Section 29A(c)- Cause Célèbre of Code

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Introduction

Until the enactment of Insolvency and Bankruptcy Code[1], Indian Insolvency regime of body corporate was pandemonium and the litigation around was a motion in commotion. Prior to this enactment insolvency resolutions were governed by various laws with numerous reliefs according to the nature of debt and commercial epithet of the part involved. Added to this profuse judicial decisions and frail institutions resulted in bankruptcy and delay of the insolvency regime.

To tackle this inconsistency in law and arduous litigation, the Insolvency and Bankruptcy Code ('Code') was enacted in 2016 consolidating all the existing laws to have a one-stop solution for any litigation that arises out of or in connection with body corporate insolvency processes. This law was aimed at making the insolvency process less laborious and economically viable arrangement. One of the main objectives of the Code was resolution through insolvency as opposed to liquidation. The law enacted didn't contain any provision that limited the parties that are actively involved in the default of debt to apply for resolution plan of resolution process of corporate debt. Such loopholes in the law lead to the abuse of law, resolution process and wrongful gain of promoters and other related parties at the loss of creditors.

This murky position in law warranted amendments to restrict the ambit of persons who can initiate corporate insolvency resolution processes. Hence, Section 29A[2] was inserted[3] to the Code with retrospective effect from November 23, 2017. Erstwhile Finance Minister and Minister of corporate affairs, Arun Jaitley while moving the Amendment bill said: "that the core and soul of the new ordinance is Section 29A which introduces grounds of ineligibility to applicants of corporate insolvency resolution plan."[4] The Second amendment[5] to the Code, effective from June 6, 2018, included major amendments to Section 29A(c). However, in due course of time, this Section became a cause célèbre.

Section 29A introduce myriads of clauses for disqualification which includes disqualification according to the Companies Act[6] and SEBI Act[7]. Disqualification of related parties of ineligible persons is also introduced through the insertion of Section 29A. Section 29A(c)[8] laws down a prohibition on persons having an NPA and persons related to such persons to apply for a corporate insolvency resolution plan.

The present paper aims to shed some light on the restriction and exception available on persons having NPA and persons related them which is laid down under Section 29A(c) ('the Section') by relying on the verbatim of the legislation, judicial pronouncements, reports of Insolvency Law Committees and available commentary.

IBC Committee Report

To gauge the effect of the IBC regime and suggest any changes, an IBC committee was established which submitted its report in March 2018.[9]

In its report, the committee among other suggestions also analysed the working of the Section.

Under the Section, a person holding an account or an account under his management or control or of which he is a promoter and such account is classified as NPA is barred from the CIRP process.

In the initial version of the relevant clause, the account would be deemed as an NPA if it had been declared so as per the guidelines released by the RBI as per the Banking Regulation Act,1949.[10] The committee observed that recognising only those NPAs which were declared so as per RBI guidelines was very limited in nature since accounts declared as NPAs by other financial sector regulators under various guidelines were included within the scope of the Section. Taking into account this anomaly, the committee suggested that the criteria under the clause must be broadened to include accounts declared as NPAs as per guidelines issued by any financial sector regulator in India, provided such guidelines have been issued under a statute.[11]

Further, the committee received suggestions that the time for holding an NPA account for the corporate debtor must be increased to three years from one year as provided under the clause NPA may have been accrued on account of market fluctuations and such fluidity usually extends over a year typically in business cycles. However, the Committee did not find enough empirical data to determine the ideal period for an NPA's existence for disqualification to occur. The Committee stated that this provision must be analysed after a few years to gauge the experience of the industry before making any amendments since there is no legal predecessor to Section 29A and hence its scope is to be determined by judicial interpretation.[12]

However, for NPAs acquired through previous CIRPs, the Committee suggested that a time limit for such NPAs must be provided since there were instances of Resolution Applicant being rejected on grounds of controlling/managing NPAs which they had acquired during previous CIRPs. It recommended a time limit of 3 years from the acquisition of NPAs from previous CIRP, which will be excused from the Section.[13]

The Committee also suggested that Financial entities be excluded from the purview of the Section due to the "nature of their business". The report recommended the exclusion of such entities from disqualification under the clause.

The suggestions made by the Committee were mostly embedded in the IBC second amendment Act, 2018. Firstly, an exception was created for financial entities under clause (c) for holding NPAs. Similarly, an exception was created for those resolution applicants with NPAs by reason of having acquired the said NPA within a period of three years before the submission of the resolution plan. The three-year period from the acquisition of the NPA was to be considered as a grace period for the applicant.

The committee had also suggested that a clarification should be made that clause (c) would be invoked to disqualify an applicant, if the applicant or its connected person, holds the NPA account on the date of the submission plan by the applicant. This position was not included in the Amendment, however, in ArcelorMittal, the Supreme court built on this position and held that the applicant or its related parties must hold the NPA when it submits the resolution plan for CIRP.

Exceptions

The original draft of Section 29A(c) was very limiting and rigid in letter and operation, closing almost all the doors for interested parties to submit a resolution application with its multi-layered restrictive mechanism. Restrictions laid down under the Section were colossal to a degree of being unreasonable and paved a path for unintended exclusions.

To address this issue of unwarranted exclusions under the Section which disqualifies certain categories of persons from submitting resolution plans under the Code, it has been recommended to streamline the Section so that only those who contributed to the default of the company or are otherwise undesirable are rendered ineligible from the bidding process.

Few exceptions were carved out in the Section to make the law more commercially viable and annihilate the problem of unintended disqualifications, taking into consideration the nature of the parties and their relation with the corporate debtor.

Clearing of NPAs

This exception i.e., removal of ineligibility by the clearing of NPA accounts finds its place as proviso to the Section. The plain wording of the proviso gives a clear impression that ineligibility can be reversed if the payment that is necessary to declassify an NPA account is made. However, the thematic complexity of the proviso enables two contradictory outcomes at the same time. One leading to the endurance of underlying objective of reducing NPAs' while the other leading to absurdities in the application and narrowing down the scope of the eligible candidate as many applicants may have acted jointly or in concert with persons whose accounts have been classified as NPAs. The only way this absurdity can be mitigated is when the potential gain of acquiring the corporate debtor for which the resolution application has been submitted far exceeds the amount accrued in the NPAs of the person with whom the applicant has acted jointly or in concert. This, however, applies to usually a small proportion of corporate debtors, thus precluding the potential applicants which undermine the purpose of the statute to prevent the corporate debtor from going into liquidation. The judicial opinion expressed in this regard further approves the legislative reasoning. In *ArcelorMittal**[14]*, the Supreme Court observed that while *"in order therefor to make the statute workable we cannot disregard the plain language of the proviso and substitute words which would have the opposite effect."*

Financial Entities

The key exception was the exemption of financial entities from related parties to the corporate debtor. The exception was recommended in the report of The Insolvency Law Committee, 2018 headed by Shri Injeti Srinivas.[15]

During consultations with the stakeholders, it was brought to the notice of the IBC Committee that considering the nature of the business that "Financial entities" (which includes scheduled banks, overseas financial institutions, Asserts reconstruction companies and investment entities such as investment vehicle and foreign investors of various strands inter alias other) are involved, it is customary to be related in one or the other way to companies of whose accounts are categorized as "NPA"(non-performing Assets). Further by the virtue of being related to such companies they will stand disqualified as per the Section. The Committee taking note of such commercial practices and mindful of NPA crisis in the country, agreed in its wisdom to exempt pure play financial entities from being hit by disqualification under Section 29A(c). However, the committee also made it pertinent

that such exemptions would not extend to companies if they are related parties to the corporate debtor.

Consequently, same has been reflected in a proviso to clause (c) of Section 29A reiterated as here under "…'*Provided further that nothing in this clause shall apply to a resolution applicant where such applicant is a 'financial entity' and is not a related party to the corporate debtor…*"

NPA acquired through previous CIRP

The second exception that the committee accepted with alacrity was in the form of a suggestion to expedite the objectives of code. It was suggested to the committee that disqualifying a resolution applicant who acquired a corporate debtor through a previous corporate insolvency resolution process (CIRP) under this code and for the sole reason has hit by disqualification under the Section. Consequently, becoming ineligible would act as a major impediment in endeavouring underlying objectives of the code. Lest intention of the legislation going into vain or evaporate in air. Hence, the committee found it fit to provide a certain leeway in time for bidding another corporate debtor without being hit by disqualification under the Section to those corporate debtors who are holding an NPA account anent procurement[16] of a corporate debtor under CIRP processes, provided they fulfil all other requirements. After lengthy deliberations in this regard, the Committee fixed the period of suspension of disqualification under the Section up to three years. Accordingly, Committee sought to insert a proviso to clause (c) of Section 29A enabling a suspension of disqualification for three years under the Section anent holding an NPA solely because of procurement of a corporate debtor through corporate Insolvency Resolution Processes. The period of suspension of disqualification starts from the date of approval of the prior resolution plan by the adjudicating authority under this code.[17]

MSMEs

The third exception was introduced by inserting Section 240A to the code taking into consideration the unique problems faced by Micro, Small and Medium Enterprises ("MSMEs") and recognizing their importance to the economy of India. Further, reference was made by the committee to the suggestions made by the World *Bank Report of MSME Insolvency****[18]*** where it suggests that MSMEs may be better served by a separate insolvency system that is specifically designed for MSMEs.[19]

The World Bank report also recommended making modifications for existing insolvency laws in place of new laws granting certain relief in from of exemptions at a preliminary position. [20]

Committee also made consultations with various stakeholders and recommended to enable the central government to carve out a certain exemption in the application of provisions to MSMEs under the code. It noted that "*illustratively, since usually, only promoters of an MSME are likely to be interested in acquiring it, the applicability of Section 29A has been restricted only to disqualify wilful defaulters from bidding for MSMEs*".

Consequently, Section 240A was worded to have a reservation excluding disqualification contained in clauses (c) and (h) of Section 29A to the resolution of corporate insolvency processes of MSMEs.

Judicial Exposition

The first issue which was raised after the insertion of the Section vide Amendment was to when is the ineligibility of the Resolution Applicant under the Section to be decided i.e., whether it was to be attached at the time of submission of the resolution plan or with the commencement of the Corporate Insolvency Resolution Process (CIRP).

ArcelorMittal Case

This issue came up in the ArcelorMittal case[21] in which the Supreme Court discussed the scope and objective of the Section vis-à-vis the ineligibility of the resolution applicant.

Brief facts of the case are that a CIRP application under Section 7 was filed by the financial creditors of Essar Steel Limited before NCLT, Ahmedabad. Two resolutions plans were submitted thereafter, one by Numetal and the other by ArcelorMittal India Private Limited ('AMIPL').

Both the resolution plans were rejected by the Resolution Professional invoking Section 29A. the resolution plan submitted by AMIPL was rejected on the grounds that it was a 'connected party' to the ArcelorMittal Netherlands BV ('AMNBV'), which was the promoter of a corporate debtor whose account was classified as a non-performing asset for more than 12 months before the CIRP began.

The other resolution plan was similarly rejected on grounds that one of Numetal's major shareholders, Aurora Enterprises was held by a person who was the daughter of the promoter of ESIL. Further, his account had been deemed as NPA before the commencement of CIRP.

The RP invited new plans and accordingly both the parties submitted their revised plans which were also rejected. Consequently, both the parties approached the Supreme Court. Two key issues were raised before the court.

Firstly, at what stage does ineligibility attach to the resolution applicant under the Section, whether it is at the submission of the resolution plan by the applicant or the start of the CIRP process.

The SC referred to Section 29A of the Code which provides at the start that "a person shall not be eligible to submit a resolution plan…". This, the court observed, implies that it is at the time of submission of a resolution plan by a resolution applicant that the stage of ineligibility gets attached, and not at the commencement of the CIRP process.

Secondly, the issue was how to determine the ambit of management or control over the corporate debtor whose account has been declared as NPA.

The court noted that the term "management" is to deemed as de jure management exercised over a corporate debtor in the context of the Section. Ordinarily, the de jure management of a corporate debtor would be held by the board of directors.

The court further observed that the term "control" is to be interpreted as per Section 2(27) of the Companies Act[22] and includes de jure and de facto control. Section 2(27) signifies a broader interpretation of control, however, for purposes of IBC, only positive control is to be considered i.e., having the power to positively influence policy decisions or management of the corporate debtor. This would not include mere power to veto resolutions that a person may exercise over a company. Thus, the principle of *noscitur a sociis* also applies here since in the expression "management or control", the two terms take words to take colour from each other.

Swiss Ribbon Constitutionality Case

In Swiss Ribbon case,[23] the constitutionality of IBC was questioned and the Supreme Court affirmed the constitutional validity of the Code. The court also discussed the One year set under the Section for classifying accounts of corporate debtors as NPAs. It was argued that the time period set was arbitrary and irrational.

The Supreme Court in its observation stated that the legislative policy follows the logic that a person, who is unable to repay its financial debts beyond the legal grace period provided to it as such, is incapable of participating in the CIRP. Therefore, excluding persons or person with related parties having NPAs from CIRP cannot be set aside. As far as the one year is concerned, the Supreme Court noted that it is a policy matter which is set as per the guidelines given by RBI and is drawn from the Master Circular issued by the RBI. During the one year after the default, an NPA is treated as a substandard asset and no ineligibility is attached during this grace period. After the one-year period subsides, the NPA is re-classified as a doubtful asset and at this point, ineligibility is attached to the NPA.

Antecedent Facts concerning ineligibility of resolution applicant

Though the relevant time for attachment of ineligibility under clause (c) is the time of submission of the resolution plan by the resolution applicant, the court can always look into antecedent facts which are reasonably proximate to the time of submission of resolution plan to decide whether the applicant is attempting to avoid ineligibility under clause (c). This would include instances where, in the reasonably proximate time period before the submission of the resolution plan, the ineligible arranges its affairs to avoid paying debts of the NPA, such person should not be allowed to submit a resolution plan. Allowing so would defeat the purpose of the Section and of the larger objective of recovering NPAs.[24]

The court also observed that one of the applicants which had sold their shares in a corporate debtor whose accounts had been classified as NPAs could not be allowed to continue in the bidding process. The court noted that all the transactions occurred after Section 29A came into force and the intent behind the transactions was to escape the application of the Section on their bid. Allowing such applicant to continue with the bidding process would defeat the intent of the Code.

Acting Jointly

In ArcelorMittal[25], the court also clarified that the expression “acting jointly’ is not similar to a “joint venture agreement”. The court will ascertain whether the persons under scrutiny got together to act “jointly” with one another. If this is shown by the facts, there is no need to look into the added element of “joint venture”.

Conclusion

Clause (c) of Section 29A is a key tenet of IBC since it co-joins the two key objectives. Firstly, to ensure that unfit and unreliable persons are not allowed to participate in the bidding process. Secondly, it creates an incentive for persons to clear their NPAs or the NPAs of the persons with whom they have acted in concert or jointly, thus allowing for recovery of NPAs and also provides a leeway for genuine bidders and MSMEs through its various exceptions.

This provision upholds the sanctity of the IBC, along with other parts of the Section, by ensuring that the CIRP is restricted to trustworthy and credible parties who can take the corporate debtor out of insolvency.

Reference

[1] The Insolvency and Bankruptcy Code, 2016 (No. 31 of 2016).

[2] Section 29(A), Insolvency and Bankruptcy Code, 2016.

[3] The Insolvency and Bankruptcy Code (Amendment) Act, 2017.

[4] Wadhwa Guide to Insolvency and Bankruptcy Code, Volume I, Edition 2018, Page 498, Part II-Chapter II.

[5] Insolvency and Bankruptcy Code (Second Amendment) Act, 2018.

[6] The Companies Act, 2013.

[7] The Securities and Exchange Board of India Act, 1992 (Act 15 of 1992).

[8] Section 29A(c), Insolvency and Bankruptcy Code, 2016.

[9] Report of the Insolvency Law Committee, 2018.

[10] The Banking Regulation Act, 1949 (Act No. 10 of 1949).

[11] Para 14.7, Insolvency Law Committee (2018), at pg. 50.

[12] Para 14.8, Insolvency Law Committee (2018), at pg. 50.

[13] Para 14.4, Insolvency Law Committee (2018), at pg. 49.

[14] ArcelorMittal India Private Limited v. Satish Kumar Gupta, 2018 SCC Online SC 1733.

[15] Report of the Insolvency Law Committee (March 2018).

[16] Procurement here includes as laid down in the code, to have an account, or an account of a corporate debtor under the management of or control of such person or of whom such person is a promotor.

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[18] The World Bank Report, May 2017, can be accessed at: http://documents.worldbank.org/curated/en/973331494264489956/pdf/114823-REVISED-PUBLIC-MSMEInsolvency-report-low-res-final.pdf, accessed 09 December, 2020

[19] Pg:19; Ibid

[20] Pg:34; Ibid

[21] Ibid at 11.

[22] Section 2(27), The Companies Act, 2013.

[23] Swiss Ribbon Pvt. Ltd. v. Union of India, 2019 SCC OnLine SC 73.

[24] Supra.

[25] Ibid at 11.

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