that:

The liability under the provisions of sec 543 is in the nature of tortuous liability and quasi-criminal as well and therefore the recovery can be directed to be made from the director, who is held liable for causing loss to the company by his act or omissions, which tantamount to misappropriation, breach of trust, misapplication or retention of monies/ properties of the company.

He should be a director while carrying out an activity that he is otherwise empowered to carry out under the law, but performs it in such a manner that the same is improper and such impropriety has to be wilful so as to cause loss to the company.

Companies Act, 2013

The Companies Act, 2013 provides for directors to exercise their powers in the interests of the company, where a fiduciary duty is established towards the company since they are in charge of its affairs under normal circumstances. When the company enters into the resolution process, the

company moves into the control of the Committee of Creditors (CoC). However, this does not absolve the director of his actions committed prior to liquidation. Sections 339, 340 and 341 of the Companies Act 2013 deal with the fraudulent conduct of business.

Ingredients of Wrongful Trading:

The Liquidator has to establish the following-



Section 339 provides that in case any director, manager, officer or any persons knowingly carried on the business with the intent to defraud creditors or for any fraudulent purpose, the Tribunal may order that such persons will be personally responsible, without any limitation of liability, for all or any of the debts or

liabilities as the Tribunal may direct. The Tribunal may also make provisions for the

Figure 21: Ingredients of Wrongful Trading

⁷⁰AIR 1997 All 72

⁷¹(2001) 103 CompCas 422 (HP)

A Note on Fraudulent and Wrongful Trading

liability of such persons to be a charge on any debt, obligation, mortgage or on any interest in any mortgage or charge on any assets. Sub-section 3 also states that every person who knowingly carries on business in the manner aforesaid shall be liable for action under Section 447.

Section 340 confers powers to the Tribunal to inquire into and further order for the repayment or contribution to the assets by any promoter, director, manager, company liquidator or officer of the company who has misapplied, retained, become liable or accountable for money or property, or has been guilty of misfeasance or breach of trust. Section 340 imposes a criminal liability in cases of breach of trust or misfeasance.

Section 341 extends the liability under Section 339 and 340 to partners and directors who held such positions at the time of the fraudulent transaction.

Since the definition of 'winding up' as per Section 2 (94 A) of the Companies Act, 2013 is applicable to the Code, the Code can be read with Companies Act to impose liabilities on the persons responsible for fraudulent trading.

Insolvency and Bankruptcy Code, 2016

Section 66

The provisions for fraudulent and wrongful trading specifically under the insolvency laws have been adopted from the UK Insolvency Act, 1986. However, wrongful trading and fraudulent trading are provided together under Section 66 of the Code, which is divided into two sub-sections.

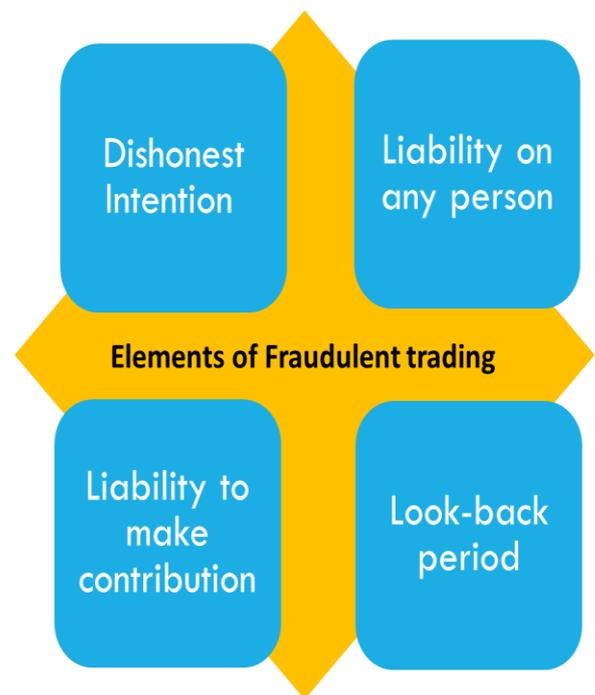
1. Section 66 (1)

Section 66 (1) imposes a liability on any persons who were knowingly parties to the carrying on of business with a dishonest intent to defraud creditors, to make contributions to the assets of the corporate debtor as per the order of the Adjudicating Authority.

1.1. Dishonest intention

The provision only applies when the person 'knowingly' carries out fraudulent activities. In

Grantham v. R, it was held that it is not necessary that the person accused must believe that there is no reasonable prospect of ever paying the creditor, but it is sufficient to show that he believed that the debt could not be paid when it became due or shortly thereafter. A person would knowingly be a party to the business of a company having been carried on with intent to defraud creditors if (a) at the time when debts were incurred by the company he had no good reason for thinking that funds would be available to pay those debts when they became due or shortly thereafter and (b) there was dishonesty involving real moral blame according to current notions of fair trading.



1.2. Liability on any person

The phrase ‘any persons’ suggest that ‘outsiders’ can also be liable for fraudulent trading, as long as they had a dishonest intention of fraudulently carrying on such trade. The provision is not only restricted to ‘insiders’ like employees, directors or partners. It is wide enough to include fraud on behalf of third parties like other corporate persons and creditors.

1.3. Liability to make contribution

The court has the power to demand contribution to the assets of the corporate debtor, from the defrauding party. The party would be personally responsible, without any limitation of liability, for the losses cause due to their fraudulent trading.

1.4. Look back period

One examination of the transactions of a corporate debtor, the liquidator of the company has the power to “claw back” and hold directors responsible for their actions even pre liquidation. Directors can be held liable for their actions usually within the ‘look-back period’. While a look- back period is specifically provided for undervalued transactions, one of the biggest advantage of using fraudulent trading as a tool is that there is no specified look- back period under section 66.

Keeping in mind the maxims, “*once a fraud, always a fraud*” and “*fraud vitiates every transaction into which it enters*”, the primary reason of not having a look back period is that if any person has acted intentionally or dishonestly against the interest of creditors, he should not be allowed to get away by using the defence of lapse of time.

2. Section 66 (2):

Section 66 (2) imposes a liability on partners or directors of the Corporate Debtor if:

- The director knew or ought to have known that there was no reasonable prospect of avoiding the commencement of the corporate insolvency resolution process of the Company and
- The director/ partner failed to exercise due diligence in minimizing the potential losses to be incurred

2.1. Due diligence

The primary purpose of Section 66(2) is to ensure that directors take action at the instant onset of any financial distress, with sufficient due diligence. Hence, directors can be punished under this section even if they did not have a dishonest intention, but acted negligently and recklessly, hence exposing the company to further risk due to such actions. While Section 66 (2) provides for a broad spectrum of actions a director could possibility take to mitigate losses, the Adjudicating Authority would ascertain whether the director has acted as a reasonable competent director would, based on the special skills he is required to possess.

The directors cannot plead ignorance or lack of knowledge under Section 66 (2). The directors have a twofold duty to ensure that the interests of the stakeholders are secured and to ensure that the

A Note on Fraudulent and Wrongful Trading

company does not incur any further debts during the twilight period. Directors must also make an active effort in the rehabilitation and revival of the company.

2.2. Twilight period

Twilight zone is the period between the time when the director knew or ought to have known that there was no reasonable possibility of avoiding the commencement of resolution of the company, till the time the company actually enters into resolution. During such period, an additional responsibility is added onto the directors to exercise due diligence, where he must act in a way to minimise the losses or potential losses to creditors of the Company.

Directors must be wary of the possible effects their actions might have in reducing the value of the assets of the company. The decisions taken in the twilight period by the directors could adversely impact the outcome of the insolvency provisions and hence, directors must not be negligent while taking decisions or performing acts on behalf of the company. There is a shift in the end result to be achieved by the actions of the directors, from maximising the interest of the shareholders to protecting the interest of the creditors.

2.3. Knowledge for wrongful trading

The offence is constituted when a director or partner knowingly incurs debt on behalf of the company without any reasonable or probable ground of paying off such debt. Recklessness or unreasonableness is sufficient to establish the offence. The directors cannot plead ignorance or lack of knowledge under Section 66 (2).

2.4. Liability on 'Insiders'

Section 66 (2) imposes a liability only on the director or partner of a company. It has a lower threshold for imposing liability, than clause (1), due to the specific fiduciary duty of the director towards the company. Directors are given immense powers in the management of the company and hence they must not misuse their position of authority. They must not misappropriate the assets of the company or subordinate the interests of the company or shareholders for their personal interests.

2.5. Civil liability of contribution

Claims for wrongful trading also include the secret profits or benefits that the directors may have earned in breach of their duties. The civil liability claims are for the purpose of benefitting the corporate debtor and not the creditors. However, the creditors benefit out of it indirectly.

2.6. Cases where directors are not responsible

A director may avoid civil liability by proving that he had taken every step with a view to minimising the potential loss to the company's creditors as he ought to have taken.

3. Difference Between 66 (1) And (2)

Section 66 (1) imposes a liability on any person including outsiders, while section 66 (2) imposes a liability only on the director or partner of a company. Under Section 66, sub-section 1 of deals with

fraudulent trading in the time period when the business is functioning normally, while sub-section 2 deals specifically with the duties of a director in the twilight period. Although not specifically differentiated, Section 66 (1) deals with fraudulent trading since there is a mandatory requirement of knowledge, while section 66 (2), deals with wrongful trading since it includes an element of negligence.

4. What follows Section 66?

Section 67 specifically deals with proceedings under Section 66, where the Adjudicating Authority may provide for the liability of any person responsible, to be a charge on any debt or obligation due from the corporate debtor to him and make further directions which may be necessary for the enforcement of any such charge mentioned under this section. Sub-section 2 also allows for the Adjudicating Authority to direct that the debt or part of debt owed to the defrauded creditor shall rank in the order of priority of payment under Section 53 after all other debts owed by the Corporate Debtor.

In cases where the Code is read with the Companies Act 2013, criminal liability can be imposed as well.

5. Comparison of Section 66 with Section 49 and Section 69 of the Code

Section 49 of the Code deals with undervalued transactions entered into with the purpose of defrauding and affecting the interests of creditors, while Section 69 provides for punishment for transactions defrauding creditors.

The similarity between **Section 49** and Section 66 is that both Section 49 and Section 66(1) include acts which are carried on with the intent to defraud creditors. However, while Section 49 requires the deliberate intention to defraud creditors by entering into such transactions, sub-section 2 of Section 66 also punishes negligent acts which affect the interests of the creditors as well. Section 49 also deals specifically with the corporate debtor itself entering into fraudulent transactions while Section 66 punishes any person responsible (sub-section 1) or director/partner (sub-section 2) specifically by imposing personal liability.

Section 69 provides for the punishment of an officer of the corporate debtor or the corporate debtor itself, for carrying transactions defrauding creditors. However, there are primarily three differences between these sections:

- a. An application under Section 66 can be made only during the corporate insolvency resolution process or liquidation process, by the resolution professional. However, the Insolvency and Bankruptcy Code (Second Amendment) Bill, 2018 brought about a change in Section 69 which now allows an application to be filed at any time when such transactions occur.
- b. The consequence of acts committed under Section 66 is the contribution by the director or any person responsible, to the assets of the corporate debtor. There is no criminal liability imposed under this section. However, the consequence under Section 69 is both civil as well as criminal. The punishment under Section 69 shall be either imprisonment for a term

A Note on Fraudulent and Wrongful Trading

which shall not be less than one year but which may extend to five years, or with fine which shall not be less than one lakh rupees but may extend to one crore rupees, or both.

- c. One of the defences provided under Section 69 is if the acts mentioned under this section were committed more than 5 years prior to the insolvency commencement date and if it is proved that such acts were committed with no intent to defraud the creditors of the corporate debtor. One of the defences for the transactions provided under Section 66 (1) is if there was no dishonest intention or if due diligence was exercised under Section 66 (2).

Difference between Fraudulent Trading and Wrongful Trading

Basis of Distinction	Fraudulent Trading	Wrongful Trading
Persons who can be held liable for the offence	Outsiders and insiders can both be held liable.	Only insiders i.e. directors or partners can be held liable.
Type of Liability	The offence attracts criminal liability as well as civil liability since it involves fraud.	The offence attracts only civil liability since it is primarily due to lack of due diligence.
Requirement of Intention	The presence of dishonest intention is mandatory for defrauding creditors.	It includes acts done recklessly or negligently which might affect the creditors liabilities.

Comparison Between UK And Indian Laws

Basis of Distinction	Fraudulent Trading	Wrongful Trading
Provision of fraudulent and wrongful trading	UK Insolvency Law has separate provisions for fraudulent trading and wrongful trading.	The Indian Code provides for both offences under Section 66.
Imposition of criminal liability	UK Insolvency Law allows for the imposition of criminal liability for both fraudulent and wrongful trading	The Code does not have such a provision. Criminal liability provisions is only specified under the Companies Act, 2013..
Explanation of the thresholds required under the law	The laws have defined thresholds for imposing liability.	The recent laws still do not specify the thresholds for 'dishonesty' and 'negligence' for the purpose of the Code

Corporate knowledge	There are specified circumstances under which the acts of the individual will be attributed to the corporate debtor.	The issue is not settled in India
Initiation of proceedings	The proceedings are initiated by the liquidator.	The proceedings are initiated by the Re (process)
Breach of duties	The offender violates the notion of fair trade	The offender fails to take due-diligence and does not fulfill fiduciary duties.

Suggestions

The Insolvency Committee, Singapore, is of the view that creditors and contributories should also be able to apply for relief under the insolvency trading provisions, if they obtain the consent of the relevant insolvency office-holder, or the leave of the court. This is because, in insolvent liquidations or other analogous insolvency procedures, the sums recovered are property of the company and are applied for the benefit of all its creditors as opposed to a single creditor or contributory. Under the Code, an application under Section 66 can be made only by the resolution professional which is restrictive and should be done away with.

The thresholds for liability for wrongful and fraudulent trading are not fixed. It is difficult to determine the liability as it is a subjective matter. Proceedings might fail due to uncertainty of liability and difficulty in establishing it. Moreover, the cost of such proceedings might deter resolution professionals from using this remedy as such costs are charged on the assets of the company when it is in an already compromising state.

Conclusion

The inclusion of provisions for fraudulent trading and wrongful trading was one of the most noteworthy changes in the history of insolvency laws. However, section 66 is still an under-used remedy under the Code. It is the duty of the liquidator or the resolution professional to get the highest value of the assets and satisfy the claims of the creditors. In such a case, transactions which have put the company at an economically weaker position, like fraudulent trading or wrongful trading, must be reversed. The board of directors although suspended at the commencement of insolvency process, should not be let go off freely as it was their fiduciary duty to act in the best interests of the company and its stakeholders.

While the aspect of criminal liability of directors for their fraudulent acts was always present under Companies Act, 2013, it was not helpful during the process of liquidation since there was no way of recuperating the losses caused to the corporate debtor and its creditors. Most directors were either dishonest or indifferent in their actions in spite of knowing that their acts might affect the value of

A Note on Fraudulent and Wrongful Trading

the company or even increase its liability towards creditors, especially if done in the twilight period. This was because directors used the cloak of limited liability to get away with the actions that might have affected the functioning of the company risking liquidation, or even exposed the company into further losses. Section 66 not only brings about a huge shift by making the liability of a director unlimited but also provides for a new dimension of imposing civil liability, where the losses caused by the misconduct and negligence of creditors can be made up by their contribution.

Unlike the tools used for other types of transactions provided under the Code, there is no specified look-back period for fraudulent trading under section 66. Hence the resolution professional is allowed to “claw back” without any limitation of time and correct all the wrongs done by insiders or outsiders at any point of time since they became directors of the company.

Hence, realising the advantages and intention of bringing such provisions into the Insolvency Code, 2016, Section 66 must be used more commonly to ensure that the losses cause to the creditors are recovered in the event of liquidation and that the directors who caused such losses are made personally liable to make up for such losses.

One perspective that remains unanswered is through the perspective of sick industries. The right of voluntary initiation of the resolution process was available even before the commencement of the Code. However, the Sick Industries Companies Act, 1985 (SICA) was repeatedly abused by promoters who enjoyed the unending moratorium and protection provided under SICA, while remaining in possession of the assets of the company. Directors have a duty to take steps with due diligence to minimise losses and one such step might be the initiation of Corporate Insolvency Resolution Process under section 10. Hence, can the existence of sick industries or a reference thereunder be used as a defence for Section 66? This question still remains.

LOOK- BACK PERIOD VIS-A-VIS FRAUDULENT TRANSACTIONS

- **Richa Saraf**

Editor's Notes: Avoidance proceedings are a common feature in insolvency proceedings that seek to bring the assets back home – by annulling preferential, undervalued, extortionate and fraudulent transactions. When it comes to questioning the vires of such transactions, the law travels back to a particular period (which is often 1-2 years), often referred to as 'look-back period', or 'twilight zone', or 'relevant period' to determine whether such transactions contributed to the gradual downfall - as insolvency cannot be an abrupt accident. An interesting question that arises here is, whether 'fraud' has an expiry date. That is, is it possible to see beyond the 'look-back' period to undo a fraudulent transaction?

The article explores this possibility:

Sections 45, 49, 66, 69 of the Code requires and empowers the Liquidator to apply to the Adjudicating Authority for appropriate orders in case of any vulnerable transactions that the Liquidator comes across during the process of liquidation. Such transactions may either be with respect to breach of applicable law, or deleterious to the interests of creditors or stakeholders, or otherwise, not transactions designed to be in good faith. The transactions whether being undervalued or fraudulent shall be considered to be vulnerable to the interest of the stakeholders of the Company.

The article hinges on the crucial question of applicability of the limitation to the aforementioned sections. In this regard, we shall discuss how the provisions were imbibed in the Code, despite there being no equivalent in the Companies Act, 2013 or previous Companies Act. The general notion is that that limitation should be applicable to all transactions, including fraudulent transactions referred to in Section 49 of the Code. However, the article will explain as to how undervalued transaction, done deliberately without due compliances, partakes the nature of a fraudulent transaction, and since fraud is a nullity forever, in case of such transactions, as covered by Section 49, there is no question of any look- back period at all.

Deciphering the intent of incorporation of provisions relating to vulnerable transactions:

The concept of "fraudulent preference" existed both in Companies Act, 1956 and 2013, however, the provision pertaining to undervalued and fraudulent transaction is a unique incorporation in the Code, adopted from the UK Insolvency Act, 1986. The Bankruptcy Law Reform Committee, referring to Section 243 of UK Insolvency Act, 1986, recommended that a provision voiding transactions defrauding creditors should be included. It is further, pertinent to note that the Committee, while discussing the intent behind insertion of this provision in the statute, observed that the provision for fraudulent transactions should not have any time- bar. The relevant extract from Interim Report (page 98-99) of the Committee is reproduced below:

Lookback Period vis-à-vis Fraudulent Transactions

“In the UK, Section 423 of the IA 1986 voids transactions at undervalue if such transactions have been entered into with the intention of putting the assets beyond the reach of, or otherwise prejudicing the interests of a person who is making or may make a claim against the company. While the scope of this provision is similar to that of the provision avoiding transactions at undervalue (Section 238, IA 1986), Section 423 actions differ in that they do not have any time limit for the challenged transactions, and is available in and outside formal insolvency proceedings. The inclusion of such a provision in the CA 2013 would reinforce the protection given to creditors under avoidance law by permitting the liquidator to set aside transactions entered into prior to the one year period ending in the company’s insolvency. *This is necessary to guard against the siphoning away of corporate assets by managers who have knowledge of the company’s financial affairs in cases where a long period of financial trouble, extending over a year, ends in insolvency.*

**

A provision invalidating transactions defrauding creditors similar to Section 423 of the IA 1986 should be inserted in CA 2013. Such provision would apply without any time limits and should be available in and outside formal insolvency proceedings.

It is clear that the analogous provision in the UK law does not have any limitation period, and also, there is no limitation period with reference to Sections 49 and 66 in the language of the law itself. Here, it is relevant to cite Report of Insolvency Law Committee (March, 2018), by virtue of which an amendment was made to exclude time limit from Section 69 of the Code:

“24.1. Section 69 of the Code provides for punishment for transactions defrauding creditors by the corporate debtor or its officers “on or after the insolvency commencement date”. However, *as per sub-section (a), if the transaction results in a gift or transfer or creation of a charge or the accused has caused or connived in execution of a decree or order against the property of the corporate debtor, the accused shall not be punishable if such act was committed five years before the insolvency commencement date or if she proves that she had not intended to defraud the creditors. In this respect, the pre-fixing of the offence with “on or after the insolvency commencement date” is erroneous.* Further, pre-fixing the same phrase in sub-section (b) is also erroneous, as the transaction involves concealment or removal of any property within two months from the date of any unsatisfied judgement or order for payment of money. *Thus, the Committee decided that the phrase “on or after the insolvency commencement date” be deleted from section 69.*”

Additionally, vulnerable transactions are generally considered to be transactions of a continuing nature, having their adverse and prejudicial impact on the ongoing financial position of the Company, which has already slipped into distress, and therefore, the concept of any look-back period or claw-back period will not be applicable, since it cannot be contended that a transaction, done with a deliberate, culpable design, becomes washed of its gullibility merely because the liquidation proceedings are initiated certain number of years after the date of commission of the relevant transaction.

Distinction between Section 45 and Section 49:

Both Sections 45 and 49 pertains to avoidance of undervalued transactions, the only difference being that Section 49 deals with undervalued transactions undertaken with a malafide or wrongful intent, while for Section 45, the presence of any motive is not required. The reference in section 49 to transactions covered by section 45 is merely for the factual ambit of transactions covered by the section, and the additional element of intent marks the crucial difference between the two sections.

Moreover, while a look- back period has been provided for undervalued transactions under Section 46, there is no limitation period for fraudulent transactions covered under Sections 49 and 66 of the Code. The intent being “once a fraud, always a fraud”, a time- honoured doctrine clearly applies. The maxim “*fraud vitiates every transaction into which it enters applies to judgments as well as to contracts and other transactions*” is a part of common law jurisprudence, largely based upon equitable doctrines and has been upheld by courts repeatedly in several cases such as *The People of the State of Illinois v. Fred E. Sterling*, 357 Ill. 354; 192 N.E. 229 (1934), *Allen F. Moore v. Stanley F. Sievers*, 336 Ill. 316; 168 N.E. 259 (1929), and further, *In re Village of Willowbrook*, 37 Ill.App.2d 393 (1962), wherein it was observed “It is axiomatic that fraud vitiates everything.”.

Fraud destroys the validity of everything into which it enters, and that it vitiates the most solemn contracts, documents, and even judgments, is well settled, and has been time and again reiterated in various judgments in broad and sweeping language. If both the sections were to encompass a time-limit then it would defy the whole purpose, and the reason for incorporating two separate provisions in the Code would fail. The basic essence is that any person who has done any wilful act should not be allowed to get away by citing reasons such as lapse of time.

In light of the aforesaid, it can be concluded that while an undervalued transaction is a matter of fact, for which intention does not matter, however, when the intention to cause a prejudice to the creditors is embedded in such undervalued transaction, the transaction comes within the offence of Section 49. If a transaction, so imbued with a malafide intent, was subject to the same fate and the same limitation as a transaction mentioned in Section 45, then Section 49 would not have any relevance at all. On the contrary, it can be pointed out that Section 49 was inserted specifically for the so-called wilful defaulters, for which the limitation of time, mentioned in Section 45, cannot be relevant at all. Thus, it will not be correct to say that there is any claw-back for wilfully undervalued transactions under Section 49 and fraudulent conduct of business under Section 66.



SECTION VI: NON-CORPORATE INSOLVENCY

Editor's Note:

The law of insolvency is much older than the law of companies, and therefore, obviously, insolvency laws were originally made for individuals. Later, as law of corporations developed, insolvency principles, with certain modifications, were adopted by corporate laws. Before IBC made its mark, the corporate insolvency law in India too, drew inspiration from personal insolvency law, as is clearly evident from a reading of section 529 of the Companies Act, 1956. The personal insolvency law, in turn, was contained in two centenarian (even older!) laws, namely, Presidency Towns Insolvency Act, 1909 (PTIA) and Provincial Insolvency act, 1920 (PIA). PTIA covers the erstwhile presidency towns, namely, Calcutta (now Kolkata), Bombay (now Mumbai) and Madras (now Chennai), and the rest of the country is covered by PIA, though the two laws are by and large similar.

However, as discussed in Law Relating to Insolvency and Bankruptcy Code 2016, there is an essential difference in the philosophical foundations of corporate insolvency regimes, and personal insolvency regimes. The former has an overarching objective of rescue, and is, therefore, impelled by economic considerations. The latter has a larger humanitarian angle, as the objective to save an individual from being harassed by creditors, and hated societally. The objective is to provide the individual a relief, so that he can start living peacefully again. Therefore, the objective of personal insolvency laws is to provide for survival of the individual, whereas corporate insolvency laws will provide for liquidation of the failed entity.

The [26th Report of the Law Commission](#) (1964) suggested an overhaul of the individual insolvency laws. Many years later, in 2001, the [N L Mitra Committee](#) recommended a comprehensive corporate bankruptcy code, "Though it was felt that without individual insolvency system being straightened, the total system management can not be built up specially because rural and agrarian bias of the economy". Subsequently in 2014, the task before [BLRC](#) was "to create a uniform framework that would cover matters of insolvency and bankruptcy of all legal entities and individuals". The idea, as advocated by BLRC was:



"This has two distinct advantages in improving the insolvency and bankruptcy framework in India. The first is that all the provisions in one Code will allow for higher legal clarity when there arises any question of insolvency or bankruptcy. The second is that a common insolvency and bankruptcy framework for individual and enterprise will enable more coherent policies when the two interact. For example, it is common practice that Indian banks take a personal guarantee from the firm's promoter when they enter into a loan with the firm. At present, there are a separate set of provisions that guide recovery on the loan to the firm and on the personal guarantee to the promoter. Under a common Code, the resolution can be synchronous, less costly and help more efficient recovery."

Therefore, as a part of its recommendations on individual insolvency, BLRC proposed that PTIA and PIA be repealed and individual insolvency law be included in the unified code. The adjudicating authority for individual insolvency processes shall be the debt recovery tribunals.

Non-Corporate Insolvency

As such, IBC in Part III, envisages two distinct processes for individual bankruptcy law – Fresh Start Order and Insolvency Resolution Process. In fresh start process, individuals with assets and income lower than specified amounts are eligible for a discharge from their qualifying debts, subject to maximum prescribed limit. Their debts will be written off, giving them a ‘fresh start’. On the other hand, insolvency resolution process will involve a process of negotiation between the debtor and the creditors supervised by a resolution professional (akin to corporate insolvency resolution process). The debtor will prepare a repayment plan in consultation with the resolution professional to be approved by the creditors. Hence insolvency resolution process will give the debtor an ‘earned start’ – the debtor gets a ‘discharge’ but only in terms of the repayment plan. However, if the negotiations fail, the obvious outcome will be to proceed with declaration of the insolvent debtor as ‘bankrupt’. Hence, bankruptcy process is initiated led by a bankruptcy trustee appointed by the adjudicating authority (which is debt recovery tribunal). The debtor gets a discharge from bankruptcy after a specified time.

A schematic description of each of these processes is as follows –

Fresh Start Process

Fresh Start is a new and laudable concept indeed, equivalent to debt waivers, allowing a person to give a fresh start to his life. Fresh start is a once-in-life-time opportunity granted to the individual, to seek moratorium, phasing out obligations, etc. so that the individual may start his life afresh. However, the applicability of the option is greatly limited by the very narrow monetary limits laid – annual income of Rs 60,000, and assets of Rs 20,000. This largely covers the bottom-of-the-pyramid individuals who may not have qualified for any borrowing in any case.

Fresh start application may be made by the debtor himself, provided the income and asset criteria are within the thresholds referred to above, and the “qualifying debt” for which the individual seeks relief is limited to Rs 35000/- . Secured debt is not included within the definition of “qualifying debt”. Also, student loans are also excluded from the purview, as they are defined as “excluded debt. As it appears, the limits of income, assets and the debt fixed under the law are paltry. Not only should these limits be enhanced to make the provision practical, the law should not fix the limits – the limits should be left for the government or the Board to notify. It seems highly impractical that an individual seeking relief in respect of debt upto Rs 35000/- will afford the fees and expenses of the resolution process, including those of the insolvency professional, and that the institutional framework should act as Samaritan for such small value cases. The idea of the Committee may be that the **fresh start option will lead to financial inclusion, but whether the population segment covered by the provisions will at all be able to reach out to the institutional framework under the Bill will remain doubtful.**

A fresh start application may be made in a case of inability to pay the qualifying debt, for which prima facie recommendations will be made by an insolvency professional. The AA may admit the application based on the recommendations. If a fresh start application is admitted, there will be a 6-months’ moratorium against any legal action for recovery of the qualifying debt. Of course, during this period, there is an injunction on entering into several to-be notified transactions by the debtor. He may travel overseas only with the approval of the AA.

A fresh start process is akin to a one-time waiver of debt, based on the adjudication of the AA.

Insolvency Resolution Process

The insolvency resolution process is often referred to as the process of “earned start”, since there are no straight debt waivers like in the case of fresh start process. The most important ingredient in the process is a “repayment plan” which is devised by the debtor in consultation with the resolution professional. This is unlike ‘resolution plan’ in corporate insolvency resolution process where the corporate debtor cannot be a resolution applicant.

The insolvency resolution process may be initiated by the debtor or a creditor of the debtor, by making an application, either personally or through a resolution professional, to the AA. On filing of application, an interim-moratorium commences in respect of all the debts, to last till the admission or rejection of the resolution application.

The resolution professional is appointed who examines the application for initiation of insolvency resolution process, recommending whether the application shall be approved or rejected. On the basis of the recommendation made by the resolution professional, the AA approves or rejects the application. Where the application is rejected, subject to certain conditions, the creditor is entitled to file for bankruptcy order. However, where the application is admitted, the interim-moratorium ceases, while a fresh moratorium commences in relation to all the debts. The moratorium lasts for 180 days from the date of the admission of the application.

A public notice is issued inviting claims from all the creditors. The creditors register their claims with

the resolution professional, who in turn, prepares a list of creditors.

The debtor prepares a repayment plan in consultation with the resolution professional. The resolution professional prepares a report on the repayment plan for submission to the AA – also stating, whether there is a necessity of summoning a meeting

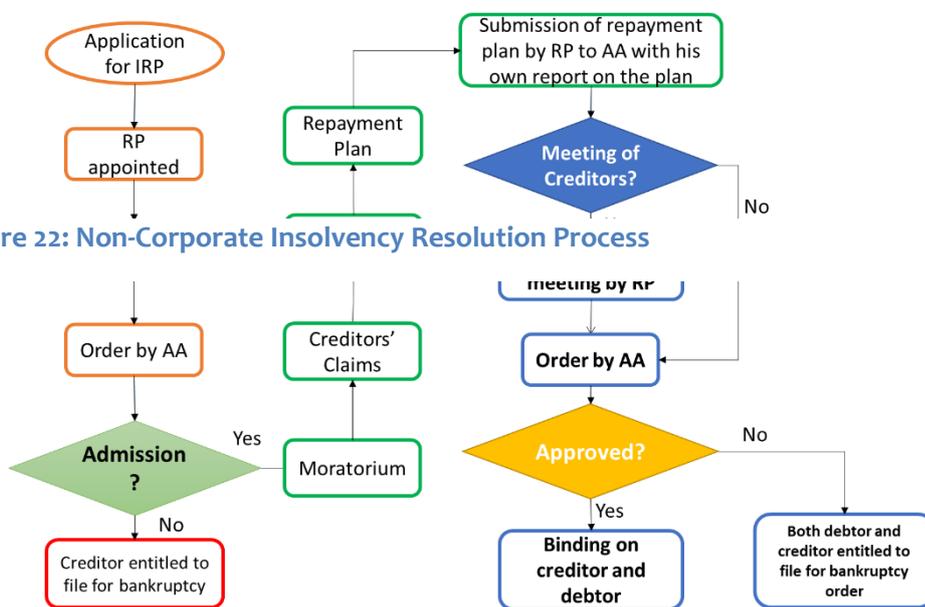


Figure 22: Non-Corporate Insolvency Resolution Process

of creditors. Where the meeting of creditors is not summoned, the AA passes an order on the repayment plan on the basis of the report on the repayment plan prepared by the resolution professional. However, where the meeting of creditors is summoned, the repayment plan has to be approved by the creditors, a report of the meeting is prepared by the resolution professional and the AA passes an order on the repayment plan on the basis of the report of the resolution professional on the meeting of creditors.

Non-Corporate Insolvency

The resolution professional supervises the implementation of the repayment plan. Once the repayment plan is completed, the resolution professional sends notice of the same to the concerned persons, and a report on implementation of the repayment plan. The resolution professional also applies to the AA for a discharge order in relation to the debts mentioned in the repayment plan and the Adjudicating Authority may pass an order accordingly. The repayment plan may provide for an early discharge or discharge on complete implementation of the repayment plan.

Bankruptcy Process

Akin to liquidation process envisaged for corporate persons as a matter of 'last resort'; where the attempts to provide an individual debtor either a "fresh start" or an "earned start" fail, the last recourse left is an application for bankruptcy. Undoubtedly, there are differences in the provisions relating to liquidation of corporate debtor and bankruptcy of non-corporate debtor.

The debtor or the creditor(s) of the debtor, both are eligible to make an application for bankruptcy order, under 3 specified circumstances – a resolution application is not admitted, a repayment plan is not approved by creditors or the adjudicating authority, or a repayment plan fails prematurely.

Once an application is filed, an interim-moratorium commences – which is similar to that under the individual insolvency resolution process. A bankruptcy trustee is appointed to manage the process. Within 14 days of confirmation of appointment of a bankruptcy trustee, the adjudicating authority passes a "bankruptcy order". This date becomes the bankruptcy commencement date, and the bankruptcy process continues to have effect till the debtor is discharged.

On the bankruptcy order being passed, these consequences follow – (a) the estate of the bankrupt vests in the bankruptcy trustee, (b) the interim-moratorium ceases and a fresh moratorium starts, and (c) the bankrupt submits a statement of financial position (if so required). The bankrupt is required to submit a statement of financial position within 7 days of the commencement date.

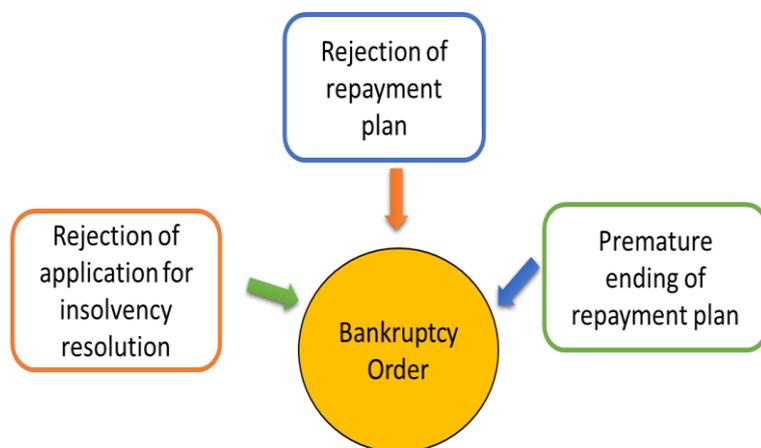


Figure 23: What leads to Bankruptcy Order

Public notice is issued inviting claim from creditors. The creditors register their claims with the bankruptcy trustee. Based on such claims, the bankruptcy trustee prepares a list of creditors, and summons a meeting of the creditors for the purpose of establishment of a "committee of creditors". The committee may, among other powers, replace the interim bankruptcy trustee.

The bankruptcy trustee administers and distributes the estate of the bankrupt in accordance with the provisions of Chapter V of Part III. The trustee takes possession and control of the bankruptcy estate, exercises powers pertaining to avoidance, vesting of after-acquired property, etc. The trustee notifies creditors to prove their claims, and values claims. The trustee makes payment of interim dividend, and before making distributing the final dividend, the trustee puts up a notice once again, requiring

creditors to have one final opportunity to prove their claims. Section 178 lists out the priority of claims of different types of creditors.

On completion of the administration, the bankruptcy trustee prepares a report of the administration and convenes a meeting of the committee of creditors for approval of the report. The bankruptcy trustee applies to the adjudicating authority for a discharge order once the approval of committee of creditors is obtained or on the expiry of 1 year from the date of bankruptcy order, whichever is earlier. That is to say, even if the administration of estate is still continuing, the bankrupt will be eligible for discharge after 1 year from the bankruptcy commencement date.

From the bankruptcy commencement date till his discharge, the bankrupt is an “undischarged insolvent” or “undischarged bankrupt” and faces several disqualifications under the Code as well as other laws; his after-acquired property is also liable to be vested in the trustee. After discharge, the once-bankrupt is a free man.

The provisions pertaining to undue preferences, fraudulent transfers, onerous contracts, extortionate credits etc., in case of non-corporate debtors are similar to those in case of corporate debtors.

Status of enforcement

Part III of IBC has not been enforced yet.

So far, the Central Government and IBBI has come up with the following **draft** rules and regulations (respectively) concerning non-corporate insolvency law contained in the Code –

- (i) [The Insolvency and Bankruptcy Board of India \(Insolvency Resolution Process for Individuals and Firms\) Regulations, 2017;](#)
- (ii) [Insolvency and Bankruptcy \(Application to Adjudicating Authority for Insolvency Resolution Process for Individuals and Firms\) Rules, 2017;](#)
- (iii) [The Insolvency and Bankruptcy Board of India \(Bankruptcy Process for Personal Guarantors to Corporate Debtors\) Regulations, 2019;](#)
- (iv) [Insolvency and Bankruptcy \(Application to Adjudicating Authority for Bankruptcy Process for Personal Guarantors to Corporate Debtors\) Rules, 2019.](#)

In the Discussion Paper issued by IBBI in April, 2019, IBBI seems to suggest separate rules and regulations shall be formulated for each of the three classes of individuals (personal guarantors to corporate debtors, partnership and proprietorship firms, and other individuals). The Discussion Paper suggests that the provisions of the Code may first be notified for personal guarantors to corporate debtors. The remaining provisions of Part III of the Code applicable to individuals with business and to individuals without business may be notified in subsequent phases.



SECTION VII: MAJOR JUDICIAL DEVELOPMENTS

CONSTITUTIONAL VALIDITY OF INSOLVENCY AND BANKRUPTCY CODE

- **Richa Saraf**

Editor's Notes: IBC was introduced as a complete overhaul in the approach of dealing with matters of insolvency, both for incorporated entities and individuals. However, evolving from the six-decade old insolvency regime under SICA and other relevant acts was not an easy task after all. Like any new legislation of this stature was expected to face, the Code was no exception. Soon after it came into force, an application questioning the constitutional validity of the Code was preferred before the Hon'ble Madras High Court. However, the Madras High Court was pleased to uphold the constitutional validity of the Code.

The article gives a deep insight into the said order and its implications. As we seen in the next article, the constitutional validity of IBC was upheld by the Apex Court too.

A writ petition has been filed in the Madras High Court, by Southern Polypet Private Limited, wherein the petitioner has challenged the Code as being contrary to the provisions of the Constitution of India and the Hon'ble High Court comprising Chief Justice Indira Banerjee and Justice M. Sundar has issued a notice with respect to this petition.

Major grounds:

- Sections 7, 8, 9, 14 and 31 of the Code deprives the basic right of the petitioner to present its case before being subjected to the National Company Law Tribunal (NCLT) and is contrary to principles of natural justice *e. right to be heard (audi alteram partem)*, principle of legitimate expectation and doctrine of fairness. Also, the act of the NCLT of not serving a prior notice on the petitioner before admitting the application is in violation of Sections 420 and 424 of the Companies Act, 2013 read with Rule 37 of the National Company Law Tribunal Rules, 2016.
- Section 8(2) of the Code imposes restriction in the nature of repayment of debt. For instance, it does not recognise a settlement by transfer of property to be a valid repayment of unpaid operational debt and requires that attested copy of record of electronic transfer from bank account of corporate debtor or attested copy of record that operational creditor has encashed a cheque issued by corporate debtor. Further, there exists no intelligible differentia while discriminating between operational and financial creditors as, under Section 8(2), only an operational creditor is required to send a notice to corporate debtor whereas a financial creditor is not required to do so. Again, the same is in contravention of Article 14 of the Constitution.

Southern Polypet Private Limited vs. Union of India, Madras High Court:

Major grounds of challenge:

- No right to be heard
- Restriction on nature of repayment
- Discrimination b/w OC and FC
- Violation of Right to Freedom

Constitutional Validity of Insolvency & Bankruptcy Code

- Sections 17 and 20 of the Code vests the management of affairs of the corporate debtor in the interim resolution professional and suspends the powers of the board of directors or the partners of the corporate debtor, as the case may be. Here, the principle contention of the petitioner is that eviction of the existing management is wholly arbitrary and based on irrational criteria, namely, existence of a suit or arbitration proceeding on the date of receipt of the notice of insolvency under Section 8(1). This is in violation of Article 19(1)(g) of the Constitution, which provides for the freedom of occupation, trade or business upon the citizens of India.

Comments:

In the case of *Sree Metaliks Limited v. Union of India*⁷², the Calcutta High Court has already ruled that the AA has to adhere to the principle of natural justice while deciding application under section 7.

The relevant extract of the judgment is hereunder-

“In an application under Section 7 of the Code of 2016, the financial creditor is the applicant while the corporate debtor is the respondent. A proceeding for declaration of insolvency of a company has drastic consequences for a company. Such proceeding may end up in its liquidation. A person cannot be condemned unheard. Where a statute is silent on the right of hearing and it does not in express terms, oust the principles of natural justice, the same can and should be read into in. When the NCLT receives an application under Section 7 of the Code of 2016, therefore, it must afford a reasonable opportunity of hearing to the corporate debtor as Section 424 of the Companies Act, 2013 mandates it to ascertain the existence of default as claimed by the financial creditor in the application”

Sree Metaliks Limited v. Union of India:

And

ICICI Bank v. Innoventive Industries Ltd

“Where a statute is silent on the right of hearing and it does not in express terms, oust the principles of natural justice, the same can and should be read into in.”

The abovementioned rationale was reiterated by NCLAT in the case of *ICICI Bank v. Innoventive Industries Ltd*.⁷³

However, one important point for consideration could be that, under the provisions of the Code, the revival plan of the corporate debtor is prepared by the committee of financial creditors, further they have the voting power and will be the decision making authority to approve the resolution plan before presenting the same to NCLT. The operational creditors are not prohibited from attending the meeting of committee of creditors and can have their say in the proceedings but they cannot be a party to the decision making. This may evoke a question on equal treatment as the financial creditors have a greater say in the making and implementation of the plan. There

Update

Subsequently, in the matter of *“Swiss Ribbons vs. Union of India”*, the Hon’ble Supreme Court has upheld the constitutional validity of the Code.

Various grounds of challenge were put by the bunch of appeals, and all were serially discussed and settled by the Apex court.

⁷²WP 7144(W) of 2017, CalHC

⁷³Company Appeal (AT) (Insolvency) No. 1 & 2 of 2017, decided on 15.05.2017.

may be certain other flaws in the Code, which the government may rapidly solve by way of an Amendment Act and a ruling of the Apex Court on the issues may also address the problems and close the doors for any fresh writ petitions challenging the constitutionality of the Code.

SWISS RIBBONS SC RULING:

IBC Must Stay On, The Defaulters Paradise Is Lost!

- **Resolution Services Team, Vinod Kothari & Company**

Editor's Note: *It shall not be an exaggeration of say that the instant case has laid down the foundation of bankruptcy law once again. The Hon'ble Supreme Court has endorsed the Code right from its inception and vide its order has reinforced the validity of the Code. In its [order dated 25.01.2019](#), the Hon'ble Supreme Court stated that:*

"The defaulter's paradise is lost. In its place, the economy's rightful position has been regained. The result is that all the petitions will now be disposed of in terms of this judgment."

This piece discusses the key highlights of this landmark judgement.

The following is our quick summary of the ruling of the Apex Court.

Arguments assailing the Code

1. Objections as to constitution of NCLT and NCLAT
 - Whether the same is in accordance with Madras Bar Association ruling?
 - Whether the Tribunals should not be working under the administrative control of the Ministry of Law?
2. Scheme of the law distinguishing between financial and operational creditors is not based on intelligible criteria, and is, therefore, discrimination
3. Information utilities can be given the power to certify the existence of a default
4. Sec 12A allows CoC members to continue to dominate proceedings even if the corporate debtor has settled with the creditor who is not paid
5. RP has powers of adjudication – which is violative of the basic principles of dispensation of justice
6. Several issues on sec. 29A
 - Retrospective application of sec. 29A
 - 29A is contrary to the objective of speedy resolution
 - Blanket bar on all promoters without distinguishing between those who are unscrupulous, and others, is bad in law
 - Relatives without having any relation with the promoters have been ousted from bidding

SC ruling

7. Judiciary should play minimal role in role of the legislature in framing economic laws, based on several Indian and global precedents
8. The foremost objective of the Code is “reorganisation”, that is, resolution. Liquidation is only the last resort
9. On appointment of NCLT and NCLAT members, the Apex court went by the Govt affidavit on adherence to the guidelines set by the SC in the Madras Bar Association case
10. NCLAT circuit Benches (that is, regional benches) will be set up within 6 months – direction of the Apex court
11. The Court makes statement on putting NCLT and NCLATs under the administrative charge of the Ministry of Law, without any specific time frame
12. Classification of creditors into financial creditors and operational creditors
 - Neither arbitrary, nor discriminatory, nor violative of Art 14
 - While the court notes the submission of the Counsel that this distinction is not there anywhere in the world, it refers to BLRC report for the basis of the distinction
 - Court pointed to several reasons for distinguishing, including the fact that financial creditors may engage in viability studies and may restructure the debt – which operational creditors do not.
 - As regards operational creditors not having the power to vote, reference to the Insolvency Law Committee report which discussed the issue, and decided not to make change in the law on this point
 - Principle of fair and equitable treatment of all creditors is incorporated, since now Reg 38 requires the resolution applicant to state how the plan meets the interests of operational creditors too
13. Sec 12A being violative of Art 14
 - Once the CIRP is triggered, the proceeding becomes a proceeding in rem, that is, collective proceeding, which cannot be terminated by an individual creditor.
 - Additionally, the Apex court has directed as follows: “We make it clear that at any stage where the committee of creditors is not yet constituted, a party can approach the NCLT directly, which Tribunal may, in exercise of its inherent powers under Rule 11 of the NCLT Rules, 2016, allow or disallow an application for withdrawal or settlement.
 - Further, the Apex court also clarifies: “it is clear, that under Section 60 of the Code, the committee of creditors do not have the last word on the subject. If the

Swiss Ribbons SC Ruling:

committee of creditors arbitrarily rejects a just settlement and/or withdrawal claim, the NCLT, and thereafter, the NCLAT can always set aside such decision under Section 60 of the Code.” From this dictum of the Apex court, the powers of the NCLT under sec. 60 get a strong boost. In appropriate circumstances, the Tribunals may even overrule the decision of the CoC.

14. Information utilities determining existence of default

- The noting of the default by the IU is only prima facie evidence. It may be rebutted.

15. RP having adjudicative powers:

- RP is only given administrative, rather than quasi-judicial powers. As against this, a liquidator “determines” the claim, which is quasi-judicial in nature, and may be appealed against in terms of sec. 42
- The RP is a facilitator of the process. The liquidator does not work under the control of the CoC [para 61]

16. Constitutionality of sec 29A

- Retrospective application of sec. 29A – no vested right has been taken away. Resolution applicants have no vested right to put resolution plans.
- Malfeasance is not the only criteria for making a person ineligible.
- The bar of ineligible persons continues over resolution as well as liquidation – para 69
- Very importantly, the Court has ruled that the categories of “related persons” in sec 29A have to be read *noscitur a sociis*[*eiusdem generis*, that is, having the same flavour] with Explanation 1, and if so read, “would include only persons who are connected with the business activity of the resolution applicant.”

17. Section 53 is not violative of art 14

- The Court found the following criteria to be intelligible: “We have already seen that repayment of financial debts infuses capital into the economy inasmuch as banks and financial institutions are able, with the money that has been paid back, to further lend such money to other entrepreneurs for their businesses.”

APPLICABILITY OF LIMITATION ACT TO INSOLVENCY AND BANKRUPTCY CODE

- **Richa Saraf**

Editor's Note: Amidst the entire hullabaloo on applicability of the limitation law in matters of insolvency, the Hon'ble NCLAT, vide one of its order ruled that matters under the Insolvency Code are not subject to the limitation law. To undermine the importance of applicability of limitation law, or otherwise shall be a grave mistake as it forms one of the most pertinent question on grounds of which the application is accepted or rejected. The author in the note below made a respectful deviation to the order and was of the opinion that limitation law shall be applicable to the Code.

Subsequently, it was also clarified by the Hon'ble Supreme Court, in the matter of [B.K. Educational Services Private Limited v Parag Gupta And Associates](#), that IBC proceedings cannot be initiated based on time barred claims and that Limitation Act is applicable to IBC.

In a recent NCLAT ruling of Neelkanth Township and Construction Pvt. Ltd. v. Urban Infrastructure Trustees Ltd.⁷⁴ (11.08.2017), several issues with regard to the [Code](#) were discussed. One of the issues for consideration before the NCLAT was whether the application under Section 7 of the IBC is time barred, as the debt claim related to the years 2011, 2012 and 2013 and it was held that the [Limitation Act, 1963](#) (Limitation Act) does not apply to IBC. Below we discuss the ruling along with its analysis:

Brief Facts of the Case:

In the present case, an appeal was preferred by the Corporate Debtor (Appellant) against order dated April 21, 2017⁷⁵ passed by the Learned AA (NCLT), Mumbai Bench, wherein the Learned AA entertained the application preferred by the Financial Creditor (Respondent) under Section 7 of IBC and ordered moratorium, with further order to appoint an IRP.

The Appellant assailed the impugned order on several grounds, one of which being that time barred debt cannot be enforced by filing of application for CIRP. The Learned Counsel for the Appellant contended that the claim of Respondent is completed time barred as the Debenture Certificates were due for redemption as far back as in the years 2011, 2012 and 2013 respectively; consequently, the application filed in the year 2017 is hopelessly time barred.



⁷⁴ Company Appeal (AT) (Insolvency) No. 44 of 2017

⁷⁵ C.P.No.69/I&BP/NCLT/MAHA/2017

Applicability of Limitation Act To Insolvency and Bankruptcy Code

However, NCLAT dismissed the appeal against bankruptcy proceedings, saying the reference to Limitation Act that prescribes a time limit to initiate recovery of loans is not applicable. NCLAT has taken a view that the ground taken on behalf of the Appellant, that the debt is barred by limitation as the debentures matured between the years 2011 and 2013 is not based on law and that there is nothing on record that Limitation Act is applicable to IBC. NCLAT further held that *“IBC is not an Act for recovery of money claim; it relates to initiation of corporate insolvency resolution process. If there is a debt which includes interest and there is a default of debt and having a continuous course of action, the argument that the claim of money is barred by limitation cannot be accepted.”*

Discussion of Law:

It is a famous saying that time and tide waits for none. The Limitation Act prescribes a time limit for different suits within which an aggrieved party can approach the court. The object of limitation laws is as follows:

to compel a litigant to be diligent in seeking remedies in a Court of law; and

- a. to indirectly punish those who are not proactive i.e. who did not approach the Court and/ or did not take legal action to recover their dues.

The purport of the Limitation Act is not to destroy the rights but it is founded on public policy fixing a life span for legal remedy for general welfare. A person who did not promptly act to enforce his rights should lose them as stale claims leaves the court no time to attend promptly to more recent and urgent matters. The parties who seek to uphold their legal right cannot sleep over the matter and at a later stage seek to enforce their rights which is likely to cause prejudice to the other parties. The statute of limitation is, therefore, a statute of repose because it extinguishes stale demands and is based on the principle that long dormant claim have caused more of cruelty than of justice in them⁷⁶.

In *M/s. Bharat Barrel & Drum MFG. Co. v. the Employees State Insurance Corporation*⁷⁷, the Honourable Supreme Court held as under:

“The necessity for enacting periods of limitation is to ensure that actions are commenced within a particular period to give effect to the principle that law does not assist a person who is inactive and sleeps over his rights by allowing them when challenged or disputed to remain dormant without asserting them in a Court of law. The principle which forms the basis of this rule is expressed in the maximum vigilantibus, non dormientibus, jura sub-veniunt (the laws give help to those who are watchful and not to those who sleep). Therefore, the object of the statutes of limitations is to compel a person to exercise his right of action within a reasonable time as also to discourage and suppress stale, fake or fraudulent claims.”

Part- III of the Limitation Act, deals with computation of period of limitation and Section 2(j) defines the term **“period of limitation”** to mean *“the period of limitation prescribed for any suit, appeal or application by the Schedule”*.

⁷⁶ A Court v. Cross (3) BEST

⁷⁷1971 (2) SCC 860

Section 433 of the Companies Act, 2013⁷⁸ provides for limitation, it reads as follows:

“The provisions of the Limitation Act shall, as far as may be, apply to proceedings or appeals before the Tribunal or the Appellate Tribunal, as the case may be.”

Further, Section 60(6) of IBC lays down:

“Notwithstanding anything contained in the Limitation Act or in any other law for the time being in force, in computing the period of limitation specified for any suit or application by or against a corporate debtor for which an order of moratorium has been made under this Part, the period during which such moratorium is in place shall be excluded.”

On the question whether Section 60(6) shall prevail over such a provision of the Limitation Act, the issue will be, whether the provision for excluding the moratorium period is inconsistent with the Limitation Act. The answer will be clearly negative. The intent of the Code is to provide a further extension to the limitation period- since

the creditor cannot take any action during the stand- still period. Therefore, it is quite logical that the limitation be extended by that period. In essence, therefore, the limitation will be still computed as per the Limitation Act, applying all the principles thereunder, and the limitation computed thereunder shall get further extended by the moratorium period⁷⁹.

Analysis:

Earlier when the applicability of the Limitation Act was judged upon by the National Company Law Tribunal (NCLT), they had held that the same would very much be applicable on the IBC.

It is quintessential to discuss the case of *Sanjay Bagrodia v. Sathyam Green Power Pvt. Ltd.*⁸⁰(25.05.2017), wherein the preliminary issue that was considered by NCLT, Principal Bench was whether insolvency process can be triggered in a matter where the default had occurred beyond a period of 3 (Three) years and the claim has become time barred on account of period of limitation prescribed by the Limitation Act or by virtue of rule of prudence developed by the Courts.

In this case, the default had occurred in respect of non-payment of salary for the period October, 2012 to September 20, 2013 and the petition was before this Tribunal on 12.05.2017. If the period of 3 (Three) years is applied, the limitation period expires on September 20, 2016. The claim was thus,

Limitation under:

Companies Act, 2013	Insolvency & Bankruptcy Code
<i>Sec 433- The provisions of the Limitation Act shall, as far as may be, apply to proceedings or appeals before the Tribunal or the Appellate Tribunal, as the case may be</i>	<i>Sec 60(6)- Notwithstanding anything contained in the Limitation Act or in any other law for the time being in force, in computing the period of limitation specified for any suit or application by or against a corporate debtor for which an order of moratorium has been made under this Part, the period during which such moratorium is in place shall be excluded</i>

⁷⁸ <http://www.indiacode.nic.in/acts-in-pdf/2016/201631.pdf>

⁷⁹Taxmann’s Law Relating to Insolvency and Bankruptcy Code 2016 by Vinod Kothari and Sikha Bansal (Edition 2016)

⁸⁰ C.P. No. (IB)108(PB)/2017

Applicability of Limitation Act To Insolvency and Bankruptcy Code

made long after the expiry of period of 3 (Three) years. The relevant extracts of the judgment are reproduced as follows:

Para 3. The learned counsel for the Operational Creditor argued that the aforesaid view was taken without any detail discussion of various judgments rendered by the Hon'ble Supreme Court laying down that NCLT(s) are creatures of a Statute and the Limitation Act cannot be read into the Statutes creating the NCLT(s) unless it is expressly provided. In support of his submission, learned counsel has placed reliance on the judgments of the Supreme Court in the cases of L.S. Synthetics Ltd. v. Fairgrowth Financial Services Ltd. & Anr.⁸¹ and M.P. Steel Corporation v. Commissioner of Central Excise⁸² and has argued that in the absence of any provision made by IBC incorporating the provision of the Limitation Act, no such provision can be read into the IBC. The learned counsel further pointed out that NCLT must perform its functions within the parameters laid down by IBC.

*** Para 10. There is broad indication implicit in the IBC for application of the Limitation Act itself. In that regard, Section 60(6) reads as:*

(6) Notwithstanding anything contained in the Limitation Act or in any other law for the time being in force, in computing the period of limitation specified for any suit or application by or against a corporate debtor for which an order of moratorium has been made under this Part, the period during which such moratorium is in place shall be excluded.



SC STAYS NCLAT ORDER THAT SAID LIMITATION ACT DOESN'T APPLY TO PROCEEDINGS UNDER IBC

A perusal of the above quoted provision would show that for computing the period of limitation specified for any suit or application by or against a corporate debtor, the period during which such moratorium has remained in operation is to be excluded. In other words, if the resolution of insolvency has failed then in case a suit or application is filed then moratorium period has to be excluded. If an Operational Creditor has approached the NCLT after 3 (Three) years or prescribed period of limitation then, how his claim in the suit or application could be within the period of limitation prescribed. The simple result flowing from the plain reading of Section 60(6) IBC is that the claim made before the NCLT must also be within the period of limitation as prescribed by the Limitation Act.

*Para 11. Even otherwise the rule of prudence would require that public policy of law must be given effect which is widely followed namely it does not come to the rescue of those who sleep over their rights. It come to the help of those who are vigilant. Before a Constitution Bench of the Hon'ble Supreme Court in the case of **State of M.P. v. Bhailal Bhai & Ors.**⁸³, the question arose whether any period of limitation can be implied for a litigant to file a writ petition. When the period of limitation was absent for filing of a writ petition, Hon'ble the Supreme Court has*

⁸¹ (2004) 11 SCC 456

⁸² (2015) 7 SCC 58

⁸³ AIR 1964 SC 1006

taken the view that the period of limitation as prescribed in the Limitation Act would be the maximum.

NCLT then questioned the counsel whether an application under IBC would be maintainable to recover the amount which fell due 50 years ago and then concluded by saying that that the Tribunal cannot be a flowering pot for claims which have become dead and are wholly time barred.

NCLT also referred to the case of *M/s. Deem Roll-Tech Limited v. M/s. R.L. Steel & Energy Ltd.*⁸⁴ (31.03.2017), wherein the Principal Bench had taken a view that the period of limitation would be applicable as the claim made by the Operational Creditor was barred by limitation and was being made after the expiry of period of 3 (Three) years. The views of the Principal Bench are evident from the following paras:

"Section 255 of IBC provides that the Companies Act, 2013 shall be amended in the manner specified in the eleventh schedule to IBC and a perusal of the eleventh schedule of IBC discloses the amendments made to the Companies Act of several provisions though not Section 433 of the Companies Act wherein specifically the provisions of the Limitation Act is made applicable and that it shall, as far as may be apply to the proceedings or appeals before the Tribunal or Appellate tribunal as the case may be."

Thus, it can be humbly stated that since IBC is silent on the time period from the date of default within which an application for insolvency resolution must be filed then of course in the absence of any specific bar in the IBC to the application of the Limitation Act read with Section 433 of Companies Act, the debt, which is barred by limitation, cannot be the basis for invoking IBC before NCLT/ NCLAT.

⁸⁴ Company Application No. (I.B.) 24/PB/2017

RBI'S 12TH FEBRUARY CIRCULAR: THE LAST WORD BECOMES THE LOST WORLD

- **Abhirup Ghosh**

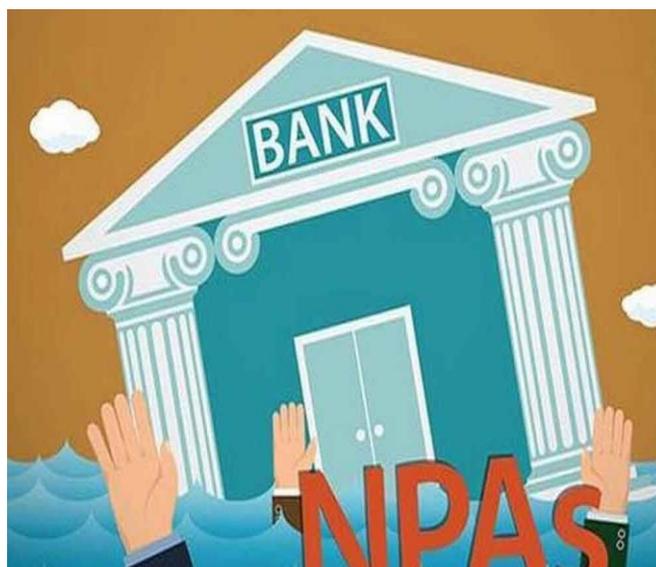
Editor's Notes: *The fact that the deep-rooted presence of bad-loans is at an ever rising high in India, is no new news. Though the most essential element of the Code is its timeliness, it does not take away the basic rights of a Corporate Debtor. However, the infamous RBI circular on treatment of stressed assets proved to be in the contrary. More colloquially referred to as the "12th February Circular", it happens to be one of the sternest measures against insolvent companies, now annulled by the Hon'ble Supreme Court. In the note below we take you through the entire episode of the 12th February Circular from its rise to its fall.*

The [12th February 2018 circular](#) of the Reserve Bank of India (RBI) (Circular), arguably one of the sternest of measures requiring banks to stop ever-greening bad loans, and resolve them once for all, with a hard timeline of 6 months, or mandatorily push the matter into insolvency resolution, was aimed at being the last word, overriding several of the previous measures such as CDR, JLF, SSSS-A, etc. However, with the Supreme Court striking it down, in the case of [Dharani Sugars and Chemicals Limited vs Union of India and Ors](#), the mandate of the RBI in directing banks with how to deal with stressed loans has fallen apart. While the SCI has used very technical grounds to quash the 12th Feb circular, the major question for the RBI is whether it should continue to micro-manage banks' handling of bad loans, and the major question for the banks is when will they grow up into big boys and stop expecting RBI to tell them how to clean up the mess on their balance sheet.

The judgment has received mixed reactions from various parts of the economy. This write-up will take you through how it started, and how it ended and what the way forward is.

How it started?

The inception of the entire trail dates back to 5th May, 2017 when the Banking Regulation (Amendment) Ordinance, 2017 was notified. The Ordinance was passed with the intention to empower the Central Government (CG) to authorise the RBI to issue directions to banking companies to initiate insolvency resolution process (IRP) under the provisions of Insolvency and Bankruptcy Code, 2017 (IBC). Two new sections were introduced in the Banking Regulation Act, 1949, namely, sections 35AA and 35AB. While section 35AA empowered the CG to authorise RBI to



direct banks to initiate IRP proceedings, section 35AB empowered the RBI to issue directions to the banking companies for resolution of stressed assets.

Soon after the Ordinance was notified, the Ministry of Finance empowered the RBI to issue [directions under section 35AA on 5th May, 2017](#).

The Ordinance was replaced by the [Banking Regulation \(Amendment\) Act, 2017 on 25th August, 2017](#). However, before the Ordinance could turn into an Act, the RBI issued a [press release](#) conveying the following:

1. That it has constituted an Internal Advisory Committee that will help identifying accounts for which IRP must be launched;
2. That it is laying down criterion for referring accounts for resolution under IBC among top 500 exposures in the banking system which are either wholly or partially NPA; and that 12 accounts satisfy the conditions;
3. That for the accounts which do not satisfy the criterion laid down by IAC, the banks must prepare a resolution plan within six months and where a valid resolution plan is not agreed upon IRP must be launched after the expiry of six months;
4. That the RBI will issue directions, based on the recommendations of the IAC, to banks to initiate insolvency proceedings under IBC;
5. That the RBI will subsequently issue framework for dealing with other NPAs.

Subsequently, the RBI came out with a framework for dealing with other NPAs on 12th February, 2018. The framework was notified by RBI, purportedly, deriving powers from four sections – sections 35A, 35AA and 35AB of the BR Act and section 45L of the RBI Act.

The central theme of this framework revolved around identification of stress in large ticket sized accounts, implementing a resolution plan within 180 days from the date of default and in case of failure to implement, IRP action must be initiated against the borrower under IBC, within 15 days from the date of expiry of the timeline. Large accounts for this purpose means accounts where the aggregate exposure of the lenders exceed ₹ 2,000 crores.

The salient features of the framework are as follows:

- Identification of early signs of stress in accounts with outstanding of Rs. 5 crores or above, through SMA account classifications and filing of relevant information with the Central Repository of Information on Large Credits (CRILC).
- Resolution plans must be worked upon for all cases of default and must be implemented within a period of 180 days from the date of default or from the reference date, that is 1st March, 2019, in case the default was subsisting as on the date of reference date. This timeline is however applicable for accounts with outstanding debt of Rs. 2000 crores. However, the reference date was accounts with outstanding of debt of less than the specified amount but more than Rs. 100 crores, for the purpose of debt resolution, has not been notified yet.

RBI's 12th February Circular:

The Last Word Becomes the Lost World

- Independent credit rating to be obtained before implementing the RP.
- In case of failure to implement the RP within the specified timeline, the account must be dragged into IRP under the IBC within a period of 15 days from the expiry of the time period. The reference under IBC can be made by the banks either singly or jointly.
- In case of timely implementation of RP, if the account faces any default during the specified period, then the same must be referred for IRP under IBC by the lenders singly or jointly, within 15 days from the date of default. Specified period, in this regard means period within which at least 20 percent of the outstanding principal debt as per the RP and interest capitalisation sanctioned as part of the restructuring, if any, is supposed to be repaid.
- Sale and leaseback transactions of any asset of the borrower will be treated as a case of restructuring for the purpose of the framework and be subject to asset classification norms applicable to restructured accounts.
- The framework repealed all the other frameworks for dealing with stressed assets, issued earlier by the RBI, namely, Framework for Revitalising Distressed Assets, Corporate Debt Restructuring Scheme, Flexible Structuring of Existing Long Term Project Loans, Strategic Debt Restructuring Scheme (SDR), Change in Ownership outside SDR, Scheme for Sustainable Structuring of Stressed Assets (S4A), and Joint Lenders' Forum (JLF) as an institutional mechanism for resolution of stressed accounts.

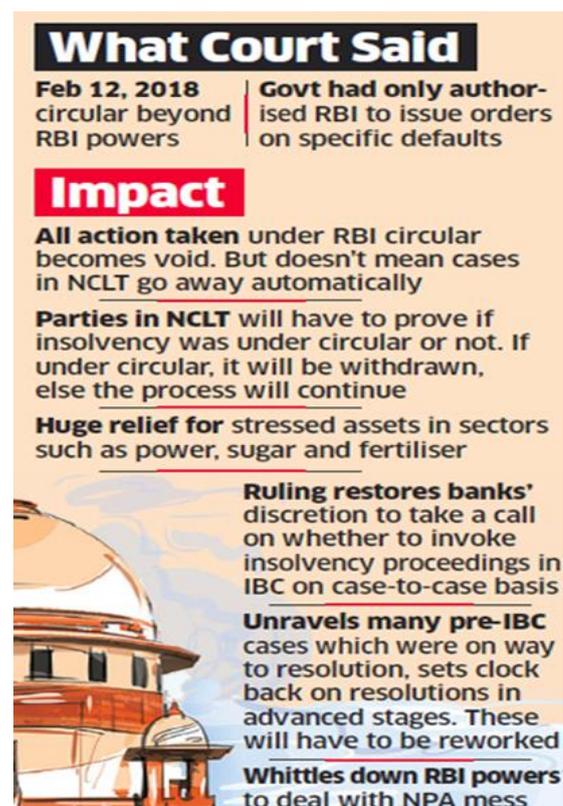
How it ended?

The framework raised several eyebrows as some felt that the RBI had categorised all defaulted accounts into one single bucket, irrespective of the kind of stress they are facing. Other felt that the framework becoming applicable even on a single day default is an unreasonable measure. However, the most important issue of contention that dragged the matter to the court was questioning the authority of RBI to issue the framework on the first place.

The ruling passed by the SCI is result of this contention and the SCI has ruled it against the RBI. The SCI declared that the issuance of the framework *ultra vires* the powers granted to the RBI under various statutes and that the framework shall be of no effect in law.

While building up this ruling the SCI considered the following:

- **Sections 35A, 35AA and 35AB of the BR Act** – The SCI stated that the stressed assets can be resolved through the provisions of IBC or otherwise. When the measure intended is IBC,



What Court Said

Feb 12, 2018 | Govt had only authorised RBI to issue orders on specific defaults
circular beyond RBI powers

Impact

All action taken under RBI circular becomes void. But doesn't mean cases in NCLT go away automatically

Parties in NCLT will have to prove if insolvency was under circular or not. If under circular, it will be withdrawn, else the process will continue

Huge relief for stressed assets in sectors such as power, sugar and fertiliser

Ruling restores banks' discretion to take a call on whether to invoke insolvency proceedings in IBC on case-to-case basis

Unravels many pre-IBC cases which were on way to resolution, sets clock back on resolutions in advanced stages. These will have to be reworked

Whittles down RBI powers to deal with NPA mess

section 35AA is the only resort. However, if the RBI wishes to resolve stressed accounts other than through IBC, then it can use general powers under section 35A and 35AB. While section 35A grants wide powers to RBI to give directions when it comes to the matters specified therein, section 35AA calls for an additional requirement of “authorisation” from CG to give directions to banks to proceed under IBC.

Therefore, for exercising powers under the 35AA, the RBI requires specific authorisation from the Central Government, however, for enforcing powers granted under sections 35A and 35AB, no specific authorisation is required. Had there been no section 35AA, RBI would have needed no authorisation to give such directions, as such power could be derived from the existing section 35A, which is wide and expansive enough.

To quote SCI –

“30. The corollary of this is that prior to the enactment of Section 35AA, it may have been possible to say that when it comes to the RBI issuing directions to a banking company to initiate insolvency resolution process under the Insolvency Code, it could have issued such directions under Sections 21 and 35A. But after Section 35AA, it may do so only within the four corners of Section 35AA.

31. The matter can be looked at from a slightly different angle. If a statute confers power to do a particular act and has laid down the method in which that power has to be exercised, it necessarily prohibits the doing of the act in any manner other than that which has been prescribed. . .”

The court pointed out that if the RBI had the power under sections 35A or 35AB of the BR Act to direct the banks to initiate proceedings under the IBC, it would obviate the necessity of the Central Government authorisation under section 35AA to do so. It noted the following:

“40. Stressed assets can be resolved either through the Insolvency Code or otherwise. When resolution through the Code is to be effected, the specific power granted by Section 35AA can alone be availed by the RBI. When resolution de hors the Code is to be effected, the general powers under Sections 35A and 35AB are to be used. Any other interpretation would make Section 35AA otiose. In fact, Shri Dwivedi’s argument that the RBI can issue directions to a banking company in respect of initiating insolvency resolution process under the Insolvency Code under Sections 21, 35A, and 35AB of the Banking Regulation Act, would obviate the necessity of a Central Government authorisation to do so. Absent the Central Government authorisation under Section 35AA, it is clear that the RBI would have no such power.”

Therefore, it becomes important to understand if the RBI acted well within its powers under section 35AA while issuing the circular. Section 35AA states the following:

*‘35AA. The Central Government may, by order, authorise the Reserve Bank to issue directions to any banking company or banking companies to initiate insolvency resolution process in respect of a **default**, under the provisions of the Insolvency and Bankruptcy Code, 2016.*

Explanation.—For the purposes of this section, “default” has the same meaning assigned to it in clause (12) of section 3 of the Insolvency and Bankruptcy Code, 2016.

Stress Factor

February 12, 2018

RBI issues a circular revising the resolution mechanism for stressed assets; puts pressure on banks and India Inc

August 27, 2018

Allahabad High Court refuses to grant interim relief to power companies seeking stay on RBI circular



As noted above, section 35AA allows the RBI to issue directions to banks to initiate IRP in respect of “a default”. The meaning of term default has been drawn from the IBC, as per which a default is non-payment of a debt when it has become due and payable by the corporate debtor. All this indicates that the default in the present context refers to a specific default and not defaults in general.

Further, the SCI also took note of the press note of the Ordinance of 5th May, 2017 which indicated that the intention of deal with resolution of “specific” stressed assets which will empower the RBI to intervene in “specific” cases of resolution of NPAs. The same was also the understanding of the Central Government when it issued the notification on 5th May, 2017 to authorise the RBI to issue directions to the banks to act against “a default” under IBC. Therefore, this made it conclusive that directions issued in relation to debtors in general,

is *ultra vires* the powers under section 35AA.

- **Section 45L of the RBI Act** – The RBI stated in the framework that it drew one of its powers from section 45L of the RBI Act. The section grants power to direct non-banking financial institutions. However, section 45(3) of the RBI Act states the following:

XX

(3) In issuing directions to any financial institution under clause (b) of sub-section (1), the Bank shall have due regard to the conditions in which, and the objects for which, the institution has been established, its statutory responsibilities, if any, and the effect the business of such financial institution is likely to have on trends in the money and capital markets.

XX

It was emphasised that in order to issue any direction under this section, the RBI must have due regard to the conditions in which, and the objects for which, the institutions have been established, their statutory responsibilities, and the effect the business of such financial institutions is likely to have on trends in the money and capital markets. However, the framework did not discuss anything as such. Further, since, the very intention of bringing in NBIs under this framework was to deal with cases which had joint lending arrangements between banks and NBIs, the SCI found it difficult to separate banks and NBIs and make the circular applicable on NBIs even though *ultra vires* for the banks.

Therefore, the entire circular was declared *ultra vires* as a whole.

What is the way forward?

The ruling has created an awkward situation, as the banks have already acted upon the directions issued by the RBI. They have either implemented an RP or dragged the borrower to NCLT to proceed under IBC. Now that the circular is gone, following are the probable outcomes:

1. For cases where RPs have been implemented – the lenders may decide to go ahead as per the RP and treat the same as restructured account.
2. For cases where the corporate debtor has been taken to the NCLT – now that the very basis for taking the account to NCLT is gone, the lenders will have to take a call whether they want to pursue the proceedings under the Code without making references to RBI Circular.

Another apparent question that arises here is what will happen to the various frameworks which were withdrawn vide the 12th February circular. As stated by the SCI, the Circular will have no effect in law, therefore, the “withdrawal” clause too has been nullified. Therefore, the old restructuring frameworks can be said to be existing as on date.

Nevertheless, the Circular played the role of a game-changer by inducing a certain degree of credit discipline or at least the fear of being dragged into IBC. Now, as the Circular goes away, RBI may have to think of new restructuring frameworks – if that is through IBC, it would surely need CG’s authorisation.

Know More....

On 7th June, 2019, the RBI brought a new set of directions titled Prudential Regulations for Resolution of Stressed Assets. These regulations give substantia liberty to the lenders, and while the lenders will still be required to carry out a review of a defaulter’s exposure, form an inter-creditor forum and agree on the measures for resolution within a period of 30 days, there is no mandatory reference to IBC. Instead, there is a range of options available to the lenders – IBC being only one. The lenders are required to implement the resolution within 6 months of the end of the review period. For a discussion by Vinod Kothari Consultants on the revised framework, see here: <http://vinodkothari.com/2019/06/fresa/>

PLIGHT OF A POWER OF ATTORNEY HOLDER VIS-A-VIS INSOLVENCY PROCEEDINGS

[-Palogix Infrastructure Pvt. Ltd. v. ICICI Bank Ltd](#)

- **Richa Saraf**

Editor's Note: Delegation of power to act on one's behalf is a very common phenomena in every strata. Such delegation can be by way of a "Power of Attorney"; "Letter of Authority" and "Authorization via Board Resolution" in case of companies. However, maligned use of such power is very likely. Hence, in order to avoid fraudulent initiation of corporate insolvency, the Hon'ble National Company Law Appellate Tribunal, very interestingly held that Power of Attorney Holders are not authorised to present an Insolvency Application under IBC. Below we discuss and analyse the the said ruling of the Appellate Tribunal.

The Hon'ble NCLAT has held that 'Power of Attorney' holders are not authorized to present Insolvency Application under Section 7, 9 and 10 of the Code. It is only authorized representatives, duly authorized by Board Resolution, who are authorized to present the same. The same is based on a simple rationale that company being juristic person only acts through its Board of Directors, who can exercise all powers which company is entitled to and they may vide resolution authorize any person to present application. Further, officers authorized by Board cannot give Power of Attorney to any other person. Below, we discuss the ruling.

Facts of the Case:

ICICI Bank Ltd. (Financial Creditor) filed an application under section 7 of IBC for initiation of 'Corporate Insolvency Resolution Process' against Palogix Infrastructure Pvt. Ltd. (Corporate Debtor).

The case was first heard by a Division Bench of the Adjudicating Authority, which having noticed that the Financial Creditor preferred the application through 'Power of Attorney Holder', passed two separate orders- one holding the application, through Power of Attorney, is not maintainable (Member Judicial) and the other (Member Technical) held that the application was maintainable, as the Power of Attorney was given in favour of the Legal Manager, to initiate proceedings before the National Company Law Tribunal (NCLT), which is the Adjudicating Authority under IBC.

The case was then referred to the Hon'ble President, NCLT exercising power under Section 419(5) of the Companies Act, 2013 for constituting a larger Bench for decision, wherein by majority judgment, the Adjudicating Authority held that there should be specific authorization to the Power of Attorney Holder to initiate the corporate insolvency resolution process. The Financial Creditor having not filed such specific authorization was directed to rectify the defects.

The Financial Creditor challenged the said order on the ground that no specific authorisation required for initiation of corporate insolvency resolution process.

Issue for Determination:

Whether the constituted attorney authorised to file suits and/ or proceedings against the company for recovery of the amount and also to affirm complaints cum affidavits and other pleadings in any court of India including NCLT can file application for initiation of corporate insolvency process under Section 7 of IBC?

Discussion of Law:

Rule 2(6) of the NCLT Rules, 2016 defines an “authorised representative” to be a person authorised in writing by a party to present his case, before the NCLT, as the representative of such party, as provided under Section 432 of the Companies Act, 2013. The said rule having not been adopted under IBC or rules framed thereunder, therefore, the Hon’ble NCLAT was of the view that no reliance can be placed on such rule.

Order III of the Code of Civil Procedure, 1908 provides for recognized agents and pleaders, but Code of Civil Procedure is not applicable for filing application under IBC.

Section 179 of Companies Act, 2013 empowers the Board of Directors to do all such acts that a company is authorised to do. A company being a juristic person is capable of initiating and defending legal proceedings and, therefore, the Board of Directors is empowered to exercise such rights on behalf of the Company or may duly empower an authorised representative to do so on its behalf. Thereby the person authorised by the Board of Directors is duly empowered to initiate or defend any legal proceedings by or against the Corporate Debtor in any Court of law, including the matters relating to Insolvency and Bankruptcy proceedings.

A Power of Attorney is an authorization by a ‘principal’ to its ‘agent’ to do an act. A fortiori, such authorisation can only be of acts which are in the contemplation and knowledge of the principal as on the date when such authorisation is given. If the principal itself is unaware of an eventuality, it cannot authorize its agent for such eventuality. This is more so when IBC sets in motion a very serious and irreversible process, therefore, the procedural pre-requisites under IBC must be strictly construed. For instance, in situations where the Financial Creditor executed the power of attorney, but he could not have visualised even remotely that the donee would be required one day to initiate a corporate insolvency proceeding under section 7, the donee cannot initiate the corporate debt resolution proceedings as he lacks the requisite authority.

For determination of question relating to Power of Attorney, it is desirable to refer Section 2 of Power of Attorney Act, 1882 which reads as follows:

“Execution under Power-of-Attorney: The donee of a power-of-attorney may, if he thinks fit, execute or do any instrument or thing in and with his own name and signature, and his own seal, where sealing is required, by the authority of the donor of the power; and every

A Power of Attorney is an authorization by a ‘principal’ to its ‘agent’ to do an act. A fortiori, such authorisation can only be of acts which are in the contemplation and knowledge of the principal as on the date when such authorisation is given

Plight of A Power Of Attorney Holder Vis-À-Vis Insolvency Proceedings

instrument and thing so executed and done, shall be as effectual in law as if it had been executed or done by the donee of the power in the name, and with the signature and seal, of the donor thereof. This section applies to powers-of-attorney created by instruments executed either before or after this Act comes into force."

The Apex Court in *A. C. Narayanan v. State of Maharashtra*⁸⁵ held-

"28. The power of attorney holder is the agent of the grantor. When the grantor, authorises the attorney holder to initiate legal proceedings and the attorney holder accordingly initiates such legal proceedings, he does so as the agent of the grantor and the initiation is by the grantor represented by his attorney holder in his personal capacity."

However, in the case of *T.C. Mathal v. District & Sessions Judge, Thiruvananthapuram, Kerala*⁸⁶, the Hon'ble Supreme Court held-

"Section 2 of the Power of Attorney Act, 1882 cannot override the specific provision of a statute which requires that a particular act should be done by a party-in-person."

On the question whether following the enactment of IBC, the situations have gone sea change as regards insolvency of corporate debtor or liquidation thereof, insolvency and bankruptcy of individual and partnership firm, it was held that a complete new regime is put in place. IBC is a complete Code in itself. The Hon'ble Supreme Court in *M/s. Innoventive Industries Ltd. v. ICICI Bank*⁸⁷ held-

59. IBC is an Act to consolidate and amend the laws relating to reorganization and insolvency resolution, inter, alia of corporate persons. Insofar as corporate persons are concerned, amendments are made to the following enactments by Sections 249 to 252 and 255.

*** 60. It is settled law that a consolidating and amending act like the present Central enactment forms a code complete in itself and is exhaustive of the matters dealt with therein.*

*** 63. There can be no doubt, therefore, that the Code 4 is a Parliamentary law that is an exhaustive code on the subject matter of insolvency in relation to corporate entities, and is made under Entry 9, List III in the 7th Schedule which reads as '9. Bankruptcy and Insolvency'.*

Also, in *Shantilal Khusaldas and Bors Pvt. Ltd v. Smt Chandanbala Sughir Shah*⁸⁸ and in *Coromandel International Ltd. v. Chemcel Biotech Ltd.*⁸⁹, it was held that it is a settled principle of law that the power of attorney needs to be interpreted strictly, reason behind such principle being that the powers given are not abused by agent or the actions are restricted within an only to the extent the power is indicated or given. In the aforesaid cases, it was further held that when the donor of a power of attorney had authorised the donee to initiate suits, the donee, being armed with such a power of attorney, cannot initiate a winding up proceeding⁸⁵ since a winding up proceeding under the

⁸⁵(2014) 11 SCC 790

⁸⁶(1999) 3 SCC 614

⁸⁷2017 SCC OnLine SC 1025

⁸⁸(1993) 77 Comp Cas 253

⁸⁹(2011) 166 Comp Cas 676

company law can never be equated with a suit. The relevant part of *Coromandel International Ltd (supra)* is reproduced below:

"A suit for recovery of money is essentially a suit between the parties where no third party can seek any indulgence or impleadment. The proceedings under the Companies Act for winding up are entirely different, a special remedy provided for and the idea is not to restrict the proceedings to the parties alone and its range is widened and all steps taken in winding up proceedings are in public interest. Sometimes the relief for winding up is denied when it is against public interest. "

One of the reasons why the Hon'ble NCLAT has held that a 'Power of Attorney holder' cannot file any application under Section 7 or Section 9 or Section 10 of IBC was because there may be cases where the Insolvency Resolution proceeding has been initiated by such person fraudulently or with malicious intention for personal act on the part of an individual

This apart, authorization in the case of a company would mean a specific authorization by the Board of Directors of the company by passing a resolution⁹⁰. Therefore, the application under Section 7 if signed and filed by a 'General Power of Attorney Holder' without specific authorization is not maintainable. Also, the pre-requisites under IBC are mandatory and it should be strictly construed and barring specific Power of Attorney, no application can be entertained. In this regard, Rule 10 of the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016 states that till the time rules of procedure for conduct of proceedings under the IBC are notified, an application made under section 7(1) shall be filed before the Adjudicating Authority in accordance with Rules 20, 21, 22, 23,

24 and 26 of Part III of NCLT Rules, 2016. Rule 23(1) permits an authorised representative to present an application or petition before the Tribunal. The form and manner in which an application under section 7 is to be filed by a Financial Creditor is provided in Form No. 1 of such Adjudicating Authority Rules. Upon perusal of the aforesaid rules and Form-1, it may be duly noted that the IBC, and the rules thereunder, recognizes that a Financial Creditor being a juristic person can only act through an "Authorised Representative". Entry 5 and 6 (Part I) of Form No. 1 mandates the Financial Creditor to submit "name and address of the person authorised to submit application on its behalf" and requires the authorisation to be enclosed. Further, the signature block of Form No. 1 requires the authorised person's detail to be inserted and also includes, *inter alia*, the position of the authorised person in relation to the Financial Creditor. Thus, it is clear that an authorised person of the Financial Creditor can make an application under Section 7 and if an officer, such as senior manager of a bank has been authorised to grant loan, for recovery of loan or to initiate a proceeding for corporate insolvency resolution process against the person who have taken loan, in such case the Corporate Debtor cannot plead that the officer has power to sanction loan, but such officer has no power to recover the loan amount or to initiate corporate insolvency resolution process, in spite of default of debt. If a plea is taken by the authorised officer that he was authorised to sanction loan and had done so, the application under section 7 cannot be rejected on the ground that no separate specific authorization letter has been issued by the Financial Creditor in favour of such officer designate.

⁹⁰*State Bank of Travancore v. Kingston Computers India Fyi. Ltd.* (2011) 11 SCC 524

***Plight of A Power Of Attorney Holder
Vis-À-Vis Insolvency Proceedings***

Comments

One of the reasons why the Hon'ble NCLAT has held that a 'Power of Attorney holder' cannot file any application under Section 7 or Section 9 or Section 10 of IBC was because there may be cases where the Insolvency Resolution proceeding has been initiated by such person fraudulently or with malicious intention for personal act on the part of an individual. However, proceedings made under Section 7 of IBC does not necessarily lead to liquidation of the Corporate Debtor. Under Section 20(1), the Interim Resolution Professional shall make every endeavour to protect and preserve the value of the property of the Corporate Debtor and manage the operations of the Corporate Debtor as a going concern. It may lead to liquidation or winding up, in case no viable Insolvency Resolution Plan could be evolved in consultation with the Committee of Creditors.

Also, in the instant case, the power of attorney clearly mentions that the legal manager is empowered to initiate proceedings under the NCLT which automatically includes its role as an Adjudicating Authority under IBC and pursuant to the judgment of the Hon'ble NCLAT, every petition under the IBC, involving a Financial Creditor, must be filed on the basis of a specific power of attorney on a Board's Resolution, which will defeat the very purpose of the IBC, viz. speedy resolution of insolvency cases.



Working group



SECTION VIII: GROUP INSOLVENCY

ENTITY VERSUS ENTERPRISE: DEALING WITH INSOLVENCY OF CORPORATE GROUPS

- **Vinod Kothari & Sikha Bansal**

Editor's Notes: Corporate laws, even now, remain anchored to the principle of 'separate legal entity', despite the fact that businesses these days are increasingly being viewed on 'enterprise' basis. In cases where the assets, resources, operations, of an enterprise are scattered across multiple entities, then this entity-focussed approach may not be as effective as expected to be in rescuing the ailing enterprise.

IBC too, explicitly excludes assets of a subsidiary from the liquidation estate, following the principle of separate corporate existence. However, experience shows that business activities may be integrated in a 'group' structure comprising of a web of holding, subsidiary, associate, investee companies, so much so, that picking one and leaving the other would defy the very objective of insolvency proceedings against an entity.

The article discusses why it is important to adopt a holistic approach and how the same can be achieved.

Business today spans across entities, and, indeed, jurisdictions. Most large corporates have business and operations across multiple entities, within a jurisdiction, and often, across jurisdictions. There are some entities that house assets, some hold investments, some hold intellectual property, and many hold different business verticals. Thus, whether all the resources of an enterprise are housed into a single entity or not is a crucial corporate structure decision, taken based on vast and complex array of factors, including ease of control, ease and tax factors in exit, market valuations, ring-fencing of certain assets, financing of assets of different operating units on their own strength, etc.

Appropriately, accounting standards have moved from entity-based reporting to group-based reporting, in form of consolidated financial statements, which consolidate assets and liabilities of subsidiaries, joint ventures and associates. Securities regulators, in their natural tendency to be aligned to the way the capital markets perceive it, are also driven by group-based regulation.

However, as Justice Sabyasachi Mukharji⁹¹ had to say, "The ghost of the case of [Aron Salomon v. A. Salomon & Co. Ltd.](#), [1897] AC 22 at 27, 30, 31, still visits frequently the hounds of Company Law." Corporate laws are still primarily based on "legal entity" rather than "enterprise", and unsurprisingly, insolvency laws, in most global jurisdictions, are still anchored on the concept of legal entity. Enterprise insolvency or group insolvency is aspirational, and even as advances are made once in a while to move to group insolvencies, the move to a mandated insolvency of a corporate enterprise group remains largely a distant optimism.

It would be apt to quote from leading author *Goode on Principles of Corporate Insolvency Law*⁹²:

"Business, entity or group enterprise?"

⁹¹State of UP and others vs Renuagar Power Co and others, 1988 AIR 1737; 1988 SCR Supl. (1) 627;

⁹²Fifth Edition, by Kristin Van Zwieten, pg. 29-30

Entity vs. Enterprise

The subject of insolvency proceedings has always been, and continues to be, the particular corporate entity that has become insolvent, and this focus is accentuated by the reluctance of English law to pierce the corporate veil. What insolvency law here and overseas has so far singularly failed to accommodate is the management of enterprise groups where one or more, or possibly all, members of the group have become insolvent. Whereas the preparation and filing of group accounts has long been required, when it comes to insolvency the distinct legal personality of each individual company within the group is respected, with separate proceedings for each company, *yet the insolvency of one member of a group may threaten the viability of previously solvent members and where the group activity is integrated a co-ordination of the management of the group as a whole may be highly desirable*. This is particularly the case as regards multinational group of companies, *where the complexity is exacerbated by the variety of corporate structures and the possibility of concurrent proceedings in different jurisdictions governed by different laws, . . .*" [emphasis supplied]

This Paper discusses the need for recognising "enterprise" over an "entity", explores the legislations in several jurisdictions, various judicial interpretations and recognitions, and various authorities on the subject and seeks to answer how the enterprise approach can be given effect to.

Accordingly, the discussion has been sequenced as follows –

1. Relevance of enterprise approach in insolvency
2. Current discussions on enterprise approach
3. Approaches to Group Insolvency
4. Pre-requisites for Adopting Enterprise Approach
5. The Cross-Border Angle in Group Insolvency
6. Precedents in global jurisdictions and in India
7. Issues in group-based insolvency proceedings
8. Making groups insolvency work under current framework of the Code

Relevance of Enterprise Approach in Insolvency

The relevance of the enterprise approach may be seen from two perspectives – the objective of insolvency or liquidation proceedings, and the complex, inter-connected nature of legal entities in corporate groups of the present day.

The objective of insolvency law is, primarily, rescue, by reorganisation or any other means, and if rescue does not work out, then liquidation and distribution of liquidation estate equitably. If the assets or operations of a corporate group are scattered across inter-connected entities, it is not possible to achieve a meaningful rescue without taking a group-focused approach. The idea of a rescue plan is to focus on enterprise value, and not be tunnel-visioned by the entity approach.

If the proceedings pertain to liquidation, there again, it is quite common to have assets, contracts, licenses, concessions and intangible assets scattered across entities. If the liquidator's reach is limited to only the assets in the entity, many of the assets may either be difficult to liquidate, or the objective of value maximisation will not be served.

The other perspective, highlighting the need for, and potentially, difficulties in, group-focused approach is the sheer complexity and expanse of entities in present-day large corporate groups. Various factors have led to proliferation of entities across jurisdictions. Foreign direct investment norms of most countries require a locally-incorporated entity – hence, as business moves to an offshore jurisdiction, there is a local vehicle. Then, owing to taxation preferences for certain originating jurisdictions, the investment is made to move from a different jurisdiction. Part of the complexity results from attempt to obscure the beneficial ownership; hence, the constant chase of accounting standards to identify “significant influence” and the tax domicile rules to trace the “place of effective management”, and the efforts by companies to try and escape such rules, creates a completely new level of complexity. Complexity is a self-breeding phenomenon –so more leads to even more.

There are numerous anecdotes of complicated entity structures of well-known global enterprises. Lehman, when it filed for bankruptcy, is known to have 8000 entities in 40 jurisdictions. The Italian dairy company Parmalat had several hundred legal entities in various countries in its enterprise group, when it collapsed. The group entity chart for the bankruptcy of Federal Mogul, when magnified sufficiently to make subsidiary names legible, fills the wall of a small office.

Yet another intuitive reason for group-focused approach is that very often, financing is extended by lenders at the holding company level, from where the funds are relegated down to an operating entity which may be several layers below. Sometimes, the structures also plays with cross-border jurisdictions, including what may appear to be round-tripping – a domestic holding entity, which has an offshore subsidiary, and a domestic step-down entity.

If the assets of the holding entity primarily include the shares of the subsidiaries, using the controlling block of the shares as the basis for disposal of the subsidiaries would have seemed to be the intuitive way to deal with the propagated group. However, this is far from easy in practice; the place where the assets and operations are housed is distanced from the holding entity through several layers, and with use of devices such as non-voting shares and warrants, the direct access of the holding vehicle to the place of real assets and operations may be insulated by these ingenious devices. It must be understood that the group structure was planned and scripted by skilled planners, when the entity was healthy, and the strategists had all the time to do a deft, skilfully insulated and ring-fenced structure.

Current discussions on Enterprise Groups Approach

Current discussions about the relevance of group-focused insolvency approach have been going on in different forums, from academia, to multilateral policy groups such as UNCITRAL, to domestic lawmakers.

One of the earliest inspirations to have a coordinated, cross-border, group-focused approach was the insolvency of BCCI, in early 1990s. BCCI had its headquarters in Luxembourg, but business in 70 countries. On the application of the liquidator, the UK court ordered pooling of assets of the Luxembourg entity with BCCI Overseas⁹³.

⁹³ Nicholls V-C wrote:

“The pooling arrangements are not conditional upon acceptance by creditors ... I am satisfied that the affairs of BCCI SA and BCCI Overseas are so hopelessly intertwined that a pooling of their assets ... is the only sensible way to proceed. It would make no sense to spend vast sums of money and much time in trying to disentangle and unravel.”

Entity vs. Enterprise

Maxwell Communications was yet another case, with the entity having assets in several countries had its main person disappear in an accident, leaving the group rudderless. The ensuing insolvency had the so-far unequalled experience of judicial cooperation in different countries. US court and UK court appointed a joint examiner and joint administrator, to undertake pooling of assets in different jurisdictions⁹⁴.

UNCITRAL had constituted a working group, [Working Group V](#), to deal with insolvency law, and through its various sessions, the Working Group has been advancing its work on insolvency of enterprise groups. Since UNCITRAL is also focused on cross-border insolvency, the Working Group has also suggested model for cross border insolvency of enterprise groups.

The UNCITRAL Legislative Guide to Insolvency Law has dedicated a complete part, viz., [Part 3, dealing with insolvency of enterprise groups](#). One of the focal points of UNCITRAL's work was cross-border judicial cooperation – therefore, UNCITRAL had group proceedings as its main theme, and not just an embellishment.

The EU Insolvency Regulation also applies in cases where there are insolvency proceedings in two or more EU member states. However, based on its structure, the EU regulation does not extend in case of a non-EU insolvency proceeding.

How does one define or recognise an “enterprise group”? Since UNCITRAL has done a lot of work on the issue, one may ideally borrow from its definition from the [UNCITRAL Model law on Enterprise Groups Insolvency](#), where there are 3 relevant definitions:

- “**Enterprise group**” means two or more enterprises that are interconnected by control or significant ownership.
- “**Control**” means the capacity to determine, directly or indirectly, the operating and financial policies of an enterprise.
- Significant ownership has not been defined – however, it appears that the definition of accounting standards will be relevant here.

Approaches to Group Insolvency

The essential objective of a group-focused approach is to swell the estate or undertaking of the entity under insolvency or liquidation, and therefore, the proponent of the group approach may look up, look down, or look laterally. “Looking up” means looking at the holding vehicles, or controlling entities, promoters or other investors who have contributed equity or similar resources to the entity in question. “Looking down” means looking at the subsidiaries, associates or ventures into which equity or resources

⁹⁴ Justice Hoffman commented:

“These parallel proceedings in the English and American courts have resulted in a high level of international cooperation and a significant degree of harmonization of the laws of the two countries. The affected parties agreed to the plan and the scheme despite differences in the two nations' bankruptcy laws. The distribution mechanism established by them - beyond addressing some of the most obvious substantive and procedural incongruities - allowed Maxwell's assets to be pooled together and sold as going concerns, maximizing the return to creditors...these accomplishments - which, we think, are attributable in large measure to the cooperation between the two courts overseeing the dual proceedings - are well worth preserving and advancing. This collaborative effort exemplifies the 'spirit of cooperation' with which tribunals, guided by comity, should approach cases touching the laws and interests of more than one country. ” In re Maxwell Communications Corp (93 F 3d 1036 2d Cir (1996))”

may have gone, directly or indirectly, from the entity in question. “Looking laterally” means looking at fellow subsidiaries, siblings or similar entities which have shared control or significant influence as that over the entity in question. The proponent may, indeed, look in all directions – look up, look down and look laterally, so as to look at the entire group.

Depending on what is being intended to be achieved, there may be various alternative approaches to achieve the group-focused results:

- (i) Extension of liability and Contribution orders
- (ii) Equitable subordination
- (iii) Avoidance applications
- (iv) Procedural consolidation
- (v) Substantive consolidation

Extension of Liability and Contribution Orders

Contribution order is a part of the “looking up” approach where the proponent of group approach seeks contributions from promoters or holding company to the equity of the entity in question. In that sense, this approach is breaching the concept of limited liability. Extension of liability is also, likewise, piercing the safety net of limited liability and extending the liability of the entity in question to other entities in the group, essentially those on whose implicit support the insolvent entity may have raised funding.

Insolvency jurisdiction does not routinely interfere with limited liability, which is the very foundation of corporate finance. Hence, a contribution order or extension of liability is generally based on circumstances where the insolvent entity has been misused by the group entities, almost under circumstances which may be either fraudulent or implying a mischief. Mostly, the order for fixing liability or ordering contribution from a group entity may in the nature of restoration of property or benefits that may have gone out of the insolvent entity. [UNCITRAL Legislative Guide, Part 3](#) mentions as many as 9 illustrative circumstances⁹⁵ in which extension of liability order may be made; most of these seem to be falling in the realm of fraudulent trading.

A discussion on extension of liability must also include the provisions pertaining to directors’ liability for fraudulent or wrongful trading. Trading is regarded as wrongful, when the directors, being already aware that insolvency is unavoidable, continue to trade. Armed with benefit of limited liability, there is little at risk for the shareholders, but the creditors continue to see a depletion in value. In such cases, the directors are made responsible to make such contribution to the liquidation estate as the court/adjudicating authority may deem appropriate. The provisions of wrongful trading were inserted in the UK law specifically at the instance of Sir Kenneth Cork, and enacted as section 214 of the UK law, they came into the IBC as section 66 (2). Additionally, section 66 (1) deals with fraudulent trading; the section corresponds to section 213 of the UK law.

⁹⁵ page 56-57

Entity vs. Enterprise

Equitable Subordination

Equitable subordination is used where a group entity is also a creditor. The proponent of group approach seeks to treat the claims of the group entities as substantive equity, and therefore, subordinate these claims to the claims of external creditors.

The general approach in equitable subordination of third parties, as in case of contribution or extension of liability, is to undo an injury that would be done if the claim was treated based on its contractual status. In the case of *Enron Corp.*, 333 B.R. 205, 222 (Bankr. S.D.N.Y. 2005), the US court put it thus: “Subordinating any amount of claim in excess of the established injury sustained would be punitive, and not consistent with the principles of equitable subordination nor permissible”.⁹⁶

In India, there is [notable ruling of the NCLT, Allahabad Bench](#), wherein equitable subordination was ordered for claims of related parties.

Avoidance Applications

Insolvency laws of most countries come with provisions to annul the impact of such transactions or trading that might have happened, either in anticipation of insolvency, or at undervalued or inadequate consideration, or with an intent of defrauding, etc. These proceedings may be with a clawback period, or in case of a deliberate mischief, without any statutory clawback period. The key element of avoidance provisions is unjust enrichment. As Goode puts it: “All grounds of avoidance known to insolvency law involve the unjust enrichment of a particular party at the expense of other creditors, whether they are preferential creditors or ordinary unsecured creditors.” Avoidance action is essentially to ensure the play of equity in the distributions to creditors, as the outward flight of resources or value by way of vulnerable transactions has presumably caused an inequitable loss to the liquidation estate.

IBC, 2016 lists several vulnerable transactions in case of corporate insolvency and liquidation – preferential transfers, undervalued transactions, fraudulent transactions, and extortionate credits. These are in addition to the provisions pertaining to fraudulent trading [sec 66 (1)] and wrongful trading [sec 66 (2)].

Consolidation with the consent of Members/Creditors

Consolidation is an extreme step of treating different entities as one – therefore, consolidating their assets and liabilities. Consolidation may be consensual – that is, done with the concurrence of at least an overwhelming majority of owners and creditors of the relevant entities, or may be non-consensual. This section deals with consensual consolidation.

Pooling or consolidation with the sanction of the members/creditors may be done, even during pendency of liquidation, by a scheme of arrangement, under sections 230-233 of the Companies Act, 2013. In corresponding provisions of laws of other countries, say, Australia, it has been held that there is no doubt that a scheme of arrangement may provide for pooling of assets and liabilities of different companies. *Dean-Willcocks v Soluble Solutions Hydroponics* (1997) 42 NSWLR 209.

⁹⁶ For a write up giving the evolution of the law on equitable subordination, see here: <http://www.lawjournalnewsletters.com/sites/lawjournalnewsletters/2014/09/01/the-continuing-evolution-of-the-basis-for-equitable-subordination/?slreturn=20190206034956>

In India, the NCLAT has held in [S C Sekaran vs Amit Gupta and others](#), that a scheme under section 230 can be filed during insolvency or liquidation proceedings.

Procedural consolidation

Procedural consolidation is actually not a consolidation – it is procedural coordination, such that while the different entities remain different, but their resolution or liquidation proceedings are put under a common procedure. Such consolidation may take various forms – common adjudicating authority, common administrator or insolvency professional, common committees of creditors, common agenda for action, etc. Procedural coordination saves time and costs, and all the more, ensures that diverse proceedings against different group entities do not result into divergent directions.

The procedural coordination may involve coordination among different judicial or adjudicating bodies as well. As we have noted elsewhere, one of the landmark examples of judicial coordination was the insolvency of BCCI. Cross-border judicial coordination, with the jurisdiction of the “center of main interests” (COMI) taking the main role, is key theme of UNCITRAL recommendations.

In procedural coordination or consolidation, the assets and liabilities of different entities remain distinct – there is no pooling of thereof.

Procedural consolidation shall also be distinguished from joint application for commencement of proceedings against entities fulfilling commencement standards.

Substantive Consolidation

Substantive consolidation is perhaps the most radical remedy for group insolvency, seeking to pool the assets and liabilities of a group of entities. Highlighting the rare success of substantive consolidation in insolvency proceedings, *Goode* says: “(Treating a group as a single economic enterprise for insolvency purposes) is not easy to achieve, even if limited to procedural consolidation, which would treat the member of the group as one for the purpose of administration, while keeping the assets and liabilities separate. It is harder still, in policy terms, to effect substantive consolidation, involving the pooling of assets and liabilities, for this interferes with the existing rights of creditors, in particular creditors of a group member having substantial assets who can legitimately argue that they dealt with that member and should not have their position impaired by consolidation of assets and liabilities with less well-placed members of the group... It is only infrequently that English courts will be willing to pierce the corporate veil. It is rarer still to consolidate assets and liabilities.”⁹⁷ US courts are far more receptive to the use of such powers, but in the USA as well, courts have called it “rough justice”⁹⁸.

The acceptability of an appeal for substantive consolidation continues to oscillate over time. However, as corporates become increasingly driven by group level governance, courts cannot be insulated from the reality, and where appropriate, courts may be open to use the power to consolidate.

To quote from UNCITRAL Legislative Guide, vol 3:

⁹⁷ *Goode on Principles of Corporate Insolvency Law*, Fifth edition, page 30

⁹⁸ In *Owens Corning*, 419 F.3d 195 (3d Cir. 2005) it was stated: “Indeed, because substantive consolidation is extreme (it may affect profoundly creditors' rights and recoveries) and imprecise, this “rough justice” remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies (for example, the possibility of more precise remedies conferred by the Bankruptcy Code)”.

Entity vs. Enterprise

Notwithstanding the absence of direct statutory authority or a prescribed standard for the circumstances in which substantive consolidation orders can be made, the courts of some jurisdictions have played a direct role in developing these orders and delimiting the appropriate circumstances. While this practice may reflect increased judicial recognition of the widespread use of interrelated corporate structures for taxation and business purposes, the circumstances that would support a substantive consolidation order are, nevertheless, very limited. They include situations where there is a high degree of integration of the operations and affairs of group members, through control or ownership, that would make it very difficult, if not impossible, to disentangle the assets and liabilities of the different group members in order to identify, for example, ownership of assets and the creditors of each group member, without significant expenditures of time and resources that would ultimately hurt all creditors.⁹⁹

Before proceeding further, the elusive difference between commonly used phrase “lifting or piercing the corporate veil” and “substantial consolidation” needs to be noted. Lifting or piercing of corporate veil, another substantive power of courts, is used in variety of circumstances to eliminate the veil of incorporation and treat a company and its owners, or a company and its owned entities, as one. There has been a long line of rulings where English courts have used this power, and recently, the UK Supreme court opted for a so-called principled approach for such lifting, piercing, or side-stepping¹⁰⁰. There is usually no intent of consolidation of liabilities in case of lifting or piercing of corporate veil, as that would not have been the intent in most cases.

On the other hand, in substantive consolidation, there will be pooling of assets as well as liabilities. Therefore, both the assets and liabilities get consolidated, and inter-company balances between the group entities get eliminated. This is the same process that happens in accounting consolidation¹⁰¹. While the liquidation estate gets merged into a larger pool, the priorities of creditors who may have made loans to different entities in the group may not be disturbed – this may be appropriately dealt with by the adjudicating body. After all, the idea of substantive consolidation is to benefit the creditors generally, without causing detriment to any.

Cross Border angle in Group Insolvency

The issue of insolvency of enterprise groups is most relevant for larger corporates, many of whom have global presence. Hence, in most such group insolvency matters, there are cross borders issues.

UNCITRAL 53rd session is reportedly working on a legislative draft of cross border insolvency of enterprise groups.

The draft legislative provisions on facilitating the cross-border insolvency of enterprise groups framed by UNCITRAL¹⁰² talk about development of a “group insolvency solution” for the whole or part of an enterprise group and cross-border recognition and implementation of that solution in multiple States. The objective is protection and maximization of the overall combined value of the operations and assets of enterprise group members affected by insolvency **and** of the enterprise group as a whole.

A “group insolvency solution” has been defined to mean a set of proposals developed in a “planning proceeding” for the reorganization, sale, or liquidation of some or all of the operations or assets of one or

⁹⁹<https://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part3-ebook-E.pdf>, p. 60

¹⁰⁰*Prest v Petrodel Resources Ltd* [2013] 2 AC 415

¹⁰¹Lord Denning's often cited quote on lifting/piercing of corporate veil was inspired by preparation of group accounts - *DHN Food Ltd vs Tower Hamlet* [1976] 1 WLR 852

¹⁰²<https://undocs.org/en/A/CN.9/WG.V/WP.158>,

more enterprise group members, with the goal of preserving or enhancing the overall combined value of the group members involved.

The expression “planning proceeding” has been defined in the context of COMI (centre of main interests) – a planning proceeding is an insolvency proceeding commenced in respect of an enterprise group member **at its centre of main interests**, provided that following conditions are fulfilled – (i) one or more enterprise group members are “participating” in such proceeding for the purpose of developing and implementing a group insolvency solution, (ii) the subject enterprise group member is a necessary and integral part of that group insolvency solution, and (iii) a group representative has been appointed (who can be a person or a body, including interim one, authorised to act as a representative of a planning proceeding).

Note that “participation” refers only to the right to appear, make written submissions and be heard in that proceeding on matters affecting the other enterprise group member’s interests and to take part in the development and implementation of a group insolvency solution. Such participation is voluntary and subject to the prohibition, if any, imposed by the court if the other enterprise group members has its COMI in another jurisdiction.

Once the conditions as above are met, and the proceeding becomes a planning proceeding, the group representative is authorised to –

- (i) seek **relief** (refer Article 13) in this State to support the development and implementation of a group insolvency solution;
- (ii) act in a foreign State and seek **recognition** of the planning proceeding (by way of an application, refer Article 14) and **relief** (provisional or otherwise, refer Articles 15,17) to support the development and implementation of the group insolvency solution;
- (iii) **participate** in a foreign proceeding relating to an enterprise group member participating or not participating in the planning proceeding.

“Relief” as used in the articles above, generally refer to moratorium provisions, imposing stay on execution against assets of the enterprise group member, suspending the right to transfer, encumber the assets, staying commencement of isolated actions, etc. Relief under Article 13 (available to a planning proceeding) may be granted by the court on the request made by the group representative. Such relief may not be granted in respect of assets/operations (located in the State) of a **participating** enterprise group member, **not subject to insolvency proceedings**. Also, where the assets/operations (located in the State) **belong to an enterprise group member having COMI in another State**, the relief can only be granted to the extent **not interfering with the administration of insolvency proceedings taking place in that State**. Similarly, relief may be refused under Articles 15, and 17 (dealing with provisional relief/relief which may be granted on application for recognition of or actual recognition of a foreign planning proceeding), if the relief would interfere with the administration of an insolvency proceeding taking place in the COMI of an enterprise group member participating in the planning proceeding.

As indicated, once a planning proceeding is recognised, the group representative may “participate” in any proceeding under the insolvency law of the enacting State concerning enterprise group members that are participating in the planning proceeding.

Entity vs. Enterprise

Presently, the insolvency jurisdiction of English Courts is derived from EU Insolvency Regulation¹⁰³, the UNCITRAL Model law on Cross-Border Insolvency (as imbibed in the Cross-Border Insolvency Regulations, 2006¹⁰⁴), and in general the Insolvency Act, 1986.

Chapter V of the EU Regulations deals with insolvency proceedings of members of a group of companies (which, by definition means a parent undertaking and all of its subsidiaries). The EU Regulation makes provisions for cases where insolvency proceedings falling within the scope of the Regulation are opened in relation to two or more members of a group of companies in more than one Member State. These provisions are however for the most part focused on enhancing co-ordination between the proceedings; **they stop short of consolidation, either substantive or procedural** – see *Goode*¹⁰⁵. The EU regulations facilitate “group coordination proceedings” (refer Article 61), however, the same is voluntary the insolvency practitioner has been given the right to object to their participation in the proceedings within a specified time period. In order to open group coordination proceedings, the court must be satisfied that the opening of such proceedings is appropriate to facilitate the effective administration of the insolvency proceedings relating to the different group members, no creditor of any group member expected to participate in the proceedings is likely to be financially disadvantaged by the inclusion of that member in such proceedings; and the group coordinator fulfils the requirements laid down under the regulations. Interestingly, the “group coordination plan”, that is, “a plan that identifies, describes and recommends a comprehensive set of measures appropriate to an integrated approach to the resolution of the group members' insolvencies”, shall **not include recommendations as to any consolidation of proceedings or insolvency estates**.

Precedents in Global Jurisdictions and in India

In re Owens Corning, 419 F.3d 195, 210 (3d Cir. 2005), the United States Court of Appeal, Third Circuit, discussed “subtle differences” among various remedies –

““Piercing the corporate veil” makes shareholders liable for corporate wrongs. Equitable subordination places bad-acting creditors behind other creditors when distributions are made. Turnover and fraudulent transfer bring back to the transferor debtor assets improperly transferred to another (often an affiliate). **Substantive consolidation goes in a direction different (and in most cases further) than any of these remedies**; it is not limited to shareholders, it affects distribution to innocent creditors, and it mandates more than the return of specific assets to the predecessor owner. **It brings all the assets of a group of entities into a single survivor. Indeed, it merges liabilities as well.** “The result,” to repeat, “is that claims of creditors against separate debtors morph to claims against the consolidated survivor.” *In re Genesis Health Ventures*, 402 F.3d at 423. The bad news for certain creditors is that, instead of looking to assets of the subsidiary with whom they dealt, they now must share those assets with all creditors of all consolidated entities, raising the specter for some of a significant distribution diminution.”

As to substantive consolidation, the US Court noted, “Substantive consolidation, a construct of federal common law, emanates from equity. It “treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated

¹⁰³Regulation (EU) 2015/848, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32015R0848>

¹⁰⁴<https://www.legislation.gov.uk/ukxi/2006/1030/contents/made>

¹⁰⁵Pg. 31.

survivor.” *Genesis Health Ventures, Inc. v. Stapleton* (In re Genesis Health Ventures, Inc.), 402 F.3d 416, 423 (3d Cir.2005).

However, “Prior to substantive consolidation, other remedies for corporate disregard were (and remain) in place. For example, where a subsidiary is so dominated by its corporate parent as to be the parent’s “alter ego,” the “corporate veil” of the subsidiary can be ignored (or “pierced”) under state law. Kors, supra, at 386-90 (citing as far back as I. Maurice Wormser, *Piercing the Veil of Corporate Entity*, 12 Colum. L.Rev. 496 (1912)). Or a court might mandate that the assets transferred to a corporate subsidiary be turned over to its parent’s trustee in bankruptcy for wrongs such as fraudulent transfers, Kors, supra, at 391, in effect bringing back to the bankruptcy estate assets wrongfully conveyed to an affiliate. If a corporate parent is both a creditor of a subsidiary and so dominates the affairs of that entity as to prejudice unfairly its other creditors, a court may place payment priority to the parent below that of the other creditors, a remedy known as equitable subordination, which is now codified in § 510(c) of the Bankruptcy Code. See generally id. at 394-95.”

US Bankruptcy Rule 1015 provides for order for joint administration of estates in cases involving two or more related persons, that is if a joint petition or two or more petitions are pending in the same court by or against a debtor and an affiliate. Notes to the said rule clarify that –

“This rule does not deal with the consolidation of cases involving two or more separate debtors. Consolidation of the estates of separate debtors may sometimes be appropriate, as when the affairs of an individual and a corporation owned or controlled by that individual are so intermingled that the court cannot separate their assets and liabilities. Consolidation, as distinguished from joint administration, is neither authorized nor prohibited by this rule since **the propriety of consolidation depends on substantive considerations and affects the substantive rights of the creditors of the different estates**. For illustrations of the substantive consolidation of separate estates, see *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941). See also *Chemical Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966); Seligson & Mandell, *Multi-Debtor Petition—Consolidation of Debtors and Due Process of Law*, 73 Com.L.J. 341 (1968); Kennedy, *Insolvency and the Corporate Veil in the United States in Proceedings of the 8th International Symposium on Comparative Law* 232, 248–55 (1971).”

Different standards have been employed by courts to determine the propriety of substantive consolidation.

In [*Union Savings Bank v. Augie/Restivo Baking Co., Ltd.*](#) (In re Augie/Restivo Baking Co., Ltd.), 860 F.2d 515, 518 (2d Cir. 1988), concluded that the factual elements considered by the courts to determine whether equitable treatment will result from substantive consolidation are “merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, ... **or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.**”

In [*Eastgroup Properties v. Southern Motel Assoc., Ltd.*](#), 935 F.2d 245 (11th Cir. 1991), the Eleventh Circuit adopted a modified version of the standard articulated by the District of Columbia Circuit in *Drabkin v. Midland Ross Corp.* (In re Auto-Train Corp., Inc.), 810 F.2d 270, 276 (D.C. Cir. 1987). According to this standard: (i) the proponent of consolidation must demonstrate that there is substantial identity between the entities to be consolidated and that consolidation is necessary to avoid some harm or to realize some benefit; and (ii) a creditor may object on the grounds that it relied on the entities’ separate credit and will

Entity vs. Enterprise

be prejudiced by consolidation, in which case the court can order consolidation only if it determines that the benefits of consolidation "heavily" outweigh the harm.

Also, in *In re Owens Corning* (*supra*), the court also discussed the principles which may be instrumental in assessing whether to order substantive consolidation, and encapsulated thus, "In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."

The approach of Indian courts in matters of insolvency or winding up towards group insolvency is a largely unexplored territory. There is no noticeable trend where, in matters of winding up, courts have used consolidation, or even lifting or piercing of corporate veil, aggressively. There are matters where winding up may have been ordered under the so-called "just and equitable" power under the Companies Act, but that is more for reasons other than insolvency.

In *Life Insurance Corporation of India v. Escorts Ltd. & Ors.*, (1986) 1 SCC 264, the Supreme Court observed,

"Generally and broadly speaking, the corporate veil may be lifted where a statute itself contemplates lifting the veil or fraud or improper conduct is intended to be prevented or a taxing statute or **a beneficial statute is ought to be evaded or where associated companies are inextricably connected as to be in reality, part of one concern.** It is **neither necessary nor desirable to enumerate the classes of cases where lifting the corporate veil is permissible**, since that must necessarily depend on the relevant statutory or other provisions, the object sought to be achieved, the impugned conduct, the involvement of the element of the public interest, and **the effect on the parties who may be affected, etc.**"

In *DHN Food Distributors Ltd. v. London Borough of Tower Hamlet* [(1976) 3 All ER 462] the Court of Appeal was dealing with three companies, out of which one was the holding company and the other two were its subsidiaries. After quoting the views of Prof. Gower that "there is **evidence of a general tendency to ignore the separate legal entities of various companies within a group, and to look instead at the economic entity of the whole group**" Lord Denning, M.R. has observed : "This group is virtually the same as a partnership in which all the three companies are partners. They should not be treated separately so as to be defeated on a technical point." (p. 467) In the same case, Goff, L.J. has said : "[T]his is **a case in which one is entitled to look at the realities of the situation and to pierce the corporate veil.**" (p.468) – see *New Horizons Ltd. v. Union of India*, (1995) 1 SCC 478.

In *Vodafone International Holdings BV v. Union of India*, (2012) 6 SCC 613, the Supreme Court observed –

"The question is what is the nature of the "control" that a parent company has over its subsidiary. It is not suggested that a parent company never has control over the subsidiary. For example, **in a proper case of "lifting of corporate veil", it would be proper to say that the parent company and the subsidiary form one entity.** But barring such cases, the legal position of any company incorporated abroad is that its powers, functions and responsibilities are governed by the law of its incorporation. No multinational company can operate in a foreign jurisdiction save by operating independently as a "good local citizen". A company is a separate legal persona and the fact that all its shares are owned by one person or by the parent company has nothing to do with its separate legal existence. If the owned company is wound up, the liquidator, and not its parent company,

would get hold of the assets of the subsidiary. . . . Thus, even though a subsidiary may normally comply with the request of a parent company it is not just a puppet of the parent company. **The difference is between having power or having a persuasive position.** Though it may be advantageous for parent and subsidiary companies to work as a group, each subsidiary will look to see whether there are **separate commercial interests which should be guarded.** When there is a parent company with subsidiaries, is it or is it not the law that the parent company has the "power" over the subsidiary. It depends on the facts of each case."

"Of course, in many cases the courts do lift up a corner of the veil but that does not mean that they alter the legal position between the companies. The directors of the subsidiary under their Articles are the managers of the companies. If new directors are appointed even at the request of the parent company and even if such directors were removable by the parent company, such directors of the subsidiary will owe their duty to their companies (subsidiaries). **They are not to be dictated by the parent company if it is not in the interests of those companies (subsidiaries).** The fact that the parent company exercises shareholder's influence on its subsidiaries cannot obliterate the decision-making power or authority of its (subsidiary's) directors. **They cannot be reduced to be puppets. The decisive criteria is whether the parent company's management has such steering interference with the subsidiary's core activities that subsidiary can no longer be regarded to perform those activities on the authority of its own executive directors."**

In fact, even for lifting or piercing of corporate veil, the courts have stressed that the same should be resorted to sparingly.

In [*Walnut Packaging Private Limited vs The Sirpur Paper Mills Limited and another*](#), a contention was brought before the AP High Court that a subsidiary company had become unable to pay its debts, and in view of nexus between the holding and the subsidiary, the holding company should be made liable to pay for the debts of subsidiary. Several well-known Indian rulings on the concept of lifting and piercing of corporate veil were cited. The court held: "By reading these two judgments¹⁰⁶, it becomes clear that an iota of right or obligation related to public good is essential for ignoring the corporate principle and resort to extreme device of lifting/piercing corporate veil. The principle is not available when ordering winding up of holding company for alleged default by its subsidiary." At another place, the court held: "The principle of lifting veil cannot be applied for ordering winding up of a holding company when creditor is unable to receive money from subsidiary company."

In [*Meekin Transmission Limited vs State of UP and Others*](#), the matter pertained to recovery of tax dues from the directors where the company had gone into winding up following failure of revival proceedings before BIFR. The Allahabad High court has cited a whole lot of rulings, and at the end of the day, decided not to invoke the doctrine of lifting or piercing of corporate veil to extend the liability of company on the directors.

Thus, other than abusive use of the corporate façade, it is difficult to find precedents for substantive consolidation, or something close to the same, in Indian rulings.

¹⁰⁶ Kapila Hingorani vs State of Bihar [<https://indiankanoon.org/doc/1455798/>] and Singer India Limited vs Chandra Mohan Ladha [<https://indiankanoon.org/doc/1134266/>]

Entity vs. Enterprise

Issues in Group-based Insolvency Proceedings

While majority of US courts have concluded that bankruptcy courts have the power to substantively consolidate debtor entities under section 105(a) of the US 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 US Bankruptcy Code. However, because forcing the creditors of one entity to share equally with the creditors of a less solvent entity is not appropriate in many circumstances, courts generally hold that substantive consolidation is an “extraordinary remedy” that should be used sparingly.

The Legislative Guide on Insolvency Law discusses that the insolvency law grants the courts a wide discretion to determine the liability of one or more group companies for the debts of other group companies, subject to certain guidelines, those guidelines may include the following considerations:

- (i) the extent to which management, the business and the finances of the companies are intermingled;
- (ii) the conduct of the related company towards the creditors of the insolvent company;
- (iii) the expectation of creditors that they were dealing with one economic entity rather than two or more group companies; and
- (iv) the extent to which the insolvency is attributable to the actions of the related group company.

Based on these considerations, a court may decide on the degree to which a corporate group has operated as a single enterprise and, in some jurisdictions, may order that the assets and liabilities of the companies be consolidated or pooled.

Another crucial consideration in insolvency laws is the effect of such measures on creditors. The laws shall reconcile the interests of two (or more) sets of creditors who have dealt with two (or more) separate corporate entities. These collective interests will conflict if the total assets of the combined companies are insufficient to meet all claims. In such a case, creditors of a group company with a significant asset base would have their assets diminished by the claims of creditors of another group company with a low asset base. One approach to reconcile as such is to consider whether the savings to creditors collectively would outweigh the incidental detriment to individual creditors.

As stated in the Guide, “The common principle of all regimes with laws of this type is that, for a consolidation order to be granted, the court must be satisfied that creditors would suffer a greater prejudice in the absence of consolidation than the insolvent companies and objecting creditors would from its imposition. In the interests of fairness, some jurisdictions allow for partial consolidation by exempting the claims of specific creditors and satisfying those claims from particular assets (excluded from the consolidation order) of one of the insolvent companies.” However, it should be noted that insolvency laws providing for consolidation do not affect the rights of secured creditors, **other than** possibly the holders of intragroup securities.

In [*Insolvency in a Group of Companies, Substantive and Procedural Consolidation: When and How?*](#), and [*Substantive Consolidation: A Critical Examination*](#), the authors discuss and include the following circumstances under which substantive consolidation should be granted or factors under which substantive consolidation may be requested:

- (i) there has been hindrance or fraud on creditors;

- (ii) there has been good faith creditors' reliance on the group as a whole (i.e. on the group as a consolidated enterprise);
- (iii) there has been intermingling of various corporate estates and of their accounts, if any;
- (iv) there exists difficulty in separating subsidiaries' assets and liabilities;
- (v) whole or part of the groups' companies have been grossly undercapitalised;
- (vi) a consolidated approach would facilitate a reorganisation plan;
- (vii) there are intercorporate loan guarantees or other forms of intercorporate financing;
- (viii) general failure to observe corporate formality;
- (ix) generally speaking, this would be in the interest of the creditors.

As discussed in [Eastgroup Properties v. Southern Motel Assoc., Ltd.](#), 935 F.2d 245 (11th Cir. 1991), in [In re Vecco Construction Industries, Inc.](#), 4 B.R. 407 (Bankr. E.D. Va. 1980), the court outlined the following seven factors in making prima facie case for consolidation –

- “(1) The presence or absence of consolidated financial statements.
- (2) The unity of interests and ownership between various corporate entities.
- (3) The existence of parent and intercorporate guarantees on loans.
- (4) The degree of difficulty in segregating and ascertaining individual assets and liabilities.
- (5) The existence of transfers of assets without formal observance of corporate formalities.
- (6) The commingling of assets and business functions.
- (7) The profitability of consolidation at a single physical location.”

Additional factors that could be presented in some cases include – (1) the parent owning the majority of the subsidiary's stock; (2) the entities having common officers or directors; (3) the subsidiary being grossly undercapitalized; (4) the subsidiary transacting business solely with the parent; and (5) both entities disregarding the legal requirements of the subsidiary as a separate organization. The US Court, however, stressed that, “We stress, however, that we mention the specific factors set out in Vecco, Ouimet, and elsewhere only as examples of information that may be useful to courts charged with deciding whether there is a substantial identity between the entities to be consolidated and whether consolidation is necessary to avoid some harm or to realize some benefit. No single factor is likely to be determinative in the court's inquiry.”

Making group insolvency work under the current regime in India

In several Indian insolvencies and liquidations, the need for some sort of group approach has already been felt. Recently, in [Venugopal N. Dhoot v. State Bank of India & Ors.](#), CA 1022(PB)/2018, the National Company Law Tribunal, Principal Bench, New Delhi has set a precedent by consolidating corporate insolvency resolution process matters of group companies as one to be heard by the National Company Law Tribunal, Mumbai Bench.

Entity vs. Enterprise

In many cases of liquidation as well, there are inter-connected investments and operations in different jurisdictions. In short, there is a clear necessity for adopting the enterprise approach.

The potential approaches to group insolvency may depend on the facts and the immediate objective. Some of the potential approaches and the circumstances in which these approaches may be relevant may be as follows:

During CIRP stage	
Initiation of CIRP proceedings against group entities	If the intent is to have a resolution plan for the entire group; as a part of the plan, the resolution applicant may make a proposal for consolidated group. The RP may, based on propriety of the matter, hold group CoC meetings, or at least ensure better coordination among the CoCs.
Appointment of common resolution professional	If the intent is merely to avoid overlaps in different RPs. The entities may have different CoC meetings, but the presence of common RP will ensure better coordination.
During liquidation stage	
Initiation of voluntary/compulsory liquidation against group entities by the liquidator of the parent	If the intent of the liquidator is to get the proceeds from disposal of the assets of the group entities. The liabilities of the group entities will first be settled from the assets; net assets will be paid over to the holding entity.
Change of management of group entities	If the intent of the liquidator is to plug any loss of value due to management reasons, or otherwise, take the group entities under the control of the liquidator.
Action against transfer of assets or business to group entities	If the business/assets have been transferred to subsidiaries/group entities in recent past, and the liquidator considers such transfer as not being bonafide, the liquidator may try to clawback and reverse the impact of these transactions.
Substantive consolidation	If the intent of the liquidator is consolidate the assets and liabilities, and eliminate the distinction between legal entities altogether.

Substantive consolidation in India

The provision of the Code providing an apparent sanctity to the separation of legal entities is clear; section 36 (3) (a) provides that the shares of an Indian or foreign subsidiary shall be included in the liquidation estate. Section 36 (4) (d) provides that the assets of any such subsidiary shall be excluded from the liquidation estate. Therefore, the law makes it clear that the bounds of the liquidation estate will extend to the shares of the subsidiaries, but will not piece the same to reach out to the asset of the subsidiary.

The inspiration behind such explicit provision is difficult to understand. However, it could not have been intended to negate the substantive power of an Adjudicating Authority to traverse the legal entity, where the separation is artificial. In essence, the intent of the explicit provision in the Code can only be that there will not be adventurous expeditions trying to break the citadel of legal entities. Hence, the creditors of the holding entity may only have a claim as to the shares of the holding entity. Therefore, it will require a demonstration of the artificiality of the legal entities, such that the assets may be regarded, in the true sense, to be the assets of the holding entity only. The true purport of this provision is simply to legislate what has been attained with series of rulings in the USA, such as *Owens Corning*.

The ability of the Adjudicating Authority to use the substance-over-form principle and question the separation of legal entities is not affected by this provision. In fact, in every jurisdiction, the exercise of equitable powers such as substantive consolidation is an exception to the separation of legal entity. The provisions of the Code are merely a statutory recognition of the separation of legal entity, which, in ordinary circumstances, is well understood. Under the US Bankruptcy Code, the power to order substantial consolidation has been said to emanate from a very broadly worded provision in section 105 (a) vesting the bankruptcy court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions”. If substantive consolidation better carries the intent and provisions of the Code, the court is said to have that equitable power. In the Indian law, section 60 (5) (c) of the Code empowers the Adjudicating Authority to entertain and dispose of “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 under this Code.”

Substantive consolidation is an equitable power; it will be futile to search for an equitable power in the statute. Reg 11 of the NCLT Regulations provides for inherent powers of the Tribunal to pass such orders as may be necessary to meet the ends of justice.

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ABOUT US

RESOLUTION SERVICES TEAM, VINOD KOTHARI & COMPANY

Practising Company Secretaries

Vinod Kothari & Company, company secretaries, has a vintage of over 30 years and has worked extensively in various fields of corporate laws. The firm is headed by Vinod Kothari, a known name in corporate laws and financial services, and an academician having taught corporate laws, insolvency law, and various topics in financial services in academic institutions in India, as also in several countries in the world.

Team Vinod Kothari & Company was involved in extensive comments and interaction while the Code was being drafted. At various stages of rule-making, we have been actively involved in discussions with the regulators as well.

Vinod Kothari and Sikha Bansal's commentary over the Code ([see here](#)) running over 2000 pages, was published almost immediately after the enactment of the Code, and was among the forerunner commentaries on the subject. The foreword to the Book was written by Dr M S Sahoo himself.

Vinod Kothari got registered as insolvency practitioner, to gain practical insights into insolvency resolution and liquidation. Currently, our team has undergone all relevant stages of insolvency and bankruptcy – interim insolvency professional, resolution professional, liquidator, voluntary liquidator, adviser to several liquidators and insolvency professionals, and arguing counsel in litigation pertaining to the Code.

Our team, based on Kolkata, Mumbai and Delhi, consists of company secretaries, chartered accountants, lawyers, and other qualified professionals.

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- Rudyard Kipling

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