MEHTA&MEHTA
Legal and Advisory

Article

The litmus test of the Insolvency and Bankruptcy Code, 2016

Dipti Mehta
Director

January 31, 2017

Mehta & Mehta Legal and Advisory Services Private Limited

Address: 201-206, Shiv Smriti Chambers, 2nd Floor, Dr. Annie Besant Road, Above Corporation Bank, Worli, Mumbai – 400018

CIN: U74140MH2006PTC163236

Phone: +91-22-6611-9696

Email: info@mehta-mehta.com

Website: www.mehta-mehtaadvisory.com

DISCLAIMER:

While Mehta & Mehta Legal and Advisory Services Private Limited ("Mehta & Mehta") has made every effort and has exercised due skill, care and diligence in compiling this report based on publicly available information, it neither guarantees its accuracy, completeness or usefulness, nor assumes any liability whatsoever for any consequence from its use. This report does not have any approval, express or implied, from any authority, nor is it required to have such approval. The users are strongly advised to exercise due diligence while using this report. This report in no manner constitutes an offer, solicitation or advice to buy or sell securities, nor solicits votes or proxies on behalf of any party. This report is just for the purpose of imparting knowledge and brings to light the impact of the provisions of the statute to reader. Further, this report in no way intends to allege any company, individual or any other person.

This report may not be reproduced in any manner without the written permission of Mehta & Mehta. All disputes are subject to jurisdiction of High Court of Bombay, Mumbai. All rights reserved.

Article

The litmus test of the Insolvency and Bankruptcy Code, 2016

Introduction and Background

World over, the commercial entities are bestowed with the responsibility of safeguarding the interest of all stakeholders. Courts have held that winding up is a discretionary relief which the Court should grant if existence of the company will cause immense prejudice to all concerned. The order of winding up should be made in rarest of rare cases. The enactment of the new Insolvency and Bankruptcy Code, 2016 ("the Code") has now tiled the way for a much-needed and much awaited modern framework to deal with the insolvency and bankruptcy. The Code is a major change and departure from the existing law, which is interpreted by the Courts in favour of debtors.

An efficient insolvency system was necessary to encourage enterprise, underpin investment, accelerate economic growth, create wealth and most importantly reduce the mounting NPAs in a bank's balance sheet. The aforementioned have been discussed at length in our previous article which can be viewed at http://bit.ly/Insolvency_Professional. It will help creating a sound environment for investment, and enable market participants to more accurately price, manage and control default risks and corporate failure. Therefore the Code promotes responsible corporate behavior to avoid the consequences of insolvency and preserves employment through an effective system for rehabilitating financially distressed but viable enterprises, while ensuring maximum play in a fair reallocation of assets to more efficient market users.

Another big factor that bought the Code into existence was to protect the interest of Micro, Small and Medium Enterprises (MSMEs). If the look at the corporate annals of the jurisdiction in India relating to matters of winding up, it takes around 4.3 years on an average to wound up and dissolve a company in India. Also, the recovery rate of estate in India of a company under winding up is only 25.7%. Added with the "debtors in possession" theory of the previous law, the new law envisages allowing decision making in the hands of the creditors during the course of winding up and revival. During the course of winding up under the erstwhile law, operational creditors were often an afterthought and lead to disharmony for the small creditors specially the MSMEs. In the new law, the creditors have been allowed with an option to file an application for revival of a company in case the company has made a default of Rs. 1,00,000 or more. This will enable creation of sound practice on the part the corporate and ensure proper repayments are made to such trade creditors. Also, there remains little scope for demarcation between the financial and operational creditor as it will be the primary duty of the resolution professional and NCLT to ensure that interest of the operational creditors is safeguarded even though the power of voting lies only with financial creditors.

However, a critical reading of the Code reveals that it requires further examination and amendments to fulfill the intent for which it was codified in the first place. There are a number of concerns. In this article we intend to analyse the key challenges that will be faced during the course of revival and if not revival than liquidation, especially the Insolvency Professional.

The litmus test of the Insolvency and Bankruptcy Code, 2016

Who can take recourse of the remedy?

The Code has empowered the corporate debtor as well as its creditors to initiate corporate resolution process on the trigger of default. On the acceptance of the application, an Interim Resolution Professional (IRP) will assume control of the corporate debtor's management, displacing the incumbents. Displacement of management of corporate debtor on account of a few unpaid operational creditors and financial creditors can cause great damage to the cause of entrepreneurship.

The operational creditors have been bestowed with the power to file an application for revival of company in case a default has occurred on the part of the company. The beauty of this Code is the fact the upon acceptance of application by NCLT, the resolution plan needs to be devised to revive the company while safeguarding not only the interest of the financial and operational creditors but also all the stakeholders. Under the erstwhile law, the operational creditors were often disenfranchised as they did not have greater motivation to move to high court due to the delay in completion of proceedings and worsening recovery rate.

However, creditors tend to lack a sense of overall day-to-day health of the corporate debtor. So, even if the creditors move the bankruptcy process, there is a risk the corporate debtor is admitted to the hospital too late for its own good. Counter-intuitively, the only stakeholders that have adequate information about the solvency risk of a firm are the management. However, they have been totally phased out from the decision making once the application for revival has been admitted by the National Company Law Tribunal ("the Tribunal").

Now let us analyse the issues in hand that may occur during the course of filing of application by any of the eligible person:

Corporate Debtor

As it is imperative that the once the application for resolution of the corporate debtor is accepted, NCLT has to declare a moratorium on the corporate debtor prohibiting it from certain activities as enunciated in section 14 of the Code. Looking at the history, Sick Industrial Companies (Special Provision) Act, 1985 ("SICA") was notified with a motive to revive the sick industries through a duty adopted revival plan approved by BIFR. However, the same was used to bad effect by many corporates as section 22 of SICA. There were entities who had falsified their net worth in order to avail a moratorium upon them and stay free from all encumbrances. Therefore, here too in the Code, moratorium should not be used by the corporate debtor for availing a stay on the actions of the company for a limited period of 180 days until the resolution plan is accepted by NCLT.

Also, in this case, as the corporate debtor is itself moving an application for its revival to NCLT, upon acceptance, the resolution professional will be vested with the management of the company. Though, it is codified under the Code that the management has to extend full support to the resolution professional for making a revival plan of the debtor, however the level of information that is to be supplied by the management to the resolution professional will need a appropriate check. Just like the creditors, resolution professional tend to lack a sense of overall day-to-day health of the debtor and therefore the completeness of information for preparing the appropriate revival plan where the interest of all the stakeholders is equally protected can be a problem.

Operational creditor

It is quite imperative that generally amount payable to corporates is lesser in value as they are paid off during their periodic cycles. However, whenever a default occurs on the part of the debtor, the trade creditor has been bestowed with the powers to file an application for revival of its debtor. However, financial creditors are the decision makers as they tend to have large chunk of the debts in the company and are more financially literate than the operational creditors. This may lead to conflict of interest between the financial creditor, operational creditor as well as the corporate debtor.

The revival plan will be have to be prepared for the revival of debtor but the committee of financial creditors will be the one who has the voting power and will approve the resolution plan before presenting the same to NCLT for final approval. The operational creditors however are not prohibited from attending the meeting of committee of creditors and can have their say in the proceedings however, they are not party to the decision making authority. The crux of the matter is the fact that equal treatment to all the parties to the revival plan will not be feasible under the Code as financial creditors have greater skin in the making and implementation of the plan.

However, it is codified in the annals of the Code that it is the duty of the resolution professional and NCLT to safeguard the interest of the operational creditors.

Financial creditor

The Code has made a well defined demarcation between the financial creditor and operational creditor; but what the Code does not distinguish is the difference between the secured creditor as well as the unsecured creditor. The secured creditor have the right to enforce their security right once the 21 days notice as mandated under the SARFAESI Act is not adequately replied with. However, once the application is accepted and the moratorium is announced on the action of the company as mandated under section 14(1) of the Code, the right of the secured creditor are stayed for the period moratorium subsists. Other issues pertinent to the same are discussed here.

The litmus test of the Insolvency and Bankruptcy Code, 2016

The role of financial creditors

Per se, there will be financial creditor who will be interested in the liquidation of its debtors. However, upon critical study it is imperative to understand that financial creditors do not lend money to the corporate debtor with a motive to take the position of secured creditor or enforce security right in order to recover their NPA(s). Their intent of providing loans to the corporates is the fact that it ensures periodic working capital to the banks and financial institution in the form receipt of interest payments against the loans extended. Consequently, if the corporate debtors are moved the realms of revival or winding up, it will be the financial creditors who will be taking the biggest hit apart from the corporate debtor and its employees. Therefore, it becomes equally important that the financial creditors established periodic dialogue(s) with the company in order to ensure that the chances of default on the part of its debtor are annulled or mitigated at the least, if not annulled.

Hence, the financial creditors, irrespective of his quantum in the debt structure of the company, will be the key to ensure that that company is in a position to satisfy its creditors. Otherwise, if the scheme of things does not go hand in hand, the financial sector of the economy may face turbulent times in the years to come.

The flaws in process

The code tilts heavily in favour of creditors, depriving debtors of fair participation and a level playing field. The Committee of Creditors has been made the sole, all-powerful authority that can either accept or reject the revival plan of the debtor company. All other creditors and stakeholders have been kept out of the decision-making processes. The participation of all stakeholders is necessary for the ultimate revival of a company. The code does not even require the corporate debtor to be heard before ordering the commencement of proceedings and the takeover of the management and debtors' powers by the insolvency professional. There are many other provisions that are contrary to principles of natural justice. This approach may not be conducive to the business environment of the Indian economy.

Borrowing from the United Kingdom, the Code proposes to catalyze an industry of Insolvency Professionals that will be regulated by the Board. Thinking through an economic prism, an Insolvency Professional acts as an agent of creditors as a class and its presence ensures the inter-creditor agency costs are minimized. Empirical studies conducted on the UK bankruptcy regime, however, reveal that while adoption of the IRP model resulted in higher realizations, they also correspondingly increased costs of bankruptcy and thus did not materially improve creditor recoveries. In the light of this evidence, the adoption of the Insolvency Professional model warrants careful scrutiny. Moreover, the emergence of a well-functioning Insolvency Professional market will be critical to the success of the Code. Evidence from

the UK appears to suggest that antitrust concerns can arise owing to secured creditor-resolution professional nexus.

Other dilemmas during the process

The insolvency resolution professional has to submit an insolvency resolution plan within 180 days (further extendable for a period of 90 days, one time) and if insolvency professional fails to do so or if the insolvency resolution plan is rejected by the adjudicating authority, the adjudicating authority has no option but to order liquidation of the corporate debtor. Before ordering the liquidation of the corporate debtor it is not clear whether the corporate debtor can be heard by the adjudicating authority for granting any reliefs. This has to be clearly laid down.

Also, during the course of revival there are several arrangements wherein the involvement of the management will be significant, especially during the planning phase i.e. making of the revival plan. However, there is dilemma with respect the fact that up to what extent the Interim Resolution Professional can seek the information and documents from the management of the corporate debtor. If the same was a codified fact, it would have been much more feasible for the resolution professional in order to ensure that the interest of all is protected and there is clear demarcation wherein there is no conflict between the management, the committee of creditors and others involved. Because analysing the scheme of things from a macro perspective, if there develops a conflict between the management, committee of creditors and others involved, it may directly affect the annals of resolution plan, thereby affecting the stakeholders at large.

Resolution Plan

The resolution professional has the responsibility to prepare the information memorandum basis which the resolution applicant will make the resolution plan. The resolution plan has to be submitted by the resolution applicant within a period of 150 days from the date on which the application is accepted by NCLT. The resolution plan has to be first approved by the resolution professional and then recommended to the committee of creditors who upon their approval, with 75% majority, will submit the same to the NCLT latest by 170th day.

The problem here is the fact "resolution professional" is defined in section 5(25) of the Code is: *"resolution applicant means any person who submits a resolution plan to the resolution professional."* This has left the field open for the any person to be a resolution professional. The financial creditor who is a member of the committee of creditors can also be a resolution applicant. Also, there is no such limit of resolution plans that can be submitted by the resolution applicant to the resolution professionals. This means that there can be multiple plans laid before the resolution professional to approve and recommend to the committee

of creditors. This seems an uphill task wherein the resolution professional will have to act as a mediator between so many parties concerned in the name of financial creditors, operational creditors, resolution applicant and the corporate debtors.

Cross border insolvency

Cross border insolvency has not found place in the Code. In recent years, Indian companies have grown multinational in character and have made high profile and high stake acquisitions abroad. A number of foreign companies have subsidiaries or branches in India. Similarly, Indian companies have set up business entities overseas. Foreign banks and creditors have financed Indian assets and Indians banks have branches overseas.

However, there is no effective mechanism for cooperation between the courts of India and those of other countries, or for administration of cross-border insolvencies and treatment of stakeholders, in the event that insolvency proceedings start in any foreign jurisdiction while involving assets or creditors in India. Many previous committees on insolvency law reform have recommended the adoption of the UNCITRAL Model Law on Cross Border Insolvency, to provide an effective mechanism to deal with cases of cross-border insolvency. The position of the government is that cross border cooperation will be achieved by signing bilateral agreements with sovereign countries and the same is addressed under section 234 and section 235 of the Code. This will not only be time consuming, but will also run the risk of different, and at times conflicting, rules being framed for different jurisdictions. The absence of a cross border framework is likely to be of considerable concern to the global entities seeking to do business with India.

Conclusion

The spate of action by regulators these days evolve around the fact that the legislation should provide easy of doing business to corporates and its stakeholders alike. The main objective that the Code seeks to provide uniform application of the bankruptcy laws to companies in distress. This approach tends to minimize the possible conflicts of interest among various stakeholders by way of fair allocation of resources. However, looking at the time bound actions that are required to be taken in the Code by all the concerned persons especially the resolution professional, it becomes imperative that fast track solution is provided to all.

However, the resolution professional faces an uphill task in hand as he is entrusted with powers of the management of the company and that is where the challenge lies. The resolution professional is required to have a background of the company, the knowledge of the industry, peer-to-peer analysis in real time. Also, the resolution professional has to be updated with the economic condition of the country vis-à-vis the economic condition of the corporate debtor. Further, the financial challenges and the financial position

of the company, its credo, etc are among the major challenges that lie in front of the resolution professional.

All the same are to be eloquently and diligently followed by the resolution professional within a period of 180 days further extendable for a maximum period of 90 days. If the resolution professional is not able to evolve in line with all the above technicalities, the resolution plan will be abruptly affected and it will lead to disharmony for all the parties concerned. Additionally, it is the prime duty of the resolution professional to ensure that the interest of all the stakeholders is protected and there lies no conflict of interest.

In order to evaluate the potential revival of a company, the incidence and the outcome of the resolution plan has to be taken into consideration. Also, the Code is introduced to improve the standing of insolvency regime and recovery rate in the matters of winding up in India. For the attainment of the said purposes, certain provisions of the Code need further examination.

It is further suggested that in order to maintain balance of economy, corporates are required to show more activeness with respect to payment of its operational dues. The litmus test of the success of the Code will be on how these technical issues are being dealt and how it is implemented.