Unit 37. Insolvency and Bankruptcy Code: Why do we need it now?

India did not have a single bankruptcy code. What we had were age-old laws which are in conflict with each other. Lack of an insolvency and bankruptcy code had proved costly for the creditors (mainly banks) in many cases like the recent Kingfisher Airlines case. The Insolvency and Bankruptcy Code seeks to create a unified framework to resolve insolvency and bankruptcy in India.

The Code covers insolvency, liquidation, voluntary liquidation and bankruptcy. The bill makes it easier for weak companies to exit or restructure their businesses. The code seeks to amend 11 laws, including the Companies Act, 2013 and the Sick Industrial Companies (Special Provisions) Repeal Act, 2003.

Latest status: The Insolvency and Bankruptcy Code 2016 was introduced in the Lok Sabha by Finance Minister Arun Jaitley in December 2015 and the JPC's report is expected next week. The new Code is based on the report of the committee which studied the matter (Bankruptcy Law Reform Committee).

What are Insolvency and Bankruptcy?

Insolvency is the situation where the debtor is not in a position to pay back the creditor. For a corporate firm, the signs of this could be a slow-down in sales, missing of payment deadlines etc. Bankruptcy is the legal declaration of Insolvency. So the former is a financial condition and latter is a legal position. All insolvencies need not lead to bankruptcy. The new code has a sequential procedure of Insolvency resolution, failing which, it leads to Bankruptcy (following liquidation of assets).

Why do we need such a code?

1. Such a unified code is essential because currently the issue is handled under at least 13 different laws. This code seeks to replace the Presidency Towns Insolvency Act, 1909 and Provincial Insolvency Act, 1920. In addition, it seeks to amend 11 laws, including the Companies Act, 2013, Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and Sick Industrial Companies (Special Provisions) Repeal Act, 2003, among others.
2. Earlier, if a company defaults, there were at least four different legal routes available to the debtors and creditors. This could lead to multiple negotiations, multiple penalties etc. for the debtor, compounding his plight.
3. Such parallel proceedings had also given rise to numerous instances of conflict between the laws. 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 overlapping jurisdiction, giving rise to the potential of systemic delays and complexities in the process. This new bill addresses these issues, by bringing in a new uniform Code.
4. Current insolvency proceedings take months, if not years (average time: 4 years). This delay can acutely devalue the assets involved, thus making the insolvency negotiations redundant.
5. The current disposition involves the institution of official liquidator, which is prone to red-tapeism, chronic corruption, and nepotism. The new code seeks to keep the role of the adjudicator to the minimum.
6. Currently, only 25% of the asset value is recovered by the creditors even after the liquidation process.
7. All these compounded to the pitiable position our Public Sector Banks find themselves in. Rising NPAs and mounting Stressed Assets have also eroded their profits, as the recent SBI reports point out. The easing of liquidation process can help the banks recover a lot of bad debts.
8. India fares poorly in the Ease of Doing Business index of World Bank. Easiness of Exit is an important parameter in this index. The present morass of laws doesn't help in easing the exit of trouble-prone entities.
9. According to World Bank data, it takes **more than four years** to wind up an ailing company in India, almost twice as long as it does in China.

10. Just like the US Bankruptcy Code that provides for fairly quick liquidation or reorganisation of business, India too need a new code which will prevent the economy from tumbling southwards.

Current insolvency mechanisms or laws (which obviously didn't work well!)

- Securitisation and Enforcement of Security.
- Corporate Debt Restructuring or CDR.
- Sick Industrial Companies Act or SICA

Insolvency Proceedings: Companies vs Individuals

The code will apply to all sort of business entities including corporate companies, partnerships, limited liability partnerships, individuals etc. Broadly the insolvency proceedings or the **Insolvency Resolution Process (IRP)** can be classified into two streams:

1. Companies and Limited Liability Partnerships (LLP):

The process can be initiated either by the debtor or the creditor(s). In this case, of companies and LLPs, the resolution process has to be completed in 180 days from the date of registration of the intent. That means once an application for insolvency resolution is accepted, an 180-day moratorium comes into place, during which no claims can be pursued against the debtor or its assets. This period of 180 days, can be extended by another 90 days if 75% of the financial creditors agree. The process enables the debtor and creditor to hold negotiations and finalise a draft resolution plan. The draft plan is to be agreed up on by a majority of the creditors. If they do agree, the plan is finalised and submitted to the adjudicating authority, which in this case is the National Company Law Tribunal. If the plan is not agreed up on by the majority of creditors, the company goes into liquidation.

There will be a provision for hastening up the IRP, as far as companies with smaller operations are concerned. Here the process will have to be completed within 90 days, which may be extended only if 75% of the financial creditors agree to it.

2. Individuals and Partnerships:

Here, there are steps to be followed even before the Insolvency Resolution Process, IRP starts. Before going for IRP, the debtor may apply for forgiveness of specified amount of debt, provided his total assets are below a limit set by the Central Govt. This initial pardoning has to be done within 6 months. After that, the formal IRP starts, just like the first stream of companies, mentioned above. The negotiations between the debtor and creditor will be supervised by an insolvency professional. If they negotiations succeed, the repayment plan is drafted. If the plan is agreed upon by the majority of the creditors, the plan is submitted to the adjudicator, which in this case is Debt Recovery Tribunal. If they fail, the matter will proceed to the bankruptcy resolution.

Different parties associated with insolvency

Now that we have dealt with the insolvency process, we shall move on to the different parties involved.

1. **Insolvency professionals and agencies:** as said earlier, the IRP will be managed and supervised by a licensed professional. The Insolvency Code also proposes to set up insolvency professional agencies, which can recruit the professionals and regulate them. The professionals will also have the power and duty to control the assets of the debtor during the process.
2. **Information Utilities:** The code also proposes to establish information utilities which will maintain a range of financial information about firms. Their duty is to collect and disseminate the information to facilitate the insolvency resolution process.
3. Insolvency Regulator: The Code establishes the insolvency regulator, the **Insolvency and Bankruptcy Board of India, IBBI,** which will have the mandate to oversee the insolvency resolution in the country. The Board will have a membership of 10 members, including those representing the Central Government & Reserve Bank of India. The board will also act as the apex regulator, registering and regulating the information utilities, insolvency professional agencies, insolvency professionals etc.
4. **Insolvency and Bankruptcy Fund, IBF:** deposits of the fund will include grants made by the central government, the amount deposited by the persons, interest earned on investments made from the fund etc. any person, who has contributed to the fund, may apply for withdrawal, in a case of proceedings against him.
5. **Bankruptcy and Insolvency Adjudicators:** as noted earlier, there are two different adjudicators, proposed by the code, one each for the two streams for individuals and companies. The National Company Law Tribunal will have the jurisdiction over companies and Limited Liability Partnerships, whereas the Debt Recovery Tribunal will have the jurisdiction over the individuals and partnership firms. Appeals against the orders of these tribunals may be challenged before their respective Appellate Tribunals, and further before the Supreme Court.
6. **Credit Committee**: it is to be composed of financial creditors. The primary aim of the committee is to ensure payments to operating creditors on a pre-scheduled priority order (the priority proposed is listed later in the article).
7. **Offences and Penalties:** the offences committed by the debtor under the corporate insolvency (first stream) like concealing the property, defrauding creditors etc. will be punished with imprisonment up to 5 years, with a fine of up to one crore rupees. Whereas, the offences committed by an individual (second stream), like providing false information, the imprisonment will vary based on the evidence. For most of these offences, the fine will not exceed five lakh rupees.

Advantages of the New Code

1. The bill seeks to shift from revival/recovery to resolution. This will ensure maximum assets recovered from the debtor, thus helping the balance sheets of the creditor. This would go a long way in helping the NPA-situation of the banks.
2. The new bill proposes to speed up both recoveries and restructuring procedures. There is significant a curb on the time involved, a maximum of 270 days. This will expedite the insolvency process. Time is important as the value of the assets corrodes very rapidly, when the firm is precariously placed.
3. The bill aims at promoting investments, freeing up banks' resources for other productive uses, boosting credit markets and improving ease of doing business in India, thus making a cumulative positive impact on the economy
4. The fixed time-period and predictable procedural methods will encourage creditors to join the collective insolvency resolution, rather than initiate individual actions.
5. By keeping the role of the adjudicator to a minimum, the bill ensures that delays arising from the bottlenecks in court proceedings are also reduced to the minimum. The principal business decisions such as the economic viability of the debtor, will be determined through negotiations between the debtor and creditors – an exercise that will be facilitated by insolvency professionals. The role of the NCLT is primarily to ensure that the procedures are complied with and no illegality or fraud has taken place.
6. The draft Bill also abolishes the institution of the official liquidator, which by all accounts has been a failure in non-viable businesses. Instead, the functions of the official liquidator are to be performed by insolvency professionals.

7. Industry anticipates that the change will provide an easy exit option for insolvent and sick firms.
8. The new code will matter to private sector employees too. The Bill, by forcing failed firms to shut shop, can lead to a survival of the fittest in the job market too.
9. Make it easy for the budding entrepreneurs to start or exit from the start-up business. Commerce and Industry minister says it is going to make it easy to start up as much as to get out of the start-ups because if they are not doing well, there shouldn't be a taboo. They would be able to get out faster, thus helping the Start-up India Stand-up India campaign.

Concerns regarding the Bill:

1. The draft Bill needs careful review, particularly on how the new law would interact with existing laws in this space, including the Sarfaesi Act and other debt recovery laws. Since it appears that the new Code doesn't replace the existing laws (and only amends 11 laws), there must at least be a clear demarcation of when these laws would apply and of overriding provisions in cases of conflict with the code, if we are to avoid reverting to the old regime of chaos and uncertainty.
2. The bill also provides for priority with regard to the distribution of proceeds following liquidation of the company (who gets the bounty first!). In the order of priority, the first charge will be insolvency resolution process cost and liquidation costs to be paid in full. Liquidation proceeds will then be used to clear debts owed to secured creditors, and then to pay workmen's dues for 12 months, unpaid dues to employees other than workmen, and financial dues owed to unsecured creditors, in that order. Government taxes for two years, other debts, preference shareholders and equity shareholders will receive last priority for payment (waterfall provision). Since equity shareholders could include the employees' PF, pensioners' fund etc., giving the public money the least importance has raised some eye brows.
3. The credit committee is to compose only of financial creditors. However, operation creditors is to be paid out first. This could lead to a conflict of interest.
4. Only two year history is to be checked for diversion, to check for ascertaining malfeasance. There is a suggestion that earlier history also should be taken into account.
5. The proposed Bill is also quite ambitious in the creation of a new institutional architecture to deal with insolvency. Among other things, it proposes the establishment of a new regulator, the creation of a new profession of insolvency professionals and the establishment of institutions known as information utilities that are designed to provide accurate information on defaults. These institutions and practices will take time to establish and there need to be well thought out transitional arrangements in the interim. Equally essential is significant training for insolvency professionals and judges if insolvency resolution and liquidation are to be the efficient and time-bound processes that the draft Bill envisages.
6. Promoters will have the option to buy-back the company at a certain price, with certain debt restructuring. This has to be contemplated further to avoid bankruptcy tool from becoming an instrument to be exploited to reduce debt and increase equity value.
7. There is also apprehension that the ease of exit, could lead to hire and fire, especially in the private firms and start-up companies.

Conclusion

The proposed Insolvency and Bankruptcy Bill is only a starting point for easing exits for debtors in distress, preserving value and providing creditors with greater certainty in outcomes. Yet, by providing for a linear, time-bound and collective process for insolvency resolution and liquidation, it is a step in the right direction.