Issues in Insolvency and Bankruptcy Code, 2016

Corporate Insolvency Resolution Process mechanism under the Insolvency and Bankruptcy Code, 2016 (IBC) is slowly but steadily gathering steam. Since its introduction in December, 2016, over 750 applications under different provisions of IBC have been admitted by various benches of National Company Law Tribunal (NCLT), the adjudicating authority. However, as is the case with any new legislation, Insolvency Professionals as well as creditors are still grappling with some of the key provisions of IBC to interpret their true import. It would therefore be desirable if the Insolvency and Bankruptcy Board of India, the regulatory authority designated under IBC, clears the air on these issues as soon as possible or amendments are made to IBC where required. Read on to know more….

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 (IBC), since its implementation in December, 2016, has been widely acknowledged as a bold reform in the financial sector. The report of Banking Law Reforms Committee headed by Dr. T. K. Vishwanathan, which provided the framework for the law, envisages a scenario where in case of a default by the equity owners to meet their debt obligations, control is transferred to the creditors and equity owners take a back seat. The Committee noted that this is not how things work in India and promoters continue to control the entity even after defaulting on payments. In the recent years, this situation has been the cause of unacceptably high levels of stressed assets in the banking system and this, in turn, has threatened to shake the country's financial stability.

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Through this legislation, the Government has sought to rectify the situation. The prime objective behind IBC is timely resolution of transitory financial stress being faced by businesses, due to internal or external reasons, by way of restructuring of debt in cases where the existing owners clear the default. Where the stress is not due to financial reasons but owing to management failure or where the default is not cleared, change in ownership in a time-bound manner should be facilitated so as to prevent decay in value of assets. If the stress is owing to the business itself having become unviable, it should be allowed to go into liquidation. Additionally, IBC sets out to achieve multiple objectives including the following:

i. consolidating multiple legislations under one code with one Adjudicating Authority;
ii. facilitating lending without security in increasingly asset-light service sector dominated Indian economy;
iii. encouraging finance providers to lend money for risk-taking and entrepreneurship;
iv. creation of a vibrant bond market by empowering bondholders and

v. providing a forum to operational creditors to initiate insolvency proceedings, settle their dues fast.

The pace of applications filed under IBC is steadily gathering momentum. Through an amendment to Banking Regulation Act, Reserve Bank of India has been empowered to "*issue directions to any banking company to initiate insolvency resolution process in respect of a default, under the provisions of IBC.*" Also, the recent Circular of Reserve Bank of India scraps almost all the old schemes, viz., CDR, SDR, S4A etc. and mandates banks to find a resolution in large stressed accounts within 6 months. In case these cases remain unresolved, banks are required to refer those cases to NCLT under IBC. This will likely provide greater impetus to corporate insolvency resolution process (CIRP).

As is the case with any new legislation, IBC is giving rise to several questions. Insolvency professionals (IPs), a new community created under the code drawing from CAs and other professionals, is struggling to find answers to these questions. These are practical issues being faced by IPs, creditors and CDs alike and government would do well to come out with suitable amendment or notifications quickly in order to facilitate smooth transition to this new regime.

RISK OF DOMINO EFFECT

Under IBC, an operational creditor (OC) may, in case of default by CD, demand payment. If payment is not made within 10 days and there is no dispute, OC may file an application under IBC for CIRP. While the objectives of this provision are laudable inasmuch as it allows early detection of stress and its timely resolution, the unintended fallout in case of application being admitted would be that such admission will be followed by inviting claims from creditors. It is not unfathomable that such invitation by way of public announcement may lead to other suppliers and lenders hardening their stance in terms of credit terms, interest etc. fearing liquidation of the entity going ahead. Now, in a situation where the financial stress on the CD is temporary, initiation of CIRP may spell doom on its fortunes and render a viable business potentially unviable. In a larger national context, the costs of such forced disruptions on a growing economy can be debilitating. Adjudicating Authorities, therefore, have to move with caution before admitting an application.

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NOT SO ATTRACTIVE FOR FINANCIAL CREDITORS

It is probably the likelihood of the CD irretrievably going into liquidation that is holding secured financial creditors from proceeding under IBC in a big way. As it is, nearly 75% of CIRP cases have gone for liquidation. If such lenders have to enforce security, they can do so under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) even without going for IBC route. This right is available to them even during liquidation under IBC. Remember, in case of a resolution plan approved under IBC failing during implementation, there is no option but to liquidate the CD. Secured lenders thus continue to show preference for old ways which include restructuring, selling stressed assets to Asset Reconstruction Companies, one-time settlement in odd cases etc. This probably explains why only around one-fourth of the cases for insolvency resolution process admitted by NCLT benches are filed by financial creditors despite burgeoning non-performing advances.

RELUCTANCE TO ALLOW LARGE HAIRCUTS

Lack of interest for IBC route evinced by secured lenders so far also stems from their reluctance to take a haircut. Under IBC, a Committee of Creditors (CoC) may be required to take a call on extending waivers and concessions to the Corporate Debtor (CD). It is often the leader of the consortium who is expected to initiate such a move. In case of a single lender forming CoC, she herself has to take the call. Empirical evidence suggests that lenders avoid taking such decisions fearing questioning by vigilance and this may inevitably lead the debtor into liquidation.

To counter this tendency, bank officials who do not accept a haircut and lead the CD to liquidation

should be questioned if realisations are lower in liquidation as compared to what was being offered in a resolution plan.

Secured lenders also need to be educated about the fact that it is better to rest management control with IP as resolution professional or liquidator than with the promoters while security enforcement proceedings take place. They also have to be educated that chances of change of management are far greater under IBC than when promoters control.

PRE-PACKAGED DEALS

Under the United Kingdom bankruptcy ecosystem, in a large number of cases, pre-packaging is done prior to starting IBC process. Thus, if a proposed IP gets an investor, packages the restructuring deal around the price the investor is willing to bid for and presents the same to FCs, they may get more inclined to go through IBC process. The law then acts only as a *post facto* facilitator when restructuring with new investor would have already been completed by IP before going through IBC process. In India too, IBC should ideally have similar provisions to allow pre-pack as a formal arrangement.

ACQUIRING VOTING SHARE TO BLOCK RESOLUTION-GOOD INVESTMENT STRATEGY?

In a situation where a canny investor, anticipating a resolution, buys unsecured financial debt in a stressed entity exceeding 25% of its total financial debt, she may gain a blocking voting right in any resolution plan at throwaway price. In a CoC meeting, she may be in a position to negotiate terms at par with secured lenders. The price of structurally subordinated financial debt will be much lower and recovery could become at par with secured financial debt to be able to vote in favour of resolution plan. Even in the case of the debtor going into liquidation, such investor may not lose much by virtue of her lower investment entry point. Not only this, she may even negotiate a deal with other lenders to buy out their stake at lower prices. This is a common practice in the United Kingdom and perfectly in accordance with their law. It would be interesting to see how these kind of deals plans out under IBC and how NCLT views them.

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AMALGAMATION OR MERGER OF THE CD

IBC does not spell out in clear terms as to whether a resolution plan could provide for amalgamation/merger of the CD with a potential investor. Assuming that the resolution plan meets all the other requirements stipulated in IBC, such amalgamation/merger should be possible in the opinion of the author. Section 30(2) of IBC reads as under:

> *"The resolution professional shall examine each resolution plan received by him to confirm that each resolution plan—*
> *(a) provides for the payment of insolvency resolution process costs in a manner specified by the Board in priority to the repayment of other debts of the corporate debtor;*
> *(b) provides for the repayment of the debts of operational creditors in such manner as may be specified by the Board which shall not be less than the amount to be paid to the operational creditors in the event of a liquidation of the corporate debtor under section 53;*
> *(c) provides for the management of the affairs of the Corporate debtor after approval of the resolution plan;*
> *(d) the implementation and supervision of the resolution plan;*
> *(e) does not contravene any of the provisions of the law for the time being in force;*
> *(f) conforms to such other requirements as may be specified by the Board."*

In the case of the CD going into liquidation, on the other hand, Section 35(1)(f) comes into play which provides that subject to the directions of AA, the liquidator shall have following powers and duties, namely:

> *"..... to sell the immovable and movable property and actionable claims of the corporate debtor in liquidation by public auction or private contract, with power to transfer such property to any person or body corporate, or to sell the same in parcels in such manner as may be specified.*

Upon admission of an application for CIRP or in the event of the CD going into liquidation under IBC, a moratorium prevails which bars filing of suits, stay etc. against the CD during the period of moratorium.

Provided that the liquidator shall not sell the immovable and movable property or actionable claims of the corporate debtor in liquidation to any person who is not eligible to be a resolution applicant."

Clearly, the Code does not allow for such corporate action, i.e., merger or amalgamation, at the liquidation stage. However, the entire assets of the CD can be sold to an interested buyer by way of a slump sale. A specific provision should be included in IBC to facilitate amalgamation/merger both at resolution plan stage and during liquidation to fetch a better value for the stakeholders.

MORATORIUM ON ENFORCEMENT OF PERSONAL GUARANTEES

Upon admission of an application for CIRP or in the event of the CD going into liquidation under IBC, a moratorium prevails which bars filing of suits, stay etc. against the CD during the period of moratorium. Whether this moratorium also applies to the lender proceeding against the promoters or directors/ partners to enforce personal guarantees or collateral security provided by them can be a question that may require a specific provision in IBC. In the absence of such a provision, the parties will be governed by the provisions of Indian Contract Act, 1872, which could be inferred to mean that the lenders can proceed against such guarantors /collaterals if the lenders have already demanded payment and the CD has failed to pay. Chennai bench of NCLT has, in the matter of *V. Ramakrishnan vs. Veesons Energy Systems Pvt. Ltd.* and SBI restrained the financial creditor from selling the assets of the personal guarantor during the moratorium period on the reasoning that if this was allowed, the personal guarantor will step into the shoes of a creditor against the CD and thus, a charge would be created on the assets. However, this question still needs clarity.

CRIMINAL PROCEEDINGS UNDER SECTION 138

Another question that may arise is whether moratorium under Section 14 of IBC would apply in respect of criminal proceedings under Section 138 of Negotiable Instruments Act, 1881, against the signatories of dishonored cheque issued by CD. The answer to this question could be that the moratorium under IBC is only in respect of the suits against the CD (as distinguished from signatories to its cheques). Hence, in such cases, while proceedings against individuals under aforesaid Section 138 may continue, liability of the CD should be put on hold till the end of moratorium period. A clarificatory amendment would, however, be welcome.

More important question though is that after a resolution plan is approved or liquidation is announced, what would be the fate of these Section 138 cases. In the author's view, since the underlying liability itself is settled by force of law, such cases need to be compulsorily withdrawn, maybe with just financial penalties imposed on the signatories or Directors. But to allow these cases to continue would be a travesty of justice which needs to be rectified through an amendment to the Negotiable Instruments Act, 1881.

COMPLIANCE UNDER OTHER LAWS

Section 17(1) of IBC provides that from the date of appointment of RP or liquidator, the management of affairs of the CD shall vest in the RP or liquidator. Further, the powers of the board of directors or partners of the CD shall stand suspended and be exercised by the RP or liquidator. Does that mean that onus of compliance under other laws like labour laws, taxation laws, Companies Act, 2013 will fall on RP or liquidator? Obviously, duty and responsibility go hand in hand. If the Board of Directors is suspended and RP or liquidator is handling management of the affairs of the CD, the responsibility of compliance under various laws will squarely fall on RP or liquidator, which has also been clarified by IBBI by way of a circular. In case there is an accidental omission or non-compliance, can the authorities hold her liable for the same and initiate prosecution? Moreover, in a case where the CD has been non-functional for a few years and has not complied with the applicable laws, is the RP required to make all the compliance for those years as well?

SIGNING OF FINANCIAL STATEMENTS AND OTHER DOCUMENTS

Another tricky issue is the signing of documents (like financial statements) and returns under various

laws. Where these documents require the signatures of a Managing Director, who should sign these papers when the Board of Directors is suspended and IP or liquidator is in charge of the management? IBC nowhere provides that the Code has overriding effect on the provisions of other laws in respect of such documents and returns. Suitable amendments need to be made under IBC as well as other laws to facilitate this, if indeed this is what is expected of RP or liquidator.

Additionally, IP or liquidator has to ensure that she is not held responsible for cascading effects of inaction or wrong decisions taken by earlier management which may require abundant caution on her part.

WITHDRAWAL OF APPLICATION BY OC

IBC does not make any provisions for withdrawal of application by the applicant. Once the application is admitted by AA, even if CD settles the dues of applicant OC, the proceedings would continue till a resolution plan is approved, failing which liquidation would be the outcome. When the dues have been settled, what kind of Resolution Plan is envisaged?

CHALLENGES OF RUNNING A BUSINESS

In some cases under CIRP, promoters and the existing management team do not cooperate with the RP. Besides, RP may not be familiar with the nature of business. In such a scenario, how is she expected to take commercial decisions and run business without a good knowledge of its business? Even if professionals are hired, they will take time to understand the business before they start performing. This may be specially challenging in case of a large, multi-locational company.

SUBSEQUENT DUES

IBC does not clearly spell out the treatment to be given to any dues arising subsequent to admission of application for CIRP by NCLT. It enjoins upon the Interim RP to collate claims of the creditors within 30 days of his appointment, place the details along with details of assets etc. before CoC. However, in the case of a supplier of goods or services, if the amount has not become due till the last date fixed for submission of such claims, there is no clear provision. For instance, in case of construction contracts, usually bills and payments are linked to physical progress of construction work. In case substantial work has been done by the contractor but it has not reached a stage where he can submit his bill, is he required to submit his claim on the basis of estimates? Similarly, a supplier's invoice may fall due months after the date of submission of claims. During CIRP, salaries to employees of the CD would continue to accrue. If the interim RP does not take such claims into account, the correct position may not get reflected in the statement to be placed before CoC. A clarification in the Code would therefore be in order.

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DEPOSITS

In the case of a CD who has accepted unsecured deposits from a large number of depositors, it is not clear as to how those depositors will be accommodated in the CoC. In case of secured debentures and secured deposits, a trustee has to be appointed and such trustee will obviously represent the debenture-holders and depositors in the CoC. In case of unsecured deposits though, no such trustee is required to be appointed. More clarity is required with regard to such deposit holders.

CONCLUSION

The IBC is a historic legislation aimed at transforming the corporate landscape of India by facilitating quicker identification and resolution of financial stress. This law is still evolving and a lot still needs to be done. Also, finance providers and business community have to be educated to use this mechanism in appropriate cases to create an ecosystem where the inefficient businesses are either strengthened or allowed to be run by stronger managements. At this crucial juncture, we can ill-afford to allow the benefits of the Code being frittered away in needless litigation on trivial issues due to lack of clarity. An expeditious redressal of the issues raised in this article would go a long way in creating a vibrant insolvency resolution mechanism in the country. ■

The only place success comes before work is in the dictionary. - Vince Lombardi