Prepacks: Debtor-in-Possession or Debtor-as-Protectorate?

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The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021 (“Ordinance”), was promulgated on 4th April, 2021; providing a scheme for pre-packaged insolvency resolution process (“PIRP”) of Micro, Small and Medium Enterprises (“MSME’s”). The framework has been introduced as an alternative scheme of stress resolution, which while being as efficacious as the Corporate Insolvency Resolution Process under the Insolvency and Bankruptcy Code, 2016 (“Code”); is also quicker, cost-effective, value maximising and causes the least amount of disruption to MSME’s. This article tries to analyse, how far the provisions of the Ordinance may be successful in doing so, whether the Debtor-in-Possession model has been adopted in its true spirit by the ordinance or not; and whether it offers enough incentive to managements of corporate debtors to initiate a pre-pack process.

The foundation of this framework was laid down by the Sub-Committee of the Insolvency Law Committee (“Sub-Committee”) in its report on Pre-packaged Insolvency Resolution Process. The Sub-Committee had, after detailed discussions and multiple rounds of deliberations, concluded that prepacks are a viable form of alternative insolvency resolution process in the Indian context and therefore strongly recommended the introduction of a framework for prepacks in India, while also suggesting the philosophy and features on which the same could be designed. However, the sub-committee was mindful of the relatively new nature of prepacks and the consequent dangers its implementation may pose and therefore suggested the experimentation of a prepack framework in a controlled regulatory sand box environment, before introducing it in a full-fledged manner.

Another recommendation of the Sub-Committee was with regard to the design of the prepack framework. The Sub-Committee had recommended that a Debtor-in-Possession model (“DIP”) be followed for prepacks, as while making the process simpler and easy to complete, it would also allow the Corporate Debtor (“CD”) to function at an optimal level, during the process, thereby causing the least disruption to its business. In pursuance of this recommendation, the Ordinance provides for a DIP model, which is evident on a bare perusal of Section 54H(a) of the Code. This section provides that, during the PIRP:

1. The management of the CD shall remain with the Board of Directors or Partners of the CD;
2. The Board of Directors or Partners shall make every endeavour to preserve the value of the property of the CD and manage it as a going concern; and
3. The promoters, members and personnel of the CD shall continue to exercise and discharge their rights and obligations.
While it does prima facie seem like the Ordinance has adopted the DIP model, a more careful perusal of the Ordinance, brings forth some inconsistency, between the idea of the DIP model and the way it has been sought to be implemented. In this regard, notice must be taken of the provisions of Section 54A(2)(e), 54A(3), 54J and 54K(4) of the Ordinance and Regulation 50(2) of the Insolvency and Bankruptcy Board of India (Pre-Packaged Insolvency Resolution Process) Regulations, 2021[viii] (“PIRP Regulations”).

The provisions pointed above, lay down a scheme which only prove that the entire PIRP, including its initiation and completion, is marred with the control of creditors. Section 54A(2)(e)[ix] read with Regulation 14[x] of the PIRP Regulations, provides that before initiating the PIRP, the name of the Insolvency Professional (“IP”), who may act as the Resolution Professional (“RP”), shall be suggested by Unrelated Financial Creditors (“UFC’s”) of the CD, to whom at least 10% of the value of total financial debt is owed; and the said name must be approved by UFC’s to whom at least 66% of the value of total financial debt is owed. The CD shall be barred from filing the application for initiating PIRP, unless the name of the RP has been agreed to, following the said procedure.

Another Section showing the predominant control of the creditors on the process is Section 54A(3)[xi], which prescribes that even after fulfilling all requirements under Section 54A(2), the CD shall take approval of its UFC’s to whom at least 66% of the value of total financial debt is owed, before filing an application for initiating PIRP.

While Sections 54A(2) and 54A(3) tell us of the control exercised by creditors before initiating the PIRP, Section 54J,[xii] goes one step further in this direction by placing the “Sword of Damocles” over its neck during the entire process. It provides that at any point of time during the PIRP, the Committee of Creditors (“COC”) shall be empowered to vest the management of the CD with the RP, by passing a resolution to do so, with approval of at least 66% of its voting share. An application in this regard may then be filed to the Adjudicating Authority (“AA”), who shall, if satisfied that either the affairs of the CD have been conducted in a fraudulent manner or there has been gross mismanagement of the affairs of the CD, pass an order vesting the management of the CD with the RP.

While this provision may not prima facie come across as one providing the creditors with an overwhelming amount of control over the process; the possibility of its misuse or exploitation cannot be ruled out altogether. It is the “Sword of Damocles” hanging over the neck of the management of the CD, which keeps reminding them that in the event, the creditors do not agree to their proposals, they might keep passing such resolutions and file applications for vesting its control with the RP. Even considering the possibility that all such resolutions and applications are dismissed by the AA, it would have the effect of frustrating the process, as a major chunk of the extremely brief time limit of 90 days[xiii] for completion of the process would be wasted in dealing with such applications and therefore hardly any time would be left to complete the process.

Section 54K(4) of the Code,[xiv] further provides that the COC may approve the Base Resolution Plan (“BRP”) submitted by the CD, if it does not impair the claims of the Operational Creditors (“OC’s”), which means the COC is empowered to not approve the BRP submitted by the CD, even if the rights of
the OC are protected. However, the recommendation of the Sub-Committee in this regard explicitly provided that a BRP shall be put to challenge only when it impairs the OC’s, and not otherwise. [xvi] Even if the recommendation is not considered for a moment, the choice of not approving a BRP which protects the claims of all OC’s has the effect of disincentivising the CD. The management of the CD will be aware, that no matter how good a plan they submit, it can always be put to challenge by the COC, and there is a very bleak possibility that they might at the end of the process still be in control of their enterprise.

The last straw that would break the proverbial camel’s back, here is the provision contained in Regulation 50(2)[xvii], which puts the CD under an obligation to take the approval of the COC for any action, which though not covered under Section 28 of the Code, is still prescribed to be not proceeded with in the absence of such approval, by the COC; or for transactions exceeding such amounts as may be prescribed by the COC. This provision, in effect states that it is not merely the PIRP process but also the continuation of the business of the CD, which is being driven and controlled by the creditors.

In light of the foregoing analysis, it can be stated that the high level of creditor control seems to treat the CD as a dominion or protectorate of its creditors. This protectorate status does not seem very encouraging for the management of the CD, as retaining control over their enterprise was the only incentive they were being provided with, in the framework, and taking that away from them might result in the framework being unable to produce expected results, due to lack of CD’s who would willingly participate in a PIRP. On the other hand, due to this uncertainty regarding the control over the enterprise, the management of a defaulting CD would rather unsurprisingly explore alternative debt restructuring mechanisms available to them, rather than opting for a PIRP.

The current prepack framework, which draws so heavily on the CIRP framework is essentially “old wine in a new bottle”. The PIRP framework may have been designed in such a stringent and creditor-controlled manner because of India’s previous experience with the Sick Industrial Companies Act, which was grossly misused by unscrupulous promoters[xvii] with a view to defraud their creditors. While the apprehensions of such unscrupulous promoters going the SICA way again are not completely unjustified or unfounded, the framework should have been formulated in a more hopeful manner, and in line with the more advanced insolvency ecosystems, like the ones in the United States of America[xviii] and Canada[xix], where instead of the creditors being in a controlling position, the existing management remains in control of the CD and drives the entire process while being in-charge of its day-to-day activities. We could also perhaps take lessons from the UK in this regard, which has recently taken steps to overhaul its insolvency framework from a Creditor-in-Control model to a Debtor-in-Possession model.[xx]

In conclusion, the DIP model laid down by the Ordinance, is half-hearted and rather becomes a DAP (Debtor-as-Protectorate) model. It must be noted that such a model is highly unlikely to succeed, especially because managements would hardly ever be willing to risk their control over the enterprise by entering into a PIRP, at least under the current framework. The PIRP framework, therefore can be much more successful and well received if it whole-heartedly adopted by the DIP model.
Reference:


[iv] Ibid.


[vi] Supra at 3, pg. 41.

[vii] Section 54H(a) of the Insolvency and Bankruptcy Code, 2016. Introduced by The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021.


[x] Regulation 14 of the Insolvency and Bankruptcy Board of India (Pre-Packaged Insolvency Resolution Process) Regulations, 2021.

[xi] Section 54A(3) of the Insolvency and Bankruptcy Code, 2016. Introduced by The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021.


[xv] Supra at 3, Pg. 53, Para 3.73.

[xvi] Regulation 50(2) of the Insolvency and Bankruptcy Board of India (Pre-Packaged Insolvency Resolution Process) Regulations, 2021.


