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Review Article

A Glimpse on Insolvency and Bankruptcy Code: 2016

Tanuja Biswal

Student Master in Economics. Department of Economics. Berhampur University.

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E-mail Id:
tanujasam595@gmail.com
Orcid Id:
https://orcid.org/0000-0001-7788-7744
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A B S T R A C T

The Code was enacted in 2016 following a series of recommendations to revamp India's insolvency framework. It was hoped that it would provide a consolidated insolvency framework that would give certainty of process, time and outcome to creditors, borrowers and other market participants. In the three years since its enactment, the Code has largely lived up to this promise. The National Company Law Tribunals, the National Company Law Appellate Tribunal, the High Courts and the Supreme Court have adjudicated upon matters under the Code with unprecedented speed, and have provided certainty on interpretation of key concepts under it. The Insolvency and Bankruptcy Board of India and the Government of India have also been extremely responsive in making legislative amendments to ensure that the Code is implemented in its right spirit. These developments have enriched the jurisprudence and practice of insolvency in the country.

Keywords: Code, Insolvency, Bankrupty, Liquidation, Rehabilitation, Constitutionality of The Provisions of The Code

The Code

The Code offers a uniform, comprehensive insolvency legislation encompassing all companies, partnerships and individuals (other than financial firms). The Government is proposing a separate framework for bankruptcy resolution in failing banks and financial sector entities.

One of the fundamental features of the Code is that it allows creditors to assess the viability of a debtor as a business decision, and agree upon a plan for its revival or a speedy liquidation. The Code creates a new institutional framework, consisting of a regulator, insolvency professionals, information utilities and adjudicatory mechanisms, that will facilitate a formal and time bound insolvency resolution process and liquidation.

Key Highlights

Corporate Debtors: Two-Stage Process

To initiate an insolvency process for corporate debtors, the default should be at least INR 100,000 (USD 1495) (which limit may be increased up to INR 10,000,000 (USD 149,500) by the Government). The Code proposes two independent stages:

Insolvency Resolution Process: During which financial creditors assess whether the debtor's business is viable to continue and the options for its rescue and revival; and

Liquidation: If the insolvency resolution process fails or financial creditors decide to wind down and distribute the assets of the debtor.

The Insolvency Resolution Process (IRP)

The IRP provides a collective mechanism to lenders to deal with the overall distressed position of a corporate debtor. This is a significant departure from the existing legal framework under which the primary onus to initiate a reorganisation process lies with the debtor, and lenders may pursue distinct actions for recovery, security enforcement and debt restructuring.

The Code Envisages the Following Steps in the IRP

Commencement of the IRP

A financial creditor (for a defaulted financial debt) or an operational creditor (for an unpaid operational debt) can initiate an IRP against a corporate debtor at the National Company Law Tribunal (NCLT).

The defaulting corporate debtor, its shareholders or employees, may also initiate voluntary insolvency proceedings.

Moratorium

The NCLT orders a moratorium on the debtor's operations for the period of the 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.

Appointment of Resolution Professional

The NCLT appoints an insolvency professional or 'Resolution 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 a committee of creditors. This is similar to the approach under the UK insolvency laws, but distinct from the "debtor in possession" approach under Chapter 11 of the US bankruptcy code. Under the US bankruptcy code, the debtor's management retains control while the bankruptcy professional only oversees the business in order to prevent asset stripping on the part of the promoters.

Therefore, the thrust of the Code is to allow a shift of control from the defaulting debtor's management to its creditors, where the creditors drive the business of the debtor with the Resolution Professional acting as their agent.

Creditors Committee and Revival Plan

The Resolution Professional identifies the financial creditors and constitutes a creditors committee. Operational creditors above a certain threshold are allowed to attend meetings of the committee but do not have voting power. Each decision of the creditors committee requires a 75% majority vote. Decisions of the creditors committee are binding on the corporate debtor and all its creditors.

The creditors committee considers proposals for the revival of the debtor and must decide whether to proceed with a revival plan or liquidation within a period of 180 days (subject to a one-time extension by 90 days). Anyone can submit a revival proposal, but it must necessarily provide for payment of operational debts to the extent of the liquidation waterfall.

The Code does not elaborate on the types of revival plans that may be adopted, which may include fresh finance, sale of assets, haircuts, change of management etc.

Liquidation

Under the Code, a corporate debtor may be put into liquidation in the following scenarios:

- A 75% majority of the creditor's committee resolves to liquidate the corporate debtor at any time during the insolvency resolution process
- The creditor's committee does not approve a resolution plan within 180 days (or within the extended 90 days);
- The NCLT rejects the resolution plan submitted to it on technical grounds
- 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 (including the proceeds of liquidation) vest in the liquidation estate.

Priority of Claims

The Code significantly changes the priority waterfall for distribution of liquidation proceeds.

After the costs of insolvency resolution (including any interim finance), 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, employee dues and other unsecured financial creditors. Under the earlier regime, Government dues were immediately below the claims of secured creditors and workmen in order of priority.

Upon liquidation, a secured creditor may choose to realise his security and receive proceeds from the sale of the secured assets in first priority. If the secured creditor enforces his claims outside the liquidation, he must contribute any excess proceeds to the liquidation trust. Further, in case of any shortfall in recovery, the secured creditors will be junior to the unsecured creditors to the extent of the shortfall.

Insolvency Resolution Process for Individuals/ Unlimited Partnerships

For individuals and unlimited partnerships, the Code applies in all cases where the minimum default amount is INR 1000 (USD 15) and above (the Government may later revise the minimum amount of default to a higher threshold). The Code envisages two distinct processes in case of insolvencies: automatic fresh start and insolvency resolution.

Under the automatic fresh start process, eligible debtors (basis gross income) can apply to the Debt Recovery Tribunal (DRT) for discharge from certain debts not exceeding a specified threshold, allowing them to start afresh.

The insolvency resolution process consists of preparation of a repayment plan by the debtor, for approval of creditors. If approved, the DRT passes an order binding the debtor and creditors to the repayment plan. If the plan is rejected or fails, the debtor or creditors may apply for a bankruptcy order.

Institutional Infrastructure

The Insolvency Regulator

The Code provides for the constitution of a new insolvency regulator i.e., the Insolvency and Bankruptcy Board of India (Board). Its role includes: (i) overseeing the functioning of insolvency intermediaries i.e., insolvency professionals, insolvency professional agencies and information utilities; and (ii) regulating the insolvency process.

Insolvency Resolution Professionals

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

In the resolution process, the insolvency professional verifies the claims of the creditors, constitutes a creditors committee, runs the debtor's business during the moratorium period and helps the creditors in reaching a consensus for a revival plan. In liquidation, the insolvency professional acts as a liquidator and bankruptcy trustee.

Information Utilities

A notable feature of the Code is the creation of information utilities to collect, collates, 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 information would be available to creditors, resolution professionals, liquidators and other stakeholders in insolvency and bankruptcy proceedings. The purpose of this is to remove information asymmetry and dependency on the debtor's management for critical information that is needed to swiftly resolve insolvency.

Adjudicatory Authorities

The adjudicating authority for corporate insolvency and liquidation is the NCLT. Appeals from NCLT orders lie to the National Company Law Appellate Tribunal and thereafter to the Supreme Court of India. For individuals and other persons, the adjudicating authority is the DRT, appeals lie to the Debt Recovery Appellate Tribunal and thereafter to the Supreme Court.

In keeping with the broad philosophy that insolvency resolution must be commercially and professionally driven (rather than court driven), the role of adjudicating authorities is limited to ensuring due process rather than adjudicating on the merits of the insolvency resolution.

Analysis

One ground on which the validity of the Code was challenged was that the process for initiation of the corporate insolvency resolution process was not consistent with the principles of natural justice. In Sree Metaliks Ltd. v. Union of India, 2 the constitutionality of section 7 was challenged on the ground that the provision does not provide the corporate debtor an opportunity to be heard before an application to initiate an insolvency resolution process against it is admitted. The petitioner argued that since the provisions of the Code are silent on the right of the corporate debtor to be heard, the right to hearing should be read into the provision. The Court relied on section 424 of the Companies Act, 2013, to hold that even though the Code is silent on the right of hearing of the corporate debtor, "where a statute is silent on the right of hearing and it does not in express terms, oust the principles of natural justice, the same can and should be read into in." Accordingly, the Court held that the Adjudicating Authority is obliged to give reasonable opportunity to be heard to the corporate debtor. The Calcutta High Court also delved into the question of constitutionality of certain provisions of the Code. In Akshay Jhunjhunwala and Anr. v. Union of India, 3 the validity of sections 7, 8 and 9 was challenged. It was argued that the differentiation made between the operational and financial creditors by these provisions does not have a rational or intelligible basis and is therefore, liable to be struck down. The Calcutta High Court relied on the Report of the Bankruptcy Law Reforms Committee, wherein the Committee had opined that "members of the creditors committee have to be creditors both with the capability to assess viability, as well as to be willing to modify terms of existing liabilities in negotiations. Typically, operational creditors are neither able to decide on matters regarding the insolvency of the entity, nor willing to take the risk of postponing payments for better future prospects for the entity... for the process to be rapid and efficient, the Code will provide that the creditors committee should be restricted to only the financial creditors." Given this, the Court held that "the Bankruptcy Committee gives a rationale to the financial creditors being treated in a particular way vis-à-vis an operational creditor in an insolvency proceeding with regard to a company. The rationale is a plausible view taken for an expeditious resolution of an insolvency issue of a company. Courts are not required to adjudge a legislation on the basis of possible misuse or the crudities or inequalities that may be perceived to be embedded in a legislation. The rationale of giving a particular treatment to a financial creditor in the process of insolvency of a company under the Code of 2016 cannot be said to offend any provisions of the Constitution of India." 1 Bankruptcy Law Reforms Committee, The Interim Report of the

Bankruptcy Law Reforms Committee (2015) 2 Sree Metaliks Ltd. v. Union of India, Writ Petition 7144 (W) of 2017. Decision date- 07.04.2017 3 AkshayJhunjhunwala and Anr. v. Union of India, Writ Petition No. 627 of 2017. Decision date- 02.02.2018 8 Understanding the Insolvency and Bankruptcy Code, 2016 In Shivam Water Treaters Pvt. Limited v. Union of India, 4 the Supreme Court requested the Gujarat High Court to refrain from entering the debate relating to the "validity of the Insolvency and Bankruptcy Code, 2016 or the constitutional validity of the National Company Law Tribunal." However, it did not bar the petitioners from challenging the same before the Supreme Court under Article 32. Thereafter, the constitutional validity of various provisions of the Code was challenged before the Supreme Court. In its judgment in Swiss Ribbons Pvt. Ltd. v. Union of India,5 the Supreme Court held that the judiciary should exercise restraint while examining the constitutional validity of economic legislation since "in complex economic matters every decision is necessarily empiric and it is based on experimentation or what one may call trial and error method and therefore, its validity cannot be tested on any rigid prior considerations or on the application of any straitjacket formula."6 In this background, the Court upheld the constitutional validity of all the provisions challenged before it. A large number of the challenges before the Court were against the provisions that treated financial creditors and operational creditors distinctly. First, the Court observed the distinction between financial debt and operational debt in the following terms "a financial debt is a debt together with interest, if any, which is disbursed against the consideration for time value of money. It may further be money that is borrowed or raised in any of the manners prescribed in Section 5(8) or otherwise, as Section 5(8) is an inclusive definition. On the other hand, an 'operational debt' would include a claim in respect of the provision of goods or services, including employment, or a debt in respect of payment of dues arising under any law and payable to the Government or any local authority."7 It further relied on the Final Report of the Bankruptcy Law Reform Committee, the Notes on Clause 8 of the Insolvency and Bankruptcy Bill, 2015 and the Report of the Insolvency Law Committee, to broadly lay down the distinctions between financial and operational creditors as "most financial creditors, particularly banks and financial institutions, are secured creditors whereas most operational creditors are unsecured, payments for goods and services as well as payments to workers not being secured by mortgaged documents and the like."8 The Court also distinguished between the nature of agreements entered into with financial creditors and operational creditors, where the former generally lends for working capital or on a term loan and involves a larger quantum of money as compared to the latter where the agreement mostly relates to the supply of goods and services. Therefore, the Court held that the distinction between the two is based on intelligible differentia with a rational nexus to the objectives that the Code seeks to achieve. Secondly, the Court highlighted that the most significant difference between financial and operational creditors is that "financial creditors are, from the very beginning, involved with assessing the viability of the corporate debtor. They can, and therefore do, engage in restructuring of the loan as well as reorganization of the corporate debtor's business when there is financial stress, which are things operational creditors do not and cannot do."9 This was relied on, along with the legislative and case law developments that guarantee fair and equitable treatment to operational creditors, to hold that the provisions giving only financial creditors the right to vote as part of the committee of creditors are valid. Thirdly, the Court also analysed if the difference in the process for triggering the corporate insolvency resolution process by operational creditors and financial creditors was arbitrary. The Court held that since financial creditors have to prove that there is "default" on the basis of solid documentation, or information in an information utility that is easily verifiable, it was justifiable that they were not required to provide a demand notice to the corporate debtor. This is contrary to the requirement imposed on an operational creditor to provide a demand notice to the corporate debtor, who only "claims a right to payment of a liability or obligation in respect of a debt which may be due".10 Finally, the validity of section 53 of the Code was challenged on the grounds that it was discriminatory towards operational creditors. The Court held that given the relative importance of the two types of debts, particularly the importance of repayment of financial debts for 4 Shivam Water Treaters Pvt. Ltd. v. Union of India, SLP No.1740/2018. Decision date- 25.01.2018 5 Swiss Ribbons Pvt. Ltd. &Anr. v. Union of India, Writ Petition (Civil) No. 99 of 2018. Decision date- 25.01.2019 6 Ibid. 7 Ibid. 8 Ibid. 9 Ibid. 10Ibid. 9 Understanding the Insolvency and Bankruptcy Code, 2016 promoting capital availability in the economy, a legitimate interest was being protected by section 53 of the Code. Various challenges were also raised against the validity of section 29A. The validity of this section was challenged on the grounds that first, it had retrospective application. The Court held that since a resolution applicant does not have a vested right in being considered as such in the resolution process, the section cannot be held to be retrospective. Secondly, it was argued that section 29A(c) holds unequals as equals by treating promoters who did not act with malfeasance on par with those who had. The Court held that section 29A was intended to apply to persons other than criminals or those who had been malfeasant, and this was justified by the legislative purpose of the section. Thirdly, it was argued that placing a bar on persons disqualified under section 29A from purchasing any assets of the corporate debtor in liquidation as well would be contrary to the purpose of maximizing the value of the assets of the corporate debtor. This contention was rejected on the ground that the legislative purpose would continue to apply even in liquidation. Fourthly, it was argued that the period of one year prescribed in section 29A for the disqualification to apply was arbitrary and without basis. The Court held that it was legislative policy that a person who is unable to service its own debt beyond the grace period of one year, is unfit to be eligible to become a resolution applicant, and "this policy cannot be found fault with. Neither can the period of one year be found fault with, as this is a policy matter decided by the RBI and which emerges from its Master Circular, as during this period, an NPA is classified as a substandard asset." 11 Fifthly, it was argued that the disqualification of relatives of persons who are disqualified in section 29A was arbitrary. The Court held that "The expression "related party", therefore, and "relative" contained in the definition Sections must be read noscitur a sociis with the categories of persons mentioned in Explanation I, and so read, would include only persons who are connected with the business activity of the resolution applicant."12 Finally, it was argued that the exemption of MSMEs from section 29A was arbitrary. The Court held that it was not arbitrary since "the rationale for excluding such industries from the eligibility criteria laid down in Section 29A(c) and 29A(h) is because qua such industries, other resolution applicants may not be forthcoming, which then will inevitably lead not to resolution, but to liquidation." 13 The Court also examined the validity of section 12A that was challenged as being violative of Article 14, largely since the withdrawal of a petition under section 12A requires the approval of ninety per cent of the Committee of Creditors. The Court emphasized that an insolvency proceeding is a proceeding in rem and not a lis between parties. Consequently, and as also explained in the report of the Insolvency Law Committee "all financial creditors have to put their heads together to allow such withdrawal as, ordinarily, an omnibus settlement involving all creditors ought, ideally, to be entered into. This explains why ninety per cent, which is substantially all the financial creditors, have to grant their approval to an individual withdrawal or settlement." 14 Further, if the committee of creditors arbitrarily rejects an application for withdrawal, their decision can be set aside by the Adjudicating Authority or the Appellate Authority. Given this, the court also upheld the validity of this provision. Provisions of the Code were also challenged on the grounds that the information stored in private information utilities should not be the conclusive evidence of default, and that these utilities are not governed by proper norms. The Court took note of the Insolvency and Bankruptcy Board of India (Information Utilities) Regulations, 2017 and held that "the aforesaid Regulations also make it clear that apart from the stringent requirements as to registration of such utility, the moment information of default is received, such information has to be communicated to all parties and sureties to the debt. Apart from this, the utility is to expeditiously undertake the process of authentication and verification of information, which will include authentication and verification from the debtor who has defaulted. This being the case, coupled with the fact that such evidence, as has been conceded by the learned Attorney General, is only prima facie evidence of default, which is rebuttable by the corporate debtor, makes it clear that the challenge based on this ground must also fail."15 11Ibid. 12Ibid. 13Ibid. 14 Ibid. 15Ibid. 10 Understanding the Insolvency and Bankruptcy Code, 2016 It was also argued that by giving adjudicatory powers to a non-judicial authority, that is, the resolution professional, the Code violates the basic aspects of dispensation of justice and access to justice. This contention was also rejected by the Court on the grounds that "the resolution professional is really a facilitator of the resolution process, whose administrative functions are overseen by the committee of creditors and by the Adjudicating Authority."16 The Court also dealt with challenges to the appointment of members of the National Company Law Tribunal ("NCLT") and the National Company Law Appellate Tribunal ("NCLAT") which are the Adjudicating Authority and Appellate Authority for corporate debtors, respectively, under the Code, the location and number benches of the NCLAT and the Ministry which would exercise administrative control over the NCLT and NCLAT.17 While the Supreme Court passed directions regarding the administrative control over the NCLT and the establishment of circuit benches of the NCLAT, it upheld the validity of the NCLT and NCLAT. Conclusion The provisions of the Code pertaining to initiation of the corporate insolvency resolution process, voting in the committee of creditors, distribution in liquidation, withdrawal of the corporate insolvency resolution process, disqualification from submitting a resolution plan, information utilities and powers of the resolution professional have been held valid. 16Ibid. 17One ground of challenge was regarding the appointment of members of NCLT and NCLAT, which was contended to be contrary to the judgment in Madras Bar Association v. Union

References

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