Insolvency and Bankruptcy Code 2016 - An Overview

The enactment of the 'The Insolvency & Bankruptcy Code, 2016' on May 26, 2016 is perhaps the single biggest reform undertaken in India in recent times. The Code unifies and streamlines the laws relating to recovery of debts and insolvency for both corporate and non-corporate persons. The Government and the bureaucracy must be given credit for clutching on to this opportunity provided by the prevailing NPA distress. The present article seeks to outline the existing mechanism for recovery of debts and revival of sick companies and distinguish the same with provisions in the Code. Read on to know more…

Existing Insolvency & Winding up Mechanism

Corporate Winding Up: Currently, the provisions of corporate winding up are provided in The Companies Act, 1956 as relevant provisions of Companies Act, 2013 are yet to be notified. Thus the law for corporate winding up has remained unchanged for 6 decades. It provides for winding up of companies which are unable to pay their debts. However for this, the debt should not be disputed and the High Court should be satisfied that there is no better option than to enforce liquidation. If the borrower disputes debt, the case is usually transferred to a Civil Court. As such therefore, the time involved in getting winding up order from a Company Court is very high and during this time promoters retain control of management often leading to deterioration in corporate governance. Another issue is that in the priority of payments, statutory dues get priority over other creditors. Therefore, many times secured creditors may not find this route providing the best recovery ratio. In a nutshell, owing to teething problems in the law and lack of comprehensive mechanism, this route has largely not proved effective in enforcing debts.

Non-Corporate Liquidation: Hitherto the insolvency of individuals, partnerships etc. are covered by more than a century old The Presidency Towns Insolvency Act, 1909 for erstwhile presidency towns of Mumbai, Kolkata & Chennai and by The Provincial Insolvency Act, 1920 for the rest of India. The administration of personal insolvency laws is with Civil Courts. The remedies under these laws are time consuming and costly and are out of sync of progress made over time in Insolvency Laws in the developed economies.

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Existing Laws Relating to Recovery of Debt and Revival of Borrowers

The legislation with respect to recovery of debts has undergone a gradual shift in India over the decades. At present there are many options available to different class of creditors, which are discussed in brief as follows: -

CPC: A creditor may file a money recovery suit against a defaulting debtor under the Civil Procedure Code, 1908 (CPC) with jurisdictional Civil Court. However, owing to high backlog of cases and slow adjudication process, it may take decades to obtain a decree against the debtor through this route.

SICA: The Board of Industrial & Financial Reconstruction (BIFR) was set up under Sick Industrial Companies (Special Provisions) Act, 1985 ('SICA'). However, SICA principally is inclined towards helping revive sick companies rather than helping lenders to recover their dues. SICA provides moratorium from any action against the defaulting company while a revival plan is worked out. However, there is no time restriction within which BIFR may decide whether it is practicable for a sick industrial company to stand on its feet again. Reference to BIFR thus became a safe harbour for defaulting companies to delay debt recovery. While the failed promoters retained substantial management powers that at times lead to further irreparable loss to lender's interest. Further, SICA is applicable only for industrial companies having existence of minimum 5 years and whose net-worth is eroded. Owing to these reasons BIFR route is widely believed to have failed to achieve desirable results. The new Code has therefore repealed SICA wef 01.06.2016 and all matters pending with BIFR are transferred to NCLT.

DRT: Debt Recovery Tribunals (DRTs) were established with enactment of Recovery of Debts Due to Banks & Financial Institutions Act, 1993. DRT were envisaged to provide dedicated and specialised mechanism for recovery of debts and obviate the need to go to Civil Courts. While promulgated with right intentions, here again there was no time limitation on settlement of cases. Further, the infrastructure at DRTs remained much less in comparison to the number of cases being filed there for debt recovery. Currently, it takes on an average 3 - 4 years for disposal of cases which is not in sync with international standards in this regard.

SARFAESI: The Securitization & Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 SARFAESI prescribes three alternative fast track methods for recovery of NPAs viz. securitisation, reconstruction of financial assets and enforcement of security. The SARFAESI Act provides quick resolution by allowing lenders to enforce security without reference to Court. However, this remedy is only available to Scheduled Banks and Notified NBFCs against an account which has already turned NPA. From borrower's perspective, the major lacuna of this mechanism is that unilateral security enforcement in many cases does not provide a fair chance to the borrower to revive, which in turn may permanently impair the business, thus adversely impacting the interest of other stake holders including unsecured creditors, employees etc. One can say that while SICA was too lenient on the borrowers, with SARFAESI the pendulum has swung too extreme in favour of lenders.

CDR/JLF/SDR/S4A: The RBI has provided various voluntary resolution mechanisms in case of multiple or consortium lending relationships to decide on debt restructuring, repayment rescheduling, and conversion of debt into equity etc. As per guidelines, if 60% of creditors by number and 75% of creditors by value agree to a restructuring package, then that package becomes binding on remaining creditors. However, this route has largely failed to achieve desirable results as lenders in general used the window to reschedule large accounts and postpone the inevitable. Another problem is that unsecured creditors not being part of the process generally file independent civil suits against distressed debtor and thus scuttle the revival process.

We can see from above how response of Indian policy makers to problem of debt recovery over time has progressed but failed to yield desired results. The fact that NPA levels of many Indian Banks today have reached double digits points to the reason for crippled credit markets in India. Lenders these days are wary of lending to industrial and infrastructure projects preferring rather to compete for low ticket mortgages.

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A need was therefore felt to attempt a complete overhaul of the debt recovery system. The Government has therefore enacted the Insolvency and Bankruptcy Code, 2016 on the recommendation of T. K. Viswanathan Committee. The Code repeals or overrides around 11 laws and promises to bring a sea change in how debt recovery and insolvency are handled in India, drawing from the current best practices in the West.

Distinguishing Features of the Insolvency & Bankruptcy Code

The Code provides a comprehensive and time bound mechanism to either put a distressed person on a firm revival path or timely liquidation of assets. The interests of all stakeholders have been taken care of. Some of the salient features of the code are as follows: -

1. Dedicated Adjudicating & Appellant Authority: The adjudicating authority for Corporates shall be National Company Law Tribunal (NCLT) and for others shall be Debt Recovery Tribunal (DRT). The first appeal shall lie with NCLAT & DRAT respectively and the final appeal shall lie with the Honorable Supreme Court. No other Court shall have any jurisdiction to grant any stay or injunction in respect of matters within the domain of NCLT, DRT, NCLAT and DRAT. This would provide a specialised mechanism to resolve stress accounts problem.
   Further a separate regulator i.e. the Insolvency and Bankruptcy Board of India (Board) would be set up to regulate various matters under the Code.
2. Time Bound Process: The Code provides that the insolvency resolution shall have to be completed within 180 days (maximum one extension of 90 days allowed) from the date of admission of application for insolvency resolution. If no resolution is reached in the above time frame the Code provides for automatic liquidation. Hence once default happens and insolvency resolution application is filed by any stakeholder, financial creditors would be forced to make intelligible choices so as to maximise economic value of business or face liquidation. At the same time, promoters should get sensitive about managing cash flows as default would straight lead to loss of control over business.
3. Preserving Value of Business: Once the application for insolvency resolution is admitted, there shall be complete moratorium till completion of insolvency proceedings. Board of Directors shall remain suspended and affairs of the company shall come under the control of the Resolution Professional. Though the entity shall remain a going concern. Creditors shall be precluded from taking any action against the Company including enforcement of security under SARFAESI Act during this period. Even a lessor cannot take possession of leased assets back during the moratorium period. Thus it shall provide an opportunity for the creditors to discuss sensible restructuring that can provide a better value than straight liquidation even while business and its assets are preserved during this period.
4. 'Failure to Pay' is the new Trigger: Existing mechanisms under SICA and Companies Act are tuned to provide for interjection when the borrower's ability to pay is demonstrably impaired. Whereas under the Code, a creditor can trigger insolvency resolution process just on default. Thus a defaulter can be dragged into insolvency resolution process without waiting for its net-worth to get eroded or for the account to be classified as NPA. This would be a big deterrent for able debtors to arm-twist small creditors.
   Therefore, the Code will have an effect of early identification of distress. It will instill discipline among promoters or else they will risk losing management control and also face liquidation.
5. Professionalisation of Insolvency Management: The Insolvency Professionals shall be regulated and licensed professionals and will have a critical role in the process. During the process of Insolvency Resolution, the management of the borrower shall be taken over by the Insolvency Resolution Professional. This will help preserve the value of business and assets of the debtor during the insolvency resolution process. Lenders will no longer be worried about mismanagement by promoters of distressed

corporates. As of now the only option lenders had was to convert debt into equity and take over the management for which they may not be having the requisite competency.

6. New Priority Order of Payment: A welcome change brought in by the Code is that the statutory dues are relegated to the 5th position in the priority of payment from the current 1st position. Herein even unsecured financial creditors shall be paid before clearance of dues of the Central & State Governments. This provision is likely to boost corporate bond market as well as debt funding of SMEs and startups.
7. All Creditors empowered to trigger Insolvency: All creditors whether domestic or foreign, whether secured or unsecured and whether financial or operational can apply for insolvency resolution. The defaulting debtor himself may also apply. Thus for the first time a structured mechanism for redressal of defaults is being provided to operational creditors such as suppliers, employees etc. Similarly, the foreign lenders and unsecured lenders shall find a mechanism to enforce their debts in a fair and transparent process. This no doubt will deepen the credit markets in India.
8. Enforcement of Personal Guarantees: If any corporate debt is secured by means of personal guarantee, then the bankruptcy of the personal guarantor shall also be dealt with by same NCLT rather than DRT. Thus, there will be a common forum for a creditor to enforce debt from both borrower and guarantor.
9. Information Utilities: There is an enabling provision to facilitate creation of Information Utilities which will house comprehensive credit data relating to debtors, their creditors and securities created. This will improve transparency and better decision making at all levels.
10. Fresh Start: A non-corporate debtor on finding himself unable to pay his debts may apply for a fresh start by discharge from certain debts, provided he satisfies the following conditions: -
    - Gross annual income of the debtor is not exceeding ₹60,000/-
    - Aggregate value of debtor is not exceeding ₹20,000/-
    - Aggregate value of debts is not exceeding ₹35,000/-
    - Debtor is not an undercharged bankrupt
    - Debtor does not own a dwelling unit (encumbered or not)
    - No Fresh Start Order in the last 12 months prior to the date of application

Procedure under the Insolvency & Bankruptcy Code

The procedure under the code shall be as follows: -

1. An application for initiation of insolvency resolution process to be filed before the NCLT (in case of corporate debtor) either by (i) a financial creditor on any default or (ii) an operational creditor after serving a 10 days demand notice to the debtor or (iii) debtor itself upon occurrence of default.
   Thus a financial creditor does not need to wait for an account to become NPA. It can go to NCLT on the next day of first recorded default. The threshold limit for amount of default though is not less than ₹1 lakh or such other amount as the Government may specify not exceeding ₹1 crore.
2. The NCLT shall within 14 days of filing of application ascertain whether there is a default, whether application is technically correct and if there is any objection to the proposed interim insolvency resolution professional. On satisfaction, it shall admit the application.
   There are penalty provisions if application made is found to be frivolous or having malicious intent.
3. The NCLT upon admission shall declare a moratorium for any action against debtor and make public announcement of admission of insolvency proceedings.
4. The interim insolvency resolution professional shall take over the management of the entity as a going concern. He shall make a list of all the claims against the debtor and constitute a committee of creditors consisting of all financial creditors within 30 days of admission of application.

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5. Within 7 days of its constitution, the committee of creditors shall hold its first meeting and appoint the insolvency resolution professional.
6. 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. The insolvency resolution professional shall help prepare a resolution plan which shall need to be approved by at least 75% of the value of financial creditors. There is no class of creditors concept and all financial creditors whether secured or unsecured shall have equal say in resolution plan.
7. The resolution plan then will be submitted to NCLT for approval. Once approved, the order shall become binding upon all parties.
8. If no resolution plan can be approved by the requisite creditors and by NCLT within 180 days (extendable by maximum 90 days), then company shall automatically be put into liquidation proceedings. Moratorium shall cease from the date of passing an order approving the resolution plan or order for liquidation. Meaning the secured creditors may enforce their security interests. The NCLT shall appoint a liquidator who will be vested with the management of the company and shall liquidate free and surplus assets. The money shall be distributed as per following priority order: -
   - 1st- Insolvency resolution process costs and the liquidation costs
   - 2nd- debts owed to a secured creditor who has relinquished security together with workmen's dues for the period of 24 months preceding the liquidation commencement date
   - 3rd- wages and any unpaid dues owed to employees other than workmen for the period of 12 months preceding the liquidation commencement date
   - 4th- financial debts owed to unsecured creditors
   - 5th- amount due to the CG and the SG together with debts owed to a secured creditor for any amount unpaid following the enforcement of security interest
   - 6th- any remaining debts and dues i.e. operational creditors

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   - 7th- preference shareholders
   - 8th- equity shareholders or partners
   - Fees payable to liquidator shall be deducted proportionately from the proceeds payable to each class of aforementioned recipients

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   Another mentionable point is that the contractual arrangements between creditors *inter-se* shall be disregarded i.e. there will be no consideration for second charge on security.

The Insolvency & Bankruptcy Code, 2016 has received the President's assent on 28th May 2016. The Rules governing various provisions are being notified progressively. Recently, the Insolvency and Bankruptcy Board of India (IBBI) has notified regulations pertaining to insolvency professionals for registration, regulation and oversight of such people under the Code and effective from 29th November 2016. Advocates, chartered accountants, company secretaries and cost accountants with 10 years of post-membership experience (practice or employment) or a graduate with 15 years of post-qualification managerial experience, on passing the Limited Insolvency Examination will be eligible to act as insolvency professionals, the regulations said. Any other individual passing the National Insolvency Examination will also be eligible, to become an insolvency professional.

It is expected that once the full Code is operational, it shall help cure many ills of the credit sector. It will facilitate early, transparent and fair resolution of liquidity problems. It is also expected to help India climb many notches on the Ease of Doing Business Index and thus forward our march towards creation of a prosperous economy. ■