# USHERING OF A NEW BANKRUPTCY CODE

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***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 November2015, 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 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 shied 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.

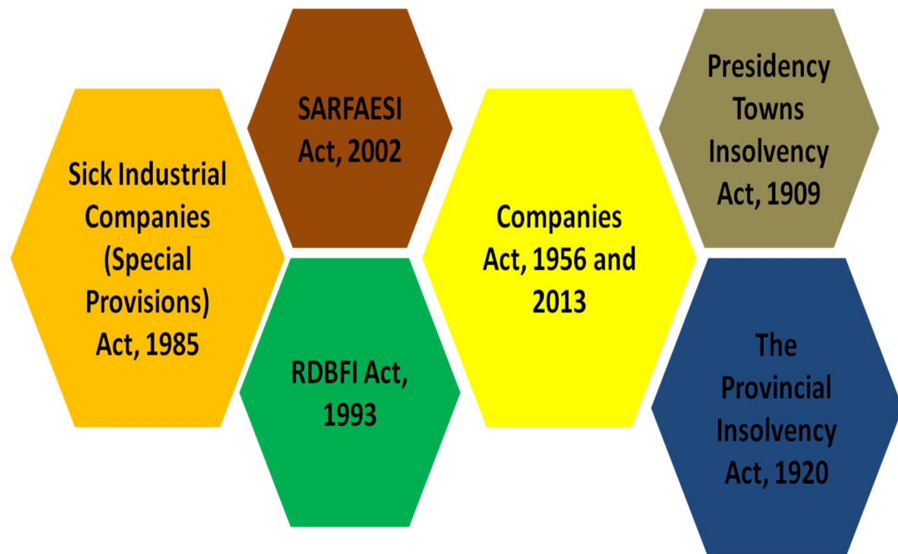


**Figure 1: Laws Governing Sickness & Insolvency**

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

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, 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.

***Observations of Eradi Committee***

- ***Avg. time taken for winding up in India- 11 years***
- ***Avg. time to resolvebankruptcy in Eastern Region- 25 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 JIrani 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 ofapplicability**

- 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

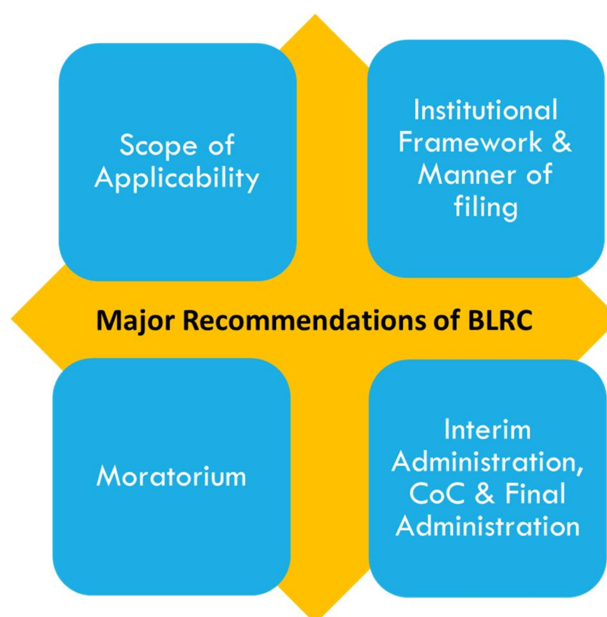


**Figure 2: Major Recommendations of BLRC**

- 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 CompaniesAct,etc.,whichmaybeeventuallyresolved.

– **Manner of filing for bankruptcy in case of corporatepersons**

- The "corporate insolvency resolution process" may be initiated onapplication 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

- 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:** theseprovisions 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 distributedby 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 balancesheet of the corporate debtor: this issue will continue to cause confusion as it relies on accounting principles which are quite often

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