CONCERNS ON GOING CONCERN:

PROPOSED AMENDMENTS IN LIQUIDATION REGULATIONS NEED RELOOK

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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.

"The key objective in GCS may be preservation of contractual and intangible assets."

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 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 if 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.

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."

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:

"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?