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## Will banks adopt Pre-Pack insolvency resolution?

The Government of India has promulgated an ordinance last month, introducing provisions for pre-packaged resolution plans under IBC for Micro, Small and Medium Enterprises (MSMEs). This is an addition to the existing Corporate Insolvency Resolution Process (CIRP) under the Code.

### A unique mechanism for MSMEs:

The main feature of the new process, Pre-Packaged Insolvency Resolution Process (PPIRP), is that when a MSME unit defaults in payment of a debt, the existing promoter/management of the MSME unit is allowed to propose a Base Resolution Plan to the creditors and to NCLT to resolve their financial stress. The existing management is also allowed to continue to manage the unit during the period of insolvency resolution. This is in contrast to the existing process of CIRP in which the powers of the existing management (including the promoters) to manage the company are suspended once CIRP is initiated. In the existing CIRP, a Resolution Professional (RP) is appointed to manage the affairs of the company under the supervision of a committee of creditors and get a resolution plan. The existing promoter/management (unless an MSME) is denied an opportunity to present a resolution plan and if the CIRP is successful, the unit transfers to a new promoter. If the creditors fails to get a resolution plan from the public, the company goes into liquidation.

In the new PPIRP, there is a change in strategy from a 'creditor-in-control model' to a 'debtor-in-control model' for insolvency resolution which is expected to be suitable to MSMEs because it is a least disruptive model and will ensure the continuity of the business and preserve jobs, the MSMEs being providers of employment to sizeable population of the country.

### Will PPIRP be more effective than the normal CIRP?

PPIRP is designed to be completed in 120 days, including a period of 30 days provided for the Adjudicating Authority to approve the resolution plan. As the unit continues to be managed by the existing management under PPIRP, the cost involved in managing the unit by the RP during CIRP is also saved. As a base resolution plan is submitted to the creditors and their consent is obtained in

advance for going through the process of PPIRP, the scope for litigation is reduced substantially. The RP need not focus on running the unit and can focus only on getting the resolution plan approved by the Committee of Creditors and the NCLT. On the other hand, the advantage of having a moratorium on the other litigation is available for PPIRP also. Further the NCLT order under PPIRP is also binding on all stakeholders such as corporate debtor, its employees, shareholders, creditors, and the government departments. All these features are expected to be beneficial to an MSME while it is trying to set its house in order. The new process is expected to be a game changer in the domain of insolvency resolution.

### **How does a creditor look at PPIRP?**

The focus of the amendments/additions to IBC made through the ordinance is on how MSMEs can be facilitated more under IBC. But the question that also needs to be examined is how the creditors would receive the new process, because the success of the new mechanism would depend a lot on adoption by the creditors, especially by the banks, being important stakeholders in the insolvency resolution process.

It is important to remember that though the corporate debtor is allowed to submit a base resolution plan to NCLT under PPIRP, he can do so only if creditors with at least 66% of vote share give their consent for filing of an application under PPIRP. Also, an RP proposed by creditors and approved by creditors having 66% of the vote share can only be appointed, though the costs involved in the PPIRP are to be borne by the MSME unit. In this scenario, it is possible that new mechanism of PPIRP can be non-starter if the creditors of a unit do not see an advantage in going through the same, in preference to the conventional CIRP or in preference to other recovery mechanisms like SARFAESI Act or One-time-settlements with some concessions.

Many observers have already pointed out that PPIRP is applicable only to the corporates among MSMEs and not to the sole proprietary and partnerships concerns. This reduces its scope as a beneficial mechanism for MSMEs. It is estimated that only about 30% of the MSMEs are set up as LLPs or Companies.

One more limiting factor appears to be the requirement that an MSME has to be registered under MSME Act, 2006 to be eligible to file an application under PPIRP. As per the data of National Sample Survey 73rd Round (2015-2016), there are an estimated 6.3 crore MSMEs in the country, but there are only 26.42 lakh MSMEs registered with an Udyam Registration (through MSME registration website).

### **Will Lenders refer Going Concerns for resolution under IBC?**

Further, it is generally agreed that CIRPs under IBCs have best chances of success if the corporate debtor is a going concern. In respect of PPIRP, this is even more relevant, given the emphasis in PPIRP on the continued management of the MSME unit by the existing management and saving jobs of the employees of the unit.

When we look at CIRPs initiated since inception of IBC (in late 2016), we can see that the creditors have been using IBC only in respect of long outstanding NPAs. Though it is repeatedly asserted by IBBI and the Courts (in various judgements) that IBC is not recovery mechanism, the mindset of the majority of the lenders is still to use it as an additional mechanism for recovery after filing suits

before Debt Recovery Tribunals. As per IBBI data<sup>[1]</sup>, it is seen that out of the CIRPs which have resulted in liquidation since inception of IBC, 73.7% were earlier with BIFR<sup>[2]</sup> or were defunct. Also, only 13% of CIRPs since inception of IBC have ended with a resolution plan. Even if we assume that all the corporate debtors who got approved resolution plans under IBC were going concerns, the chances of lenders referring a going concern for resolution under IBC would be about one in ten, if past data is any indication.

### **Will the Base Resolution Plans under PPIRP have haircuts?**

This question will also have a great bearing on PPIRP being a successful mechanism. In the CIRPs completed so far, there are many success stories, but there are also any number of cases where the lenders have suffered haircuts up to 80 % of their claims. There has been a grumbling acceptance of such haircuts by the lenders in CIRPs completed so far because, as said above, most of such cases were defunct companies where expectations of recovery were very low in the first place.

But the same cannot be said of cases which would be eligible under the new PPIRP mechanism. Such cases are expected to be going concerns which are of course under financial stress but are not old non-performing assets. Further, in the cases of advances to MSMEs, the collateral cover by way of immovable properties would be higher in comparison to the large corporates going under CIRP. It follows that the value of such a unit would be higher, especially as a going concern. It is also a condition of the PPIRP that a base resolution plan proposed by the existing promoter or management may be approved by the committee of creditors (the committee comprises of only financial creditors) if it does not impair any claims owed of the operational creditors. It is to be remembered that dues such as GST dues, Income Tax dues, Provident Fund dues are also considered as dues of operational creditors and they have a lower priority for payment under IBC, as compared to the dues of financial creditors/secured creditors. Thus, it is a moot question whether the financial lenders would bear huge haircuts in such a scenario. On the other hand, a promoter of an MSME facing financial stress would not seek redressal under PPIRP unless he is sure of get maximum concessions from the lenders (including the operational creditors). In this scenario, finding an equilibrium under PPIRP satisfactory to both the lenders and the borrower would be quite a challenge.

### **PPIRP Vs Other Resolution Frameworks:**

Though the ordinance mentions the impact of Covid-19 as one of the reasons for introduction of PPIRP, it is not intended as a temporary mitigation for Covid-19 related distress. It has been introduced as an alternative insolvency resolution mechanism for the benefit of MSMEs for the long term.

But it has come in the midst of several other measure taken by the Central Government and the Reserve Bank of India which have been implemented by the banks and other lenders. RBI has already given benefits such as a moratorium on payment of instalments and interest on term loans, relaxations in the drawing power margins for working capital loans, reassessment of working capital cycles, all without any downgrade in the asset classification of an asset. The central government has also announced a Rs. 3-Lakh Crore Credit guarantee scheme for to support the MSMEs. Further, RBI has just announced that these benefits would continue in view of the second wave of Covid infections and the on-going lockdowns. The units which have already availed such benefits would have very little head room in the short term for seeking further concessions under PPIRP by way of corporate rescue in order to make them more viable and profitable than they already are.

## Support of RBI for PPIRP:

The RBI has taken several steps of its own for restructuring of stressed assets and reduction of non-performing assets. But its response to introduction to PPIRP has been muted. Though there were guidelines earlier from RBI, advising banks to adopt IBC as a primary restructuring framework for stressed assets, this focus, for whatever reasons, has slowly come down. But, if the banks and other lenders have to adopt IBC for insolvency resolution before thinking of any other recovery mechanism, which is the main objective of IBC, the efforts of IBBI have to be accompanied by supporting measures from RBI. But in the latest concessions announced by RBI also, there is no attention to the pre-packaged resolution mechanism under IBC. If IBBI and RBI operate in separate silos, the lenders, left to themselves, are most likely to focus on recovery of their dues rather than preferring a resolution of insolvency of an MSME.

This will not be in the broader interests of the economy. Thus, in order to make PPIRP realize its potential as a successful resolution mechanism, RBI could take measures such as relaxations in asset classification norms for accounts going through PPIRP, so that the lenders do not feel that their interests would be not properly served under PPIRP.

**Brief Particulars of the author:** A Qualified CFA (India) and CAIIB and an experienced professional banker with extensive experience in Corporate Credit Management. Superannuated in April 2019 from Axis Bank after serving as a Senior Vice President. Worked in reputed public sector as well as new generation private banks for almost 4 decades. Have thorough knowledge and understanding across all functions in the Bank, like Credit Management, Branch Operations and Administration of the Bank. Managed large portfolios of corporate and SME relationships (biggest portfolio was of Rs. 45000 crores of loan exposure) as Head of large specialized corporate branches. Presently, taking up assignments as Insolvency Professional, independently as well as Associate of other IPs. Authored a book titled “**Limited Insolvency Examination MCQs and Case Analysis**” published by Taxmann Publications.

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## Reference:

[1] Quarterly newsletter of Insolvency & Bankruptcy Board of India, October-December 2020.

[2] Board for Industrial and Financial Reconstruction.

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