

Conundrum around Pre-packs for Larger Corporates

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Introduction

- In the year 2021, the President of India promulgated an ordinance^[1] under Article 123 of the Constitution of India bringing into effect a completely new process for insolvency resolution which is the Pre Packaged Insolvency Resolution Process (PPIRP).
- PPIRP is a restructuring methodology that enables creditors and debtors to come to an informal agreement before submitting it for approval. It is a non-formal arrangement for the resolution of a stressed company's debt by an agreement between creditors and the debtor, without initiating the formal insolvency procedures. In the UK and Europe, this insolvency resolution mechanism is already in existence for a longer period of time.
- Originally, this mode of insolvency resolution was extended to only Micro, Small and Medium Enterprises (MSMEs) which is defined under Section 7(1) of the MSME Development Act, 2007. However, PPIRP failed to gain traction in the market as very few cases^[2] were admitted under this mechanism.
- The PPIRP is yet once again is into the discussion as the recent MCA discussion paper recommending amendments to the Insolvency & Bankruptcy Code, 2016 has proposed to extend the concept to larger corporates also. In this article, we have tried to critically analyze the effect of such an extension.

What makes PPIRP suitable for Large Corporates?

- Time & cost-effective
 - Around 64% of cases under CIRP are going on for more than 270 days.^[3] Further, 553 CIRPs that have yielded resolution took an average of 473 days^[4] for resolution. The delays are also exacerbated by slow judicial processes at various stages of the process.
 - In view of these issues, PPIRP offers speed in the process thereby upholding one of the objectives of IBC viz. **Time-bound resolution**. Reduction in timelines also leads to a reduction in cost.
- Higher Recovery Rate
 - The recovery rate in OECD and other emerging countries where PPIRP or similar mechanisms are in place is 70% to 80%, whereas in India it is around 45%.^[5] One reason could be the limited application of PPIRP in India. So, it is imperative that we should enforce PPIRP on large corporates to enhance recoveries.
- Appropriate for systemic or genuine failures
 - PPIRP provides a less disruptive debtor-in-possession model which gives a chance to CD which becomes stressful due to systemic or genuine business failures. By providing a chance to genuine corporate debtors, PPIRP helps in furthering one of the objectives of IBC which is **to promote entrepreneurship**.
- Preservation of Goodwill

- PPIRP facilitates closed-door negotiations avoiding media attention. Publicity around insolvency can hurt the prospects of a resolution for the corporate debtor. PPIRP helps in the preservation of goodwill and aids in the **value maximization** of CD which is one of the core objectives of IBC.
- Group Resolution
 - The resolution of a group of companies can be value-adding when compared to a separate insolvency proceeding for each company of the group. In most jurisdictions due to the absence of any suitable mechanism to effectively deal with the insolvency of a group of companies, pre-packs have proved to be very effective. According to research, the pre-pack sale of an enterprise group to a single purchaser has resulted in a successful resolution in around 72% of the cases.
- Supported by international and domestic financial institutions
 - IMF in its report titled Orderly & Effective Insolvency Procedures (1999)^[6] has supported a similar framework.
 - Principle B4.2 of World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes talks about the benefits of pre-negotiated agreements for insolvency resolution.^[7]
 - UNCITRAL Legislative Guide has also voiced its support of pre-packs.
 - Recently, RBI's Depute Governor M Rajeshwar Rao has disseminated opinions in favor of the extension of PPIRP to all corporates.^[8]

Risks & Constraints

- Extrapolation of challenges faced by MSMEs to large corporates
 - Bankers are risk-averse and are not comfortable initiating PPIRP due to voluntary haircuts. There is a fear among bankers that such a decision might be scrutinized later and they will be held liable for the same.^[9]
 - Solution: Suitable alterations can be adopted before applying PPIRP to large corporates. Further, ARCs can ease the hesitancy on the part of banks.
- Lack of transparency
 - Since PPIRP includes closed-door negotiations, there is an inherent risk of opacity in decision-making.
 - However, India has incorporated certain safeguards to promote transparency like the swiss challenge and mechanisms to prevent the phenomenon of phoenixing. Phoenixing is an act of bringing a firm into an insolvency procedure while transferring its assets to a new company that is partially or entirely controlled by the prior management. It is done to avoid paying unsecured creditors.^[10]
- Lack of awareness about PPIRP
 - 51% of MSMEs are situated in rural areas and are unaware of the nuances of PPIRP.^[11] Consequently, it limits the reach of PPIRP.
 - Solution: IBBI and other bodies should engage in awareness drives in association with organizations like FICCI, ASSOCHAM, etc.
- Lack of internal policy and framework in banks
 - The decision by a bank to pursue either PPIRP or CIRP often turns out to be discretionary due to lack of internal policy. Therefore, by default CIRP becomes the natural choice for bankers.
 - Solution: Banks should consider formulating policies based on quantitative analysis.

- Verification of list of claims
 - One of the significant peril of pre-packaged insolvencies is the reliability of the list of claims. Typically, PPIRP is commenced relying on the information provided by the debtor, and this includes a complete list of claims. In such a case, verification of complete claims would be entirely incompatible with the swiftness required to implement the resolution plan envisaged under PPIRP.
 - Solution: There is a need to leverage technological infrastructure to expedite claim verification.

Conclusion

- In light of the arguments and ideas discussed above in respect of the extension of PPIRP to large corporates, it will be prudent to take steps cautiously after analyzing the current pitfalls in the PPIRP mechanism. Extensive empirical studies must be undertaken to understand the reason behind the poor adoption of PPIRP in cases of MSMEs before extending it to all corporate debtors. Otherwise, haphazard implementation has the risk of abuse of this tool.
- As emphasized by Dr. M.S. Sahoo, *“An economic law is essentially empiric, and it evolves continuously through experimentation. IBC is no exception. Therefore, I do not rule out the possibility (of a pre-pack scheme for big companies), but it is too early to think about it before experiencing how it pans out for MSMEs.”*^[12]

Reference

^[1] https://www.mca.gov.in/Ministry/pdf/IBCamedOrdinanceBill_06042021.pdf (Ordinance)

^[2] As per IBBI Newsletter only 4 cases have been admitted as on 31st Dec, 2022.

^[3] IBBI Quarterly Newsletter (Oct-Dec 2022)

^[4] IBBI Quarterly Newsletter (Jul-Sep 2022)

^[5] “Pre-Pack Insolvency Resolution Process: Judiciously Strengthening IBC in Times of Crisis” by Vellayan Subbiah and Pranay Mehrotra, Quinquennial.

^[6] <https://www.imf.org/external/pubs/ft/orderly/>

^[7] <https://thedocs.worldbank.org/en/doc/538701606927038819-0130022020/original/ICRStandardJan2011withC1617.pdf>

^[8] <https://www.thehindubusinessline.com/money-and-banking/extend-pre-pack-insolvency-resolution-process-to-all-borrowers-rbis-m-rajeshwar-rao/article65389562.ece>

^[9] <https://www.livemint.com/politics/policy/why-pre-pack-insolvency-failed-to-find-takers-11663531286274.html>

^[10] <https://www.lexisnexis.co.uk/legal/glossary/phoenixing#:~:text=What%20does%20Phoenixing%20m>

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^[11] MSME Annual Report 2022-23. Available at <https://msme.gov.in/sites/default/files/MSMEANNUALREPORT2022-23ENGLISH.pdf>

^[12] <https://www.financialexpress.com/industry/ibbi-hints-at-pre-pack-scheme-for-large-firms/2302882/>

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