

## INSOLVENCY AND BANKRUPTCY CODE, 2016: A CRITIQUE OF ITS CORPORATE RESOLUTION PROCESS

*BANKRUPTCY IS A LEGAL PROCEEDING IN WHICH YOU CAN PUT YOUR MONEY IN YOUR PANT POCKET AND GIVE YOUR COAT TO YOUR CREDITORS– JOEY ADAMS*

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**Abstract:** Insolvency is when an individual, corporation, or other organization cannot meet its financial obligations for paying debts as they are due. Insolvency can occur when certain things happen, some of which may include poor cash management, increase in cash expenses, or decrease in cash flow. The law of insolvency is a social legislation which has been enacted to provide respite and relief to the honest debtors who due to any unfortunate or unforeseen circumstances become incapable of paying back their debts.

Its object is also of securing distribution of a debtor's estate among his creditors equitably and thereafter to release him under certain conditions from liability in respect of his debts and obligations.

In the case of *Yenamulla Malludora vs P.Seetharatnam*<sup>1</sup>, the Hon'ble Supreme Court of India observed that the object of the law of insolvency is to seize the property of an insolvent before he can squander it and to distribute it amongst his creditors. It is however not every debtor who has borrowed beyond his assets or even one whose property is attached in execution of his debts, who can be subjected to such control. The jurisdiction of the Court commences when certain acts take place which are known as acts of insolvency and which give a right to his creditor to apply to the Court for his adjudication as an investment. The enactment of Insolvency and Bankruptcy Code, 2016 is a progressive step towards good governance and will improve the investor confidence and ease of doing business. The possible demerits can be addressed through discussions and consensus building.

**Keywords:** consensus building, Insolvency and Bankruptcy

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<sup>1</sup> AIR 1966 SC 918

### Introduction

Insolvency is when an individual, corporation, or other organization cannot meet its financial obligations for paying debts as they are due. Insolvency can occur when certain things happen, some of which may include poor cash management, increase in cash expenses, or decrease in cash flow. Finding of insolvency is important, as specific rights are enabled for the creditor to exercise against the insolvent individual or organization. For example, outstanding debts may be paid off by liquidating assets of the insolvent party. Prior to proceedings, it is common for the insolvent entity to meet with the creditor in order to attempt to arrange an alternative payment method.

It is possible that a business may be "insolvent" in cash flow, yet still solvent on the balance sheet. These cases may involve illiquid assets, which help the balance sheet's solvency but not the cash flows. This can also work the other way around with negative net assets (balance sheet insolvency), yet a positive cash flow. In this case, the flow of cash is simply enough to pay off debts, despite the fact that the business has more liabilities than assets.

### Limitations in the earlier Bankruptcy Laws

There were multiple overlapping laws and adjudicating forums dealing with financial failures and insolvency of companies and individuals in India. The current legal and institutional framework did not aid lenders in effective and timely recovery or restructuring of defaulted assets and caused undue strain on the Indian Credit System. Decisions were often appealed, stayed or overturned by judicial forums having concurrent or overlapping jurisdictions. Further, the pro-revival approach of the judicial systems leads to delay in the closure of unviable businesses since the standstill mechanism has been misused by corporate debtors.

The total of Non Performing Assets (NPAs) among domestic banks in India was around Rs. 5.5 lakh crores in 2016 out of total lending of Rs. 68.74 lakh crores.<sup>2</sup> Thus, the total stressed assets amounted to 9% of the total lending.

The average time taken in India to realise the debts through litigation is 4.3 years as against 1.7 years in high income countries.<sup>3</sup>

The recovery rates obtained in India are among the lowest in the world. When default takes place, broadly speaking, lenders recover around 26% of the value of debt, on Net Present Value basis.<sup>4</sup>

In resolving insolvency, India is presently ranked 136 (Out of 190 countries) in 2017 as is shown in the diagram given below:<sup>5</sup>

<sup>2</sup> Statistical Tables relating to Banks in India Advances and NPAs of Domestic Banks by Priority and Non-Priority Sectors available at <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications#14>, accessed on June 4, 2017.

<sup>3</sup> World Bank, Data for resolving insolvency available at <http://www.doingbusiness.org/data/exploreconomies/india#resolving-insolvency>, visited on June 2, 2017.

<sup>4</sup> Ibid.

<sup>5</sup> Ibid.

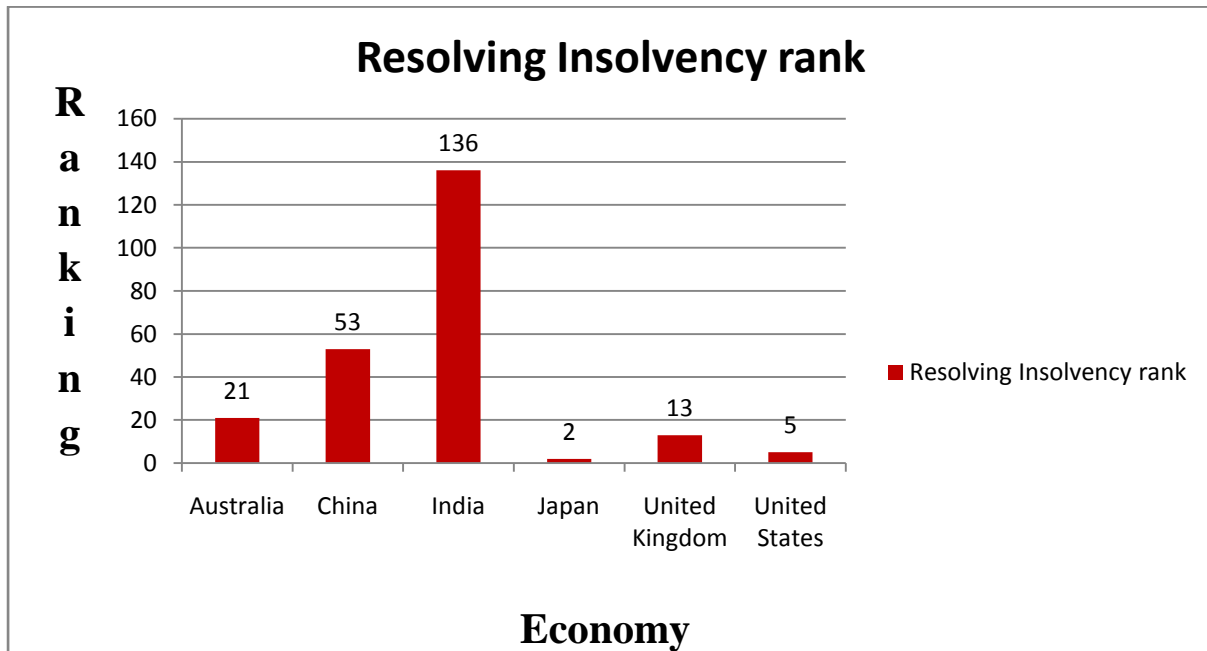
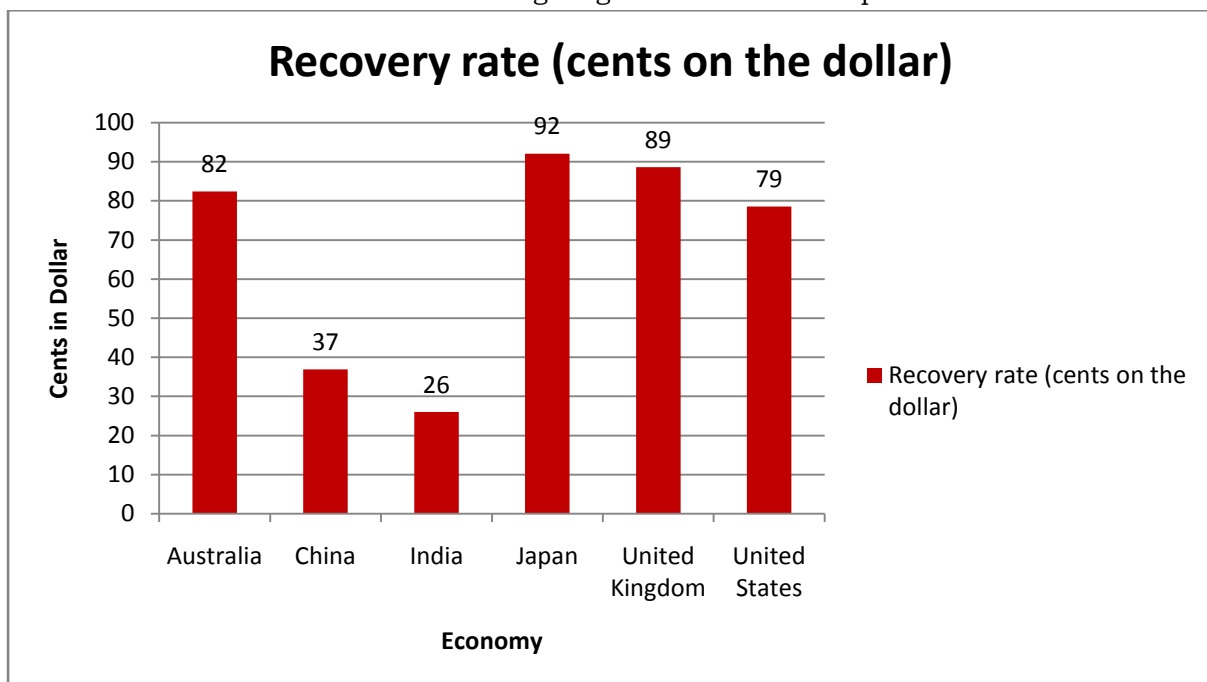


Diagram I showing Ranking in Resolving Insolvency of India with some other countries

Further, the recovery rate of debt is one of the lowest in India when compared to other countries in the world. The following diagram illustrates the position:<sup>6</sup>



<sup>6</sup> Ibid.

Diagram II showing Recovery Rate of India with some other countries

Further, the time period taken to recover the debt is also highest among the world. The following diagram illustrates the Indian position:<sup>7</sup>

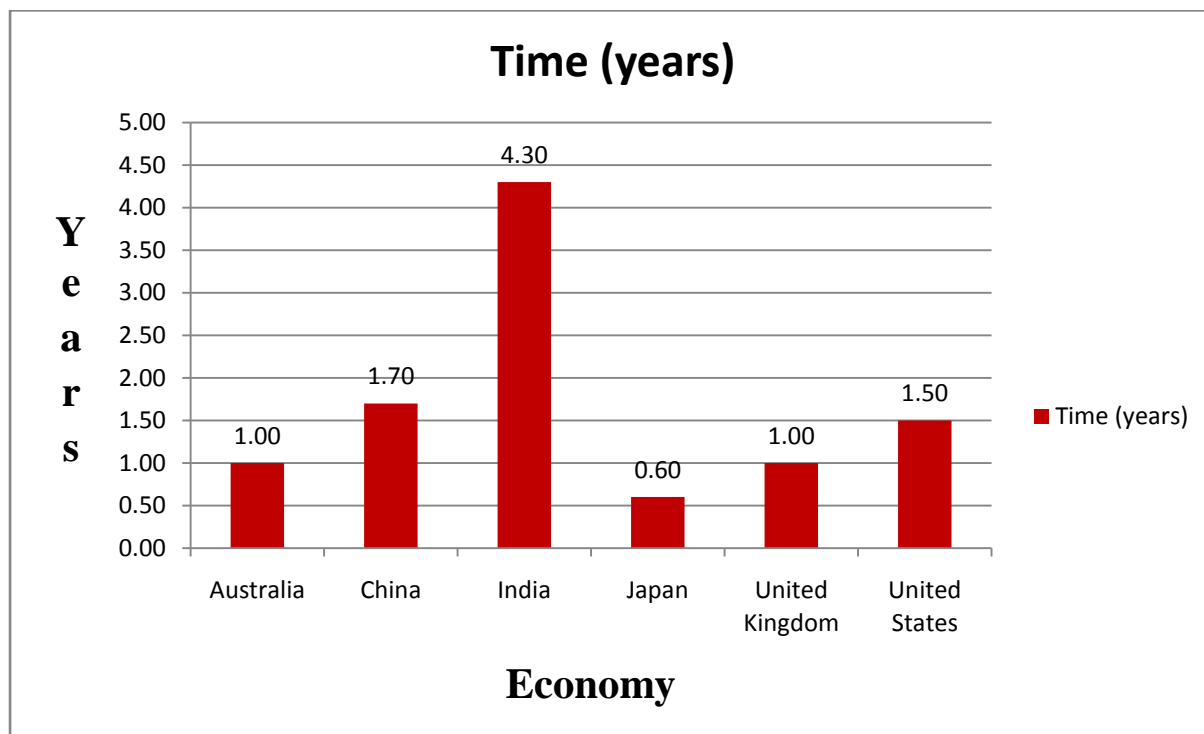


Diagram III showing Recovery Rate of India with some other countries

<sup>7</sup> Ibid.

**Object of Model Insolvency Law**

The law of insolvency is a social legislation which has been enacted to provide respite and relief to the honest debtors who due to any unfortunate or unforeseen circumstances become incapable of paying back their debts.

Its object is also of securing distribution of a debtor's estate among his creditors equitably and thereafter to release him under certain conditions from liability in respect of his debts and obligations.

In the case of *Yenamulla Malludora vs P.Seetharatnam*<sup>8</sup>, the Hon'ble Supreme Court of India observed that the object of the law of insolvency is to seize the property of an insolvent before he can squander it and to distribute it amongst his creditors. It is however not every debtor who has borrowed beyond his assets or even one whose property is attached in execution of his debts, who can be subjected to such control. The jurisdiction of the Court commences when certain acts take place which are known as acts of insolvency and which give a right to his creditor to apply to the Court for his adjudication as an investment.

Therefore, the principal focus of modern insolvency legislation and business debt restructuring practices is not the liquidation and elimination of insolvent entities but on the remodeling of the financial and organizational structure of debtors experiencing financial distress so as to permit the rehabilitation and continuation of their business.

The existing situation, therefore, required a uniform comprehensive insolvency and bankruptcy legislation encompassing all companies,

partnerships and individuals, and which also meets the international standards to attract foreign investment in consonance with the government policy of 'Ease to do Business' in India. The result was the enactment of Insolvency and Bankruptcy Code, 2016.

**Objectives of Insolvency and Bankruptcy Code, 2016**

1. To consolidate and amend laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons.
2. To promote entrepreneurship, availability of credit and balance of interest to all stakeholders.
3. To redefine the priority of payments including alteration of payments of government dues.
4. To provide an effective legal framework for timely resolution of insolvency to support development of credit markets and encourage entrepreneurship.
5. To provide for designated National Company Law Tribunal (NCLT) and Debt Recovery Tribunal (DRT) as the Adjudicating Authorities for corporate persons and firms and individuals respectively for resolution of insolvency, liquidation and bankruptcy.
6. To provide for establishment of Insolvency and Bankruptcy Board of India for regulation of insolvency professionals, insolvency professional agencies and information utilities.

**How does it bring a change or innovation on the hitherto existing structure?**

The Code provides a uniform and comprehensive insolvency legislation encompassing all companies, partnerships and individuals and removes the shortcomings of earlier

<sup>8</sup> AIR 1966 SC 918

insolvency laws. The main features of the Code are as follows:

1. The Code provides for the mechanism for assessment of viability of a Corporation at an early stage.
2. The Code symmetries the information between debtors and creditors.
3. The Code provides time bound process to better preserve the economic value.
4. The Code will ensure a collective process.
5. The Code will respect the rights of all creditors equally.
6. The Code ensures that when negotiations fail to establish viability, the outcome of liquidation must be binding.

#### Framework of the Code

##### Corporate Debtors: Two Stage Process

To initiate an insolvency process for corporate debtors, the default should be at least Rs. 1,00,000/- (Rupees One Lakh) to avoid unnecessary applications. The Code proposes two independent stages:

- Insolvency Resolution Process (IRP), which financial creditors assess whether the debtor's business is viable to continue and options for its rescue and revival; and
- Liquidation, if the insolvency resolution process fails or financial creditors' decide to wind up and distribute the assets of the company.

**Insolvency Resolution Process:** This process provides a collective mechanism to lenders to deal with the overall distressed financial position of the corporate debtor. This is a significant departure from the existing legal framework under which the primary onus to initiate a reorganisation lied with the debtors and lenders may pursue distinct legal actions for recovery of their outstanding dues.

The following steps are provided under the Code:

- (i) **Initiation of IRP:** A financial creditor (for unpaid financial debt) or an operational creditor (for unpaid operational debt) can initiate an IRP against a corporate debtor at the National Company Law Tribunal. The defaulting corporate debtor, its shareholders or employees may also initiate voluntary insolvency proceedings.<sup>9</sup>
- (ii) **Moratorium:** The NCLT orders a moratorium on the debtor's operation for the period of IRP. This operates as a 'calm period' during which no judicial proceedings for recovery, enforcement of security interest sale or transfer of assets or termination of essential contracts can take place against the debtor.<sup>10</sup>
- (iii) **Appointment of Resolution Professional:** The NCLT appoints an insolvency professional to administer the IRP. The Resolution Professional's primary function is to take over the management of the corporate borrower and operate its business as a going concern under the broad directions of Committee of Creditors.<sup>11</sup>
- (iv) **Creditor's Committee and Revival Plan:** The Resolution Professional identifies the financial creditors and constitutes the creditor's committee. Operational creditors above a certain

<sup>9</sup> Section 6, 7,8,9, 10 of the Insolvency and Bankruptcy Code, 2016.

<sup>10</sup> Section 14 of the Insolvency and Bankruptcy Code, 2016.

<sup>11</sup> Section 16, 17, 20 of the Insolvency and Bankruptcy Code, 2016.

threshold are allowed to attend the meetings of the committee, but are not allowed to vote. Each decision of the creditor's committee requires 75% of the majority vote (75% of the value of debt). The decision of the committee is binding on the corporate debtor and all its creditors.<sup>12</sup> The committee will consider whether to proceed with a revival plan or liquidation within a period of 180 days which can be extended by 90 days.<sup>13</sup>

However, the Code does not elaborate on the types of revival plans that may include fresh finance, sale of assets, change of management etc.

#### **Liquidation:**

Under the Code, a corporate debtor may be put into liquidation under the following scenarios<sup>14</sup>:

- (i) A 75% majority of Creditors Committee resolves to liquidate the corporate debtor at any time during insolvency resolution process;
- (ii) The Creditors Committee does not approve a resolution plan within 180 days (or within the extended 90 days);
- (iii) The NCLT reject the resolution plan submitted to it on technical grounds; or
- (iv) The debtor contravenes the agreed resolution plan and an affected person makes an application to the NCLT to liquidate the corporate debtor.

Once the NCLT passes an order of liquidation, a moratorium is imposed on the pending legal proceedings against the corporate debtor and the assets of the debtor vest in the liquidation estate.

#### **Priority of Claims**

The Code significantly changes the priority of distribution of liquidation

<sup>12</sup> Section 28 of the Insolvency and Bankruptcy Code, 2016.

<sup>13</sup> Section 12 of the Insolvency and Bankruptcy Code, 2016.

<sup>14</sup> Section 33 of the Insolvency and Bankruptcy Code, 2016.

proceeds. After the costs of insolvency resolution, secured debt together with workmen dues for the preceding 24 months rank highest in priority. Central and State Government dues stand below the claims of secured creditors, workmen dues, employees' dues and other unsecured financial creditors.<sup>15</sup>

There is a departure from earlier regime, where the Government dues were immediately below the claims of secured creditors and workmen in order of priority.

#### **Institutional Infrastructure**

##### **(a) The Insolvency Regulator**

The Code provides for the constitution of a new insolvency regulator, i.e., Insolvency and Bankruptcy Board of India. Its role is to oversee the function of insolvency intermediaries and regulate the insolvency process.<sup>16</sup>

##### **(b) Insolvency Resolution Professionals**

The Code provides for insolvency professionals as intermediaries who would play a key role in the efficient working of the liquidation process. The Code contemplates insolvency professionals as a class of regulated private professionals having minimum standards of professional and ethical conduct.

##### **(c) Information Utilities**

The Code provides for creation of information utilities to collect, collate, authenticate and disseminate financial information of debtors in centralised electronic databases. The Code requires creditors to provide financial information of debtors to multiple utilities on an ongoing basis. Such

<sup>15</sup> Section 53 of the Insolvency and Bankruptcy Code, 2016

<sup>16</sup> Section 188 r/w 196 of the Insolvency and Bankruptcy Code, 2016

information would be available to creditors, resolution professionals, liquidators and other stakeholders in insolvency. The purpose is to remove information asymmetry and dependence on the debtor's management for critical information needed to swiftly resolve insolvency.<sup>17</sup>

#### (d) Adjudicatory Authorities

There are following adjudicating authorities under the Code:

**(i) The Debt Recovery Tribunal ("DRT")** shall be the adjudicating authority with jurisdiction over individuals and partnership firms other than Limited Liability Partnerships ("LLPs")<sup>18</sup>. Appeals from the order of the DRT will lie to the Debt Recovery Appellate Tribunal ("DRAT")<sup>19</sup>;

**(ii)** The National Company Law Tribunal ("NCLT") shall be the Adjudicating Authority with jurisdiction over companies, other limited liability entities (including LLPs.)<sup>20</sup>.

**(iii)** The National Company Law Appellate Tribunal ("NCLAT") shall be the appellate tribunal from appeals arising out of NCLT and also act as regulator of Insolvency Professionals and Information Utility.<sup>21</sup>

<sup>17</sup> Section 210 and 214 of the Insolvency and Bankruptcy Code, 2016.

<sup>18</sup> Section 179 of the Insolvency and Bankruptcy Code, 2016.

<sup>19</sup> Section 181 of the Insolvency and Bankruptcy Code, 2016.

<sup>20</sup> Section 60 of the Insolvency and Bankruptcy Code, 2016.

<sup>21</sup> Section 61 of the Insolvency and Bankruptcy Code, 2016.

**(iv)** The Supreme Court of India shall be the appellate authority from appeals arising out of NCLAT and DRAT.<sup>22</sup>

#### Advantages of the Code

- The Code provides to address cross border insolvency through bilateral agreement with other countries.<sup>23</sup>
- The Code provides for a shorter time frame for every step in the insolvency process.
- The Code provides for robust insolvency resolution mechanism that can help creditors recover a larger part of their investment faster, allowing them to re-invest in other business, thereby facilitating efficient flow of capital across the economy.
- Creation of new class of insolvency professionals that will specialise in helping revival of sick companies.
- Creation of information utilities that will collate all information about debtors to prevent serial defaulters from misusing the system.
- The Code will ensure time bound settlement of insolvency, enable faster turnaround of business and create data base for serial defaulters which will help in resolving the bad debt problem which has crippled bank lending.
- The Code will improve India's position in the World Bank's Doing Business Ranking.
- This will be a single law in place of multiple laws and remove the overlapping jurisdiction.

#### Critique of Insolvency and Bankruptcy Code, 2016

- Time bound insolvency will require establishment of several new institutional mechanisms.

<sup>22</sup> Section 62 and 182 of the Insolvency and Bankruptcy Code, 2016.

<sup>23</sup> Section 234 of the Insolvency and Bankruptcy Code, 2016.



- The Insolvency Professionals may not have adequate knowledge to run the business as a going concern.
- The order of priority of debts is not understood as to why unsecured creditors have priority over other trade creditors and why the government dues will be repaid after unsecured creditors.
- The Code provides for creation of multiple Information Utilities. Therefore, it is possible to that complete information about a company may not be available with a single Information Utility. This may lead to information being scattered.
- The transfer of cases pending before various forums may lead to over burden of Tribunals.

#### **How do the Constitutional Objective is achieved?**

In India the process of winding up of companies is regulated by the Companies Act and is under the supervision of the court. Although article 19 (1)(g) of the Constitution of India gives freedom to practice any profession or to carry on any occupation, trade or business to the citizens of India, due to which there are restrictions on closure of any industrial undertaking. However, in the era of liberalization there is a need to change the focus from strict regulation of the activities of companies to granting freedom to the industry in conducting its business activities and lay down norms for protection of interest of stakeholders.

Further, the Directive Principles of State Policy, embodied in Part IV of the Constitution, are directions given to the state to guide the establishment of an economic and social democracy, as proposed by the Preamble.

The state is expected to keep these principles in mind while framing laws and policies, even though they are non-justiciable in nature. While stating

that the Directive Principles are not enforceable in any court of law, declares them to be "fundamental to the governance of the country" and imposes an obligation on the State to apply them in matters of legislation.<sup>24</sup> They serve to emphasize the welfare state model of the Constitution and emphasize the positive duty of the state to promote the welfare of the people by affirming social, economic and political justice, as well as to fight inequality and ensure individual dignity.<sup>25</sup>

In *I.R. Colheo v/s State of Tamil Nadu*<sup>26</sup> it was held that by enacting fundamental rights and directive principles which are negative and positive obligation of the States, the Constituent made it the responsibility of the Government to adopt a middle path between individual liberty and public good. Fundamental rights and directive principles have to be balanced. That balance can be tilted in favour of the public good. The balance, however, cannot be overturned completely overriding individual liberty. This balance is the essential feature of the Constitution.

The Code provides for insolvency resolution process in the first place i.e. firstly, the effort is made to continue the business and in the event the resolution process fails, it is only then the company will go into liquidation to serve the larger interest of the society.

The Code therefore, maintains a fine balance between the Fundamental Right to carry on business with reasonable restriction as imposed through the Directive Principles of State Policy.

<sup>24</sup> Article 37 of Constitution of India

<sup>25</sup> Article 38 of Constitution of India

<sup>26</sup> AIR 2007 SC 861

**Conclusion**

The enactment of Insolvency and Bankruptcy Code, 2016 is a progressive step towards good governance and will improve the investor confidence and ease of doing business. The possible demerits can be addressed through discussions and consensus building. If implemented earnestly, it will give a boost to job creation through skill development and also provide the required ecosystem for the success of 'Make in India'.