Insolvency and Bankruptcy Code marks the new era of Financial Reform in India

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ABSTRACT

Bankruptcy is used as the formal procedure for individuals (not companies in many countries) who are declared by law to be insolvent. The insolvency and bankruptcy processes in India are not governed by a single piece of general legislation. In the situation of insolvency, to solve the problem of NPA, make the exit process easier for the investors and attract fresh capital and foreign investors, a new legislative framework has been evolved known as Insolvency and Bankruptcy Code, 2016 (IBC). IBC, 2016 was passed by the Parliament on 11th May 2016, and received Presidential assent on 28th May, 2016. IBC is the only bankruptcy law in India which seeks to consolidate the existing framework by creating a single law for insolvency and bankruptcy. Since the success of the IBC depends on both the form of supporting legislation and the development of the institutional infrastructure, relevant policy issues must be resolved before the law can be effectively implemented. The present research paper aims to highlight the features of this new law and its various scopes and prospects in the Indian context. It also focuses on the Insolvency and Bankruptcy Codes which have been prevalent in other countries like UK and US long before its introduction in India.

Keywords: Insolvency, Bankruptcy, Law

A. Introduction

Many a time a company may not have enough assets to cover its debts and/or it cannot pay its debt on the due date, then the company is called insolvent. “Insolvency” means inability to pay debts as they fall due- from the Latin word “solvere” to pay. Bankruptcy is a collective procedure for the recovery of debts by creditors (Wood, 2007). Whether or not an act of bankruptcy has been committed, a firm is considered to have become "insolvent" when it is unable to pay its obligations back in the normal course of business or when it is unable to disburse them when they become due (Goel, 2017). Bankruptcy is used as the formal procedure for individuals (not companies in many countries) who are declared by law to be insolvent. Liquidation means turning a company’s assets into cash and then distributing this to the creditors. The most commonly used procedure for insolvent companies, liquidation is the end of the road. After the

assets are sold and the proceeds distributed, the company is struck off the register, or dissolved.

Post-independence the industrial policies in India, such as import substitution, industrial licensing, and limited private ownership, promoted a group of inefficient and uncompetitive companies. Due to deregulation, foreign competition and financial reform a number of financially unviable firms had to consider exit or restructuring options. However, the existing legal, political and social system did not provide the appropriate framework for efficient and equitable resolution of insolvency cases, thus dramatically slowing down the pace of the much-needed industrial restructuring. According to the World Bank's Ease of Doing Business Index 2015, India was ranked 137 out of 189 countries in respect to the ease of resolving the cases of insolvencies based on various indicators such as the structure of the insolvency law framework, time, costs of the procedure, recovery rate for creditors, creditor participation, a debtor's assets management during the period of insolvency proceedings etc. (World Bank, 2015).

Till very recently there was no single comprehensive and integrated policy on corporate bankruptcy in India. Previously there used to be different legislative acts and special provisions, which used to provide procedural guidance on the liquidation or reorganization process and there was an involvement of different agencies, having overlapping jurisdiction, which used to create systemic delays and complexities in the process. The main objective of a well-functioning bankruptcy system is to promote economic efficiency by maximizing the total value of assets, the Indian system fails, as under this system, liquidation or reorganization is extremely time and resource costly; the system does not encourage optimal valuation outcomes; and creates incentives for managers or stockholders to take actions that generate private benefits at the expense of firm value. In the situation of insolvency, to solve the problem of Non-Performing Assets (NPA) has been the main objective for the development and formulation of the Insolvency and Bankruptcy Code (IBC) in India.

B. Insolvency and Bankruptcy Code in other countries

In the bankruptcy process efficiency of an organisation can be measured in three stages -ex-ante, interim, and ex-post- which depend particularly on the information available at the time. Holmstrom and Myerson (1983), have defined the three stages as the ex-ante stage is the time before any private information is received by any individual; the interim stage is when private information has been received, but it has not been shared amongst others; and, ultimately, the ex-post stage is when each and every private information is common knowledge for all. Since the integrated form of the Insolvency and Bankruptcy Code in India is

a newly launched concept, we must focus on some other countries where this regulation has got a considerable amount of history. The Insolvency and Bankruptcy Codes of the two important countries that have been studied as part of the present study are UK and US.

Insolvency Code in the UK

During the process of insolvency in UK, prior to the 1986 Insolvency Act, formal reorganization of any company was mediated by the three possible routes to: 1) liquidation, 2) receivership, and 3) company voluntary arrangements. An additional procedure, administration, was introduced in 1986. The most widely used course of action is the liquidation code, which accounted for about three-quarters of all formal reorganizations since 1990, while a further 22% was accounted for receivership (Rajak, 1994).

The main objective of the liquidator is to sell the requisite amount of assets of the firm to repay creditors. The liquidator may sell the company as a going concern or in a non-operating state, but if he uses funds belonging to creditors to delay the sale, then he would risk dismissal or legal action. If one or more of the firm's creditors have a particular kind of lien on the firm's assets then it can lead to Receivership. This is known as a floating charge, which is a claim on moveable assets such as stocks and work in progress. The creditor appoints the receiver with the floating charge, and he represents the interests of that particular creditor only with virtually no duty of care towards other creditors. The powers of the receiver are significant (Franks et al, 1996).

Bankruptcy Code in the US

The Bankruptcy Code in the US is an integrated regulation. It holds two main bankruptcy procedures for US corporations: Chapter 7 and Chapter 11. Chapter 7 denotes the liquidation provision. It provides for the scope of appointing a trustee by the court to oversee the entire process of liquidation of the company. Inevitably during the liquidation procedure, the firm is closed down prior to sale and its assets are auctioned. Chapter 11 essentially allows a firm to continue its operation on one hand while on the other a plan of reorganization is worked out with its creditors. To facilitate this process, the directors of the corporation are further permitted to stay in charge also providing substantial rights to the firm, which is often referred to as the debtor-in-possession.

In the majority of the cases, the existing management remains in control, while new management is appointed in a large number of remaining cases (Gilson, 1989). In some cases, the court may appoint a trustee. Appointing a trustee is generally a temporary measure until new management is appointed. Most of the firms enter Chapter 11 only after attempting to resolve through an informal reorganization or workout outside of the bankruptcy process. The reason behind

this is primarily the cost and the time involved in the Chapter 11 procedure is huge in comparison to the procedures of workouts (Franks and Torous, 1994).

C. Background for the development of IBC

The ability to liquidate totally unviable Indian firms rapidly has often compelled creditors to support going-concern restructuring when they should have cut their losses and forced these companies to wind-up" (Goswami, 1996). Initially, there was no single comprehensive and integrated policy on corporate bankruptcy in India that is comparable with the bankruptcy code in the US or UK which have a structured framework. There were three major legislative Acts and several special provisions, which were used to provide procedural guidance on the liquidation or reorganization process. As a result, four different agencies, the High Courts, the Company Law Board, the Board for Industrial and Financial Reconstruction (BIFR), and the Debt Recovery Tribunals (DRTs), have been coinciding with one another's jurisdiction, leading to slow down of the entire system and bringing in complexities in the process (Kang & Nayar, 2004). The key legislations, regulations and non-statutory guidance amended are summarized below, which were previously followed by an assessment and implications for the companies in financial distress, namely:

- Companies Act 1956/ 2013
- Securitisation& Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act, 2002),
- Recovery of Debts Due to Banks and Financial Institutions Act, 1993 , (RDDBFI Act, 1993),
- Sick Industrial Companies Act, 1985 (SICA Act, 1985),
- Other enactments for partnership and individual insolvencies,
- Non-statutory guidelines/out-of-court mechanism

The primary problem in the current structure of the insolvency regime is due to the existence of the multi-layered legal framework that involves different statutes for different processes which has created a number of parallel proceedings and hence conflicts have emerged among these diverse statutes relating to companies in distress. The secondary issue is related to the time required to resolve the cases of insolvencies. There are significant delays in procedures of winding up and also in liquidation proceedings. Thus the aforementioned two issues are the main reasons for the current system's failure in effectively resolving corporate insolvencies and thus arises the need to develop a more comprehensive legal framework with a structured process (Ravi, 2015).

D. Insolvency and Bankruptcy Code – Implementation Journey of the Code

The Insolvency and Bankruptcy Code, 2016 (IBC) was passed by the Parliament on 11th May 2016 and received Presidential assent on 28th May, 2016. IBC was approved by both Houses of Parliament and received Presidential assent in May 2016. It was made operational from 1st December 2016. IBC at present is touted as the second most important legislative reform (after GST) that has been initiated by the Government in order to resolve the NPA problem, make the exit process easier for investors, and attract fresh capital and foreign investors. It will also target channelizing capital to more productive assets and give a boost to India's ease of doing business.

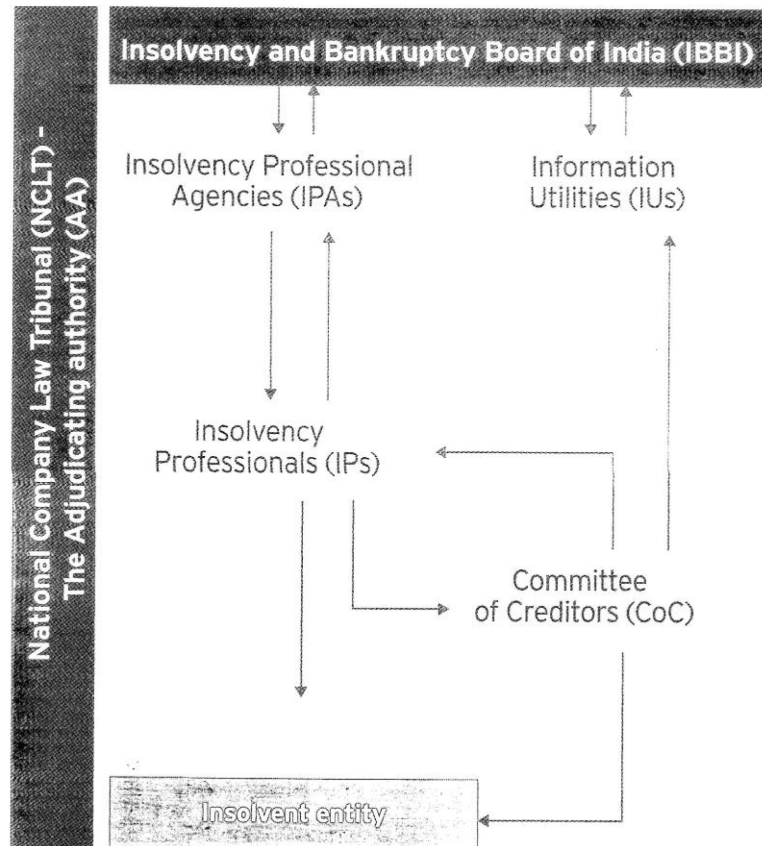
IBC is the only bankruptcy law of India that seeks to consolidate the existing framework by creating a single law for insolvency and bankruptcy (Rajoria, 2018). The Code outlines separate insolvency resolution processes for individuals, companies and partnership firms. This law replaces Sick Industrial Companies (special provisions), Repeal Act, 2003 and amends other legislations like Companies Act, 2013, The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (also known as the SARFAESI Act) , etc.. IBC will provide a timely resolution process, bringing down drastically the time taken to wind up a sick company, initiating a swift process.

E. Objective Section of the Code

- Consolidate and amend laws relating to insolvency and bankruptcy
- Maximisation of value
- Time-bound resolution
- Promote entrepreneurship and availability of credit
- Alteration of priority of payments of Government dues
- Establish an insolvency and bankruptcy board in India.

F. Insolvency and Bankruptcy Ecosystem

The following diagram shows the ecosystem and the participating organizations in the Insolvency regime. IBBIis the apex body for promoting transparency and governance in the administration of the Code. It will be involved in setting up the infrastructure and accrediting Insolvency Professionals (IPs) & Information Utilities (IUs).



Information Utilities (IUs):These are centralized repositories of financial and credit information of borrowers. It would validate the information and claims of creditors as well as borrowers, as needed.

Insolvency Professional Agencies (IPAs): These are professional bodies registered by the Board to promote and regulate the insolvency profession. These bodies will enroll IPs.

Insolvency Professionals (IPs): They are licensed professionals regulated by the IBBI. They will conduct a resolution process. They will act as Liquidators. They will be appointed by the creditors and will assume the powers of the suspended board of directors.

Adjudicating Authority (AA): It would be National Company Law Tribunal (NCLT) for corporate insolvency. It will help to entertain or dispose of any insolvency application, approve/ reject resolution plans, and decide in respect of claims or matters of law/facts thereof.

Committee of Creditors (CoC): It consists of financial creditors who will appoint and supervise actions of IPs and focus on approval of the resolution plan.

G. Role and Responsibilities of IP under the Code

The key powers and duties of Resolution professionals are as follows:

- The powers of the board of directors of the corporate debtor, shall stand suspended and be exercised by the Interim Resolution Professional (IRP) / Insolvency Professional (IP).
- The officers and managers of the corporate debtor shall report to the IP and provides access to such documents and records of the corporate debtor as may be required.
- The IP shall act and execute in the name and on behalf of the corporate debtor all deeds, receipts and other documents.
- Collate all claims, from a Committee of Creditors (CoC), conduct the Corporate Insolvency Resolution Process (CIRP).
- Prepare the information memorandum (IM) and invite resolution plans.
- Investigate the official affairs of the company, appoint valuers.
- Take control and custody of any asset owned by the corporate debtor.

H. Corporate Insolvency Resolution Process (CIRP)

Default: Failure to pay whole or any part of instalment of the amount of debt or interest due (minimum INR 1lakh).

Who can file the application?

- Financial Creditors
- Operational Creditors (including Government & employees / workmen)
- Corporate debtor

No new application for CIRP can be made.

Interim Resolution Professional (IRP) / Resolution Professional (RP)

- Financial creditor and / or corporate applicant shall propose the name of an IRP in the application.
- It is optional for operational creditor to propose the name of an Interim IP.
- All powers of the suspended Board of Directors shall vest with the IRP / RP.

- RP is responsible to run the company as a going concern during CIRP.
- IRP / RP to get immunity from legal proceedings for action taken in good faith.

Moratorium

- The National Company Law Tribunal (NCLT) to declare moratorium from insolvency commencement date until completion of insolvency.
- Moratorium shall prohibit institution of suits, transfer of assets, foreclosure, recovery or enforcement under SARFAESI, recovery of assets.

Committee of Creditors (CoC)

- It consists of financial creditors only, excluding related parties.
- It includes secured and unsecured financial creditors
- It will confirm or replace IRP as RP
- It will approve several actions of RP

Resolution plan

The resolution plan must provide for

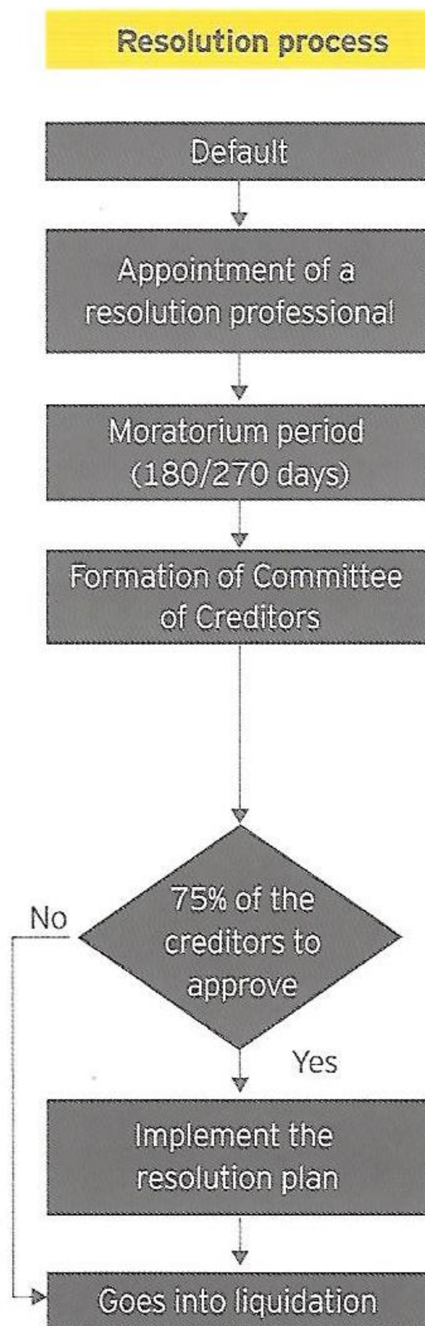
- Payment of insolvency resolution
- Process costs
- Repayment of the debt of operational creditors
- Management of affairs of the borrower after the plan is approved
- Implementation & supervision of the approved plan

Voting Power

- Only financial creditors have voting power in the committee in the ratio of debt owed
- All decision of the committee shall be approved by 75% of financial creditors
- Directors and operational creditors can attend the meeting, but would not have any voting rights

Fast Track Insolvency for debtors with

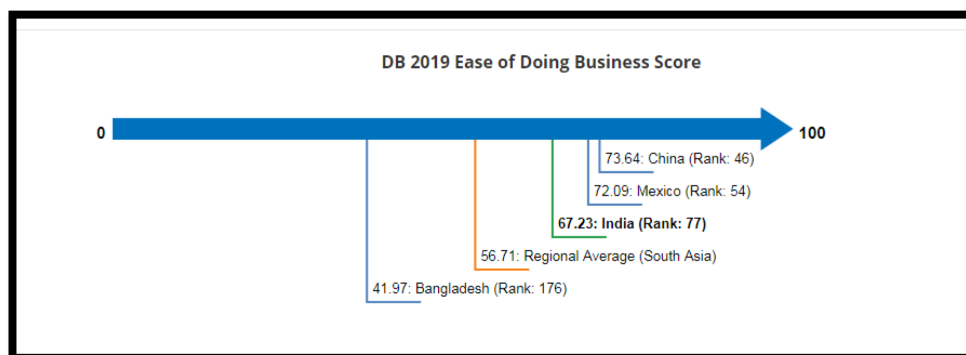
- Assets and income below a level
- Such class of creditors
- Other categories as notified by the Central Government to be completed in 90 days, with a one-time extension of 45 days.



I. Conclusion

IBC has radically altered the insolvency law landscape in India. As evident from the present study that effectiveness of Insolvency code or Bankruptcy code in countries like UK and US is due to series of alterations and integration of regulations in this regard. In Indian context the first attempt to integrate the insolvency and bankruptcy laws and procedures will need to pass through the test of time. Eventually the clear shift in the existing regulations will go a long way in resolving distressed situations, enhancing recoveries for all stakeholders

reducing the scope for the wrongful exercise of legal authority by the directors to take creditor-focused action at the early stages of financial difficulty could create pitfalls for professional managers and directors who may not have any fraudulent or criminal intent. While the legal issues are expected to be ironed out over a period of time as the insolvency landscape matures, the other practical issues can only be handled by team effort, where each stakeholder works in unison, in the interest of collective resolution instead of serving individual interests. A creditor has an option of either insolvency tools to enforce recovery and/ or liquidation of the company or the bankruptcy of the individual. In many cases, this action can be counter-productive by forcing a business to cease trading and depressing the realisable value of the assets. IBC being one the very important factors which has changed the existing structure of financial sector in India may be considered as one of the key reasons for the country's higher rank of 77 in 2019 as per World Bank's Ease of Doing Business Index 2019.



World Bank's Ease of Doing Business Index 2019 showing India's rank

source: https://www.doingbusiness.org/en/data/exploreeconomies/india

Economy	globalRank	Rank within group	Starting a business	Resolving insolvency
Bulgaria	61	61	113	61
Saudi Arabia	62	62	38	168
India	63	63	136	52
Ukraine	64	64	61	146
Puerto Rico	65	65	59	10
Brunei Darussalam	66	66	16	59

World Bank's Ease of Doing Business Index 2023 showing India's rank has improved

source: https://archive.doingbusiness.org/en/rankings

It is often preferable to ensure a business keeps trading to preserve value and future customers. This is dependent upon the directors co-operating in recognised financial difficulty and implementing a rescue procedure such as insolvency. This can require persuasion and negotiation with the creditor, who will sometimes use a threat to wind up the company as a lever. Significant value

can be preserved even in distressed situations if the lenders act swiftly with clear intent. Indian economist Montek S. Ahluwalia is of the opinion that when reform goals are indicated only as a broad direction, with the precise end-point and pace of transition left unstated, the opposition is minimised, and the government is given room to retreat if necessary (Ahluwalia, 2002). In light of the fact that the success of the IBC depends on both the form of the supporting legislation and the development of the institutional infrastructure, it needs to consider policy issues which must be resolved before the law can be effectively implemented (Sane, 2019). IBC is thus a test of the collective resilience and maturity of the creditors, debtors, professionals, and regulators combined together. In this regard, future studies could focus on the effects of the IB Code, the impact on sick industries after BIFR is abolished, and how well insolvency resolution procedures would work under the new system in India. It is also important to undertake studies regarding the implication of IB Code on cross-border cases of insolvency (Das, 2020).

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