SCHEMES OF ARRANGEMENT IN LIQUIDATION: A NEW RAY OF HOPE

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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?

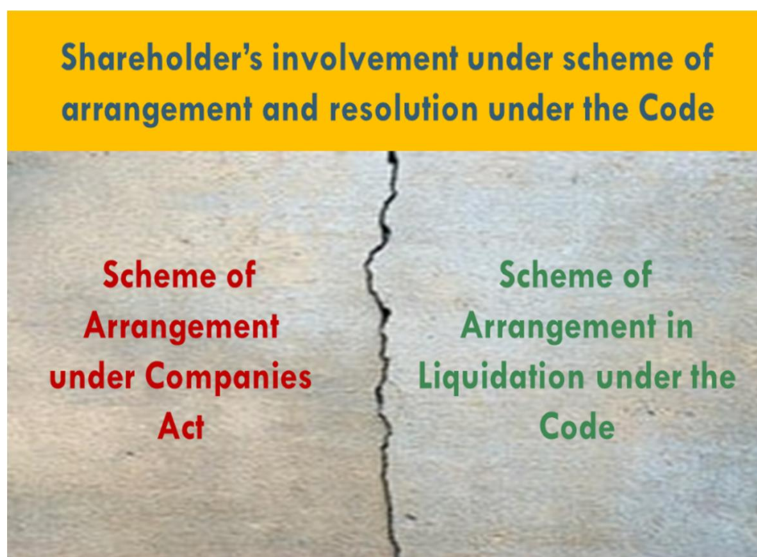
Another major question is: unlike the erstwhile Companies Act, 1956 regime where both schemes of arrangement and winding up were to occur under the same law and before the same forum, schemes of arrangement are now under the Companies Act, and liquidation under the Code. Therefore, if a scheme of arrangement 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

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.