Legal Landscape of Insolvency and Bankruptcy in India: Journey Since 2016

The impact and relevance of provisions of Companies Act, 2013 in the wake of the new insolvency law

With the advent of the new Insolvency and Bankruptcy Code, 2016 (Hereinafter "Code") India is moving into a new paradigm of economic and financial success, an era that began with the liberalization of the economy in 1991. The provisions of the Code have been implemented in a phased manner to effect a smooth transition from the previous regime, since the Code has not only overhauled the law on insolvency and bankruptcy in the country by repealing several legislations, but has also effected amendments in a whole gamut of existing laws, substantially so in certain cases. With this as the backdrop, this paper attempts to study the present and probable future impact of the Code on the Companies Act, 2013 (Hereinafter "Act"), how both the statutes will operate in tandem, and whether the existing situation requires any changes to be made in order to further simplify the bankruptcy framework in India.

Introduction

The transformation of the Indian economy from being a *license-raj* regime to the present business-friendly destination of foreign investment has been an arduous one. Central to this success story is the sweeping changes made in the regulatory space with the new Goods and Services Tax and the Code as the hallmark of such efforts. These path-breaking legislations have been key in significantly changing India's perception globally as a business-friendly environment.[1]

The Code is a comprehensive legislation "*to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner*";[2] hence bringing it into force would naturally be a difficult endeavour. The government has chosen to proceed in a cautious manner to implement it, notifying provisions in a phased manner along with the relevant rules and regulations, and even seeking stakeholders' participation for

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[1] World Bank, *Doing Business 2018 Report*, 15th Ed.
[2] Preamble to the Code.

suggestions. In this manner, while the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) has been repealed entirely, the relevant provisions dealing with winding up in the Companies Act, 2013 have been dealt with differently.[3] Certain chapters have been entirely omitted, while others have been substantially amended, even reduced to a skeletal fashion.

Hence, with the Code encroaching into the functioning of the Act, clashes between the two legislations, and subsequent confusion in their manner of working is inevitable. This research has been undertaken with the following objectives –

- Ascertain the change in position of law in the erstwhile Companies Act, 2013 before and after it was amended by the Code and its present functioning alongside the Code
- Identify the possible lacunae in the present law which might be subject to misuse
- Suggest solutions to cure the lacunae harmoniously between the Act and the Code

In the first part of the paper, the existing law in the Act is being examined with the erstwhile position of the law in the Act before the Code came in existence. Part II compares the liquidation process under the Code against the Act. Part III identifies possible loopholes in the existing regime, specifically those that emerge with the joint functioning and interaction between the Act and the Code. Part IV provides for suitable solutions to overcome these loopholes and strengthen the framework. The research questions have been individually mentioned in each of the parts surrounding the central question –

"*Whether the entire provisions of winding up in the Act should have been removed or the present situation of partly retaining the provisions in addition to provisions of the Code serves as a better model?*"

I. Companies Act, 2013: Modified or mutilated by the Code?

With the sole exception of SICA, the Code had the greatest impact on the Companies Act, 2013 under Schedule XI to the Code, which makes 36 changes to the Act. While examining these provisions we seek to answer *whether the Act has been amended in an efficient manner or whether it could have been entirely omitted*. These provisions assume significance since their scope is immense and applies to all kinds of companies, while SICA specifically applied only to industrial companies.

Chapter XIX sought to borrow the concept of "*sickness*" from SICA as a starting point to initiate corporate rescue whereby the company fails to pay 50% or more of its outstanding amount of debt within a period of thirty days of service of notice of demand.[4] In fact, the Bankruptcy Law

[3] Notification No. S.O. 3568(E), 3569(E); 25 November 2016.
[4] Companies Act 2013, s 253 (1).

Reform Committee (BLRC) has regarded Chapter XIX as an improvement over erstwhile SICA (features such as greater creditor involvement in rehabilitation, no automatic moratorium, creditor's consent for approval of scheme, appointment of administrators as mangers of the company; make it *significantly better* than SICA, yet acknowledging that the provisions require *few substantive changes and institutional changes*.).[5] Any application for determining a company as sick could be made by either the secured creditor, or the company itself, or several other entities (Section 253 (5). On determination as a sick company, any secured creditor of that company or the company may make an application to the Tribunal for the determination of the measures that may be adopted with respect to the revival and rehabilitation of such company.[6] The entire Chapter XIX stands omitted by the Code, presumably as the ambit of the resolution plan under the Code is very similar in nature to the revival and rehabilitation scheme under this Chapter. Similarly, any stay that would have been granted by the Tribunal to give suitable opportunity for the revival to take place under section 289 has also been omitted in view of the automatic moratorium under section 14 of the Code.

The Code also introduced a new definition of "winding up" in section 2 (94A) whereby winding up means winding up under the Act or liquidation under the Code, thus harmonising both statutes. The Code also introduces ancillary changes to the Act such as substituting the words "*commits default within the meaning of section 271 (2) to pay the amount of his debt or claim*" with "*commits default, within the meaning of section 6 of the IBC, 2016, in respect of the amount of his debt or claims*" for triggering reduction of share capital. Alternatively, inserting words "*liquidator appointed under this Act or the Code*" in Section 77 (3) which prescribes that unregistered charges shall not be considered by the liquidator or any creditor.

Such insertions are common throughout the Act - in every place where there is a mention of any exercise of powers by a liquidator (previously appointed under the Act), now reads as being appointed either under the Act or under the Code. Such as in sections 224 (2) (providing for winding up in pursuance to the Inspectors Report) and 230 (1), (6) (liquidator's power to compromise or make arrangements with creditors).

A very notable change introduced by the Code has been the complete omission of all voluntary liquidation provisions in the Act. Instead, the provisions for voluntary liquidation currently stand in Chapter V of the Code (refer to part III for a more detailed discussion on voluntary liquidation). Further, there are five circumstances for a Tribunal to allow winding up under

[5] Department of Economic Affairs, Ministry of Finance, *Interim Report of the BLRC* (February 2015) ch 4.3.
[6] Companies Act 2013, s 254.

section 271 (special resolution, sovereignty of India, fraud, default in compliance, justice and equity). The Code has omitted sub-section (a) – when a company is unable to pay its debt, and sub-section (d) – when a winding up has been ordered under Chapter XIX, which itself has been omitted. Similarly, in section 272 that provides for presentation of petition for winding up, creditors have been removed from being eligible persons to do so; the Registrar has also been barred from instituting a petition stating that the company cannot pay its debt. A joint reading of the changes made in the two sections gives the intention that since the Code provides for a sufficient remedy to institute insolvency resolution, winding up on grounds on inability to pay debt would be a duplication of remedies and is hence unnecessary.

Further, the Code also brings a gamut of institutional changes including insolvency professionals as the practitioners under the Code. Section 275 (2) of the Act which relates to Company Liquidators and their appointments has been harmonised with the Code to the effect that "*any provisional liquidator or the Company Liquidator, as the case may, shall be appointed by the Tribunal from amongst the insolvency professionals registered under the Code*".

The Act has also been amended in sections 326 and 327 that deal with the waterfall mechanism of preferential payment (refers to the order of priority in payment of liquidation proceeds) and overriding it. Section 326 (2) has been amended to accord the highest priority to workmen's dues and the unrealised portion of secured asset of a secured creditor additionally on a pro-rata basis with each other. Further, the erstwhile non-obstante clause in Section 326 (1) has been dispensed with and sub-section (7) added to section 327 stating that both sections 326 and 327 shall not be applicable in the event of liquidation under the Code, giving a higher priority to the waterfall mechanism provided under the Code vis-a-vis the Act. While this amendment was necessary to give supremacy to the Code and prevent conflict between the non-obstante clause under the Code and the erstwhile non-obstante clause under section 326 (1), this has rendered the Act otiose and a mere rubber stamp. The non-obstante clause under the Code reads as "*the provisions of this Code shall have effect, notwithstanding anything inconsistent therewith contained in any other law for the time being in force or any instrument having effect by virtue of any such law*".[7]

The combined effect of this interpretation and the immense positive perception surrounding the Code has resulted in almost every case being instituted in the NCLTs under the Code instead of NCLTs under the Act. The only conclusion emerges is that the approach of retaining winding up provisions under the Act has led to a duplication of remedies. Moreover, since the Code has a

[7] Insolvency and Bankruptcy Code 2016, s 238.

clear prominence over the Act, the result has been disproportionately in favour of the Code. Thus, even if the entire chapters on winding up were omitted by the Code, it would not have caused any manifest injustice to any stakeholder, since the Code provides for an adequate remedy and encompasses the entire scope of insolvency. A further discussion on these interactions between the Act and the Code continues in the forthcoming Parts.

II. Efficiency of the Code against the Act

This part shall focus on the question *whether winding up under Chapter XX of the Act provides a more efficient remedy than liquidation under Chapter III of the Code.* Since the Code has already repealed Chapter XIX of the Act and voluntary winding up under Part II of Chapter XX, at present the Code is the only statute that also allows for corporate debt recovery as well as voluntary liquidation.

For all practical purposes, the Code is more effective than the Act, since it is a legislation with wide overreach over all other legislations by virtue of the non-obstante clause and wide moratorium under section 14. Further, *Innoventive Industries* also clarified the prominence of the Code in the clearest words –

> "*There can be no doubt, therefore, that the Code is a Parliamentary law that is an exhaustive code on the subject matter of insolvency in relation to corporate entities. … It will be noticed that whereas the moratorium imposed under the Maharashtra Act is discretionary and may relate to one or more of the matters contained in Section 4(1), the moratorium imposed under the Code relates to all matters listed in Section 14 and follows as a matter of course. … It is precisely for this reason that the non-obstante clause, in the widest terms possible, is contained in Section 238 of the Code, so that any right of the corporate debtor under any other law cannot come in the way of the Code.*"[8]

Thus in any conflict between winding up under the Act and an application under the Code, the Code shall prevail. Nevertheless, academic purposes necessitate discussing the finer distinctions.

Creditors can only make an application under the Code – they cannot approach for winding up under the Act anymore by virtue of the amended section 272 (1). A major reason for the Code being perceived as more efficient against the Act is the strict timeline made out in the Code. This could be seen not just from the strict overall time period of 180 days (with a one-time extension of maximum 90 days) allowed for the corporate insolvency resolution process (CIRP), but even from the time period of initial scrutiny of the application to ascertain the existence of default has

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[8] *M/s Innoventive Industries Ltd. v. ICICI Bank Ltd. & Anr.*, Supreme Court, CA Nos. 8337-8338 of 2017

been reduced from previously 90 days under the Act.[9] Now, a CIRP may be initiated by financial creditor (section 7 (4)), by operational creditor (section 9 (5)), and by corporate applicant (section 10 (4)) in 14 days.

The reasons for the Code being more efficient than the Act are not limited to the time period under the statutes; but also reflective from the general overall scheme of the Code. The Code is a lean legislation with ample independence given to the committee of creditors and the resolution professional rather than micromanagement by the Tribunal – as is under the Act. Hence, steps such as examination of promoters and directors under section 300 of the Act, floating charges on the company property after winding up under section 332, extensive procedure for fraudulent conduct and the like in sections 336 to 342 which puts liquidators and promoters in threat of pecuniary liability and imprisonment – have been dispensed with. Instead, the Code has introduced several new concepts from common experience which were an existential reality yet were unrecognised in law, examples being undervalued transactions (section 45), transactions defrauding creditors (section 49), extortionate credit transactions (section 50, 51). Further, it has given more weight to concepts that were not adequately recognised earlier such as preferential transactions (sections 43, 44).

Similarly, earlier cases such as *Kritika Rubber Industries*[10] took place where due to a lack of basic exchange of information between regulators and adjudicators, delays and confusion followed (One group of secured creditors had initiated an action in the DRT, while another group filed a winding up petition in the High Court. The DRT decided in favour of the creditors and ordered the attachment of the property securing the debt, sold at auction. In the meantime, the High Court ordered the winding up of the debtor and appointed an official liquidator (OL). The OL sought an order to set aside the sale by auction, which the High Court allowed. Interestingly, the parties to DRT proceedings were unaware of the winding up petition, until the auction was set aside).[11]

To prevent such situations, the Code has brought about information utilities (IUs) as a centralised repository of credit information regarding lenders and debtors.[12] Moreover, under the Act, the entire process is highly judge-centric, while the Code introduces a regulator – the Insolvency and Bankruptcy Board of India (IBBI). This shall encourage more professionalism, a

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9 Companies Act 2013, s 273 (1).
10 *Kritika Rubber Industries v. Canara Bank* (Karnataka High Court), CA No 190/2008.
11 Rohan Kohli, 'Corporate Resolution and Insolvency Resolution in India: Lacunae in the present and remedy for the future', (2016) 3(2) RFMLR 97, 102.
12 Ministry of Corporate Affairs, *Report of the Working Group on Information Utilities* (10 January 2017) ch 4.2

closer oversight over each insolvency application or liquidation by recommending insolvency professionals (when CIRP has been initiated by an operational creditor and no name has been proposed (section 16 (3)), and during replacement of any such professional by the committee of creditors (section 27 (4)), in addition to prescribing standards of appointment and conduct, and conducting research. The result is a vibrant insolvency ecosystem with a continually evolving ecosystem synonymous with the continuously changing landscape.

Although, a lacuna existed which allowed some possibility for disgruntled management or shareholders to try to resist any resolution plan agreed to by the committee of creditors. Such a situation was possible in case the plan required any action to be undertaken by the company that mandates any form of board or shareholder approval or both. Such an action includes, corporate restructuring such as mergers, amalgamations, takeovers, slump sale; debt restructuring schemes including debt-equity swaps, increasing or reducing share capital by any means such as issuing or buying back shares etc.; or a combination of these. In this regard, the clarification provided by the Ministry of Corporate Affairs *regarding approval of resolution plans under section 30 and 31 of the Code* has cleared this ambiguity conclusively.[13] This clarification was sought since section 30 (2) (e) requires the resolution professional to confirm that the resolution plan does not contravene any provisions of the law for the time being in force. Section 31 (1) further binds the approved plan on all the stakeholders such as the corporate debtor, employees, members, creditors, guarantors. The circular states – "*the approval of stakeholders/members of the corporate debtor for a particular action required in the resolution plan for its implementation, which would have been required under the Act or any other law if the resolution plan of the company was not being considered under the Code, is deemed to have been given on its approval by the Adjudicating Authority.*"[14]

Thus, there can be no hesitation in affirming the Code as providing a much more efficient remedy for any insolvent company.

III. Interaction between the Code and the Act: possible lacunae and loopholes

This part shall seek to answer the question as to *what sort of conflicts may arise between the Act and the Code once they both begin functioning.* Any interaction between the Code and the Act can be clearly bifurcated into two spheres, one which relates to transitional periods which can witness confusion over the pending cases as to which forum shall adjudicate and according to which

[13] General Circular No. IBC/01/2017, Ministry of Corporate Affairs, Government of India.
[14] Ibid [5].

statute. And second relating to conflicts that may emerge from a gradual and conjoint functioning of the two statutes.

From December 15, 2016 onwards every proceedings under the Companies Act, 1956 relating to winding up where the petition has not been served on the respondent was transferred to the NCLT. However there is a difference between the winding up cases instituted due to inability to pay debts and otherwise. In the former, the cases shall be treated as application to initiate CIRP under the Code.[15] While in the latter cases, they shall be treated as winding up cases under the Act.[16] Further, any winding up initiated under provisions of SICA – which used to forward winding up cases to the High Courts – shall continue to be dealt by the High Courts as per the provisions of the Companies Act, 1956.[17] This presents a fractured regime, since there is scope of overlapping of jurisdiction in cases of multiple petitions being continuing under the previous acts. However as these provisions are of a temporary nature, the scope for long-lasting delays is minimal.

Currently, section 11 (d) of the Code bars *a corporate debtor in respect of whom a liquidation order has been made* from making an application to initiate CIRP under the Code – thereby clearly making a demarcation between the Act and the Code. But in reality, the situation has been far from this clarity.

In *Nikhil Mehta & Sons (HUF) & Ors. v. M/s AMR Infrastructures Ltd.*, one of the reasons given by NCLT in dismissing the petition was that 11 winding up petitions had been filed before the High Court, and the official liquidator had been appointed – even though no winding up order had been passed.[18] Whereas in another case, the counsel for the corporate debtor has raised an objection with regard to maintainability that a winding up petition is sub judice before the High Court which had already appointed an auditor as well, to which the High Court stated that since no winding up order had been passed and no official liquidator had been appointed, the pendency of the winding up petition cannot operate as a bar under the Code.[19] Thus, until a winding up order has been passed, even the corporate debtor can make an application under the Code, and once the winding up order had been made, an application should be made after seeking leave of the court. Nevertheless, the creditor is still open to make an application under the Code even without the leave of the court, since the bar of section 11 does not apply to a

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[15] Companies (Transfer of Pending Proceedings) Rules 2016, r 5 (1).
[16] Ibid r 6.
[17] Ibid r 5 (2).
[18] C.P. No. (ISB)-03(PB)/2017 p 14.
[19] *Alcon Laboratories (India) Private Limited v. Vasan Health Care Private Limited*, C.A/1/ (IB)/2017 [5].

creditor. Hence, these transitionary periods could witness at least some amount of such dichotomy when the tribunals grapple with pure questions of law.

In the long run, there is potential for several interesting interactions between the two statutes. One such instance arises while evaluating voluntary liquidation under Chapter V against section 271 (a), which provides for winding up on a special resolution of the company. Prima facie, the latter process might appear counterproductive since it is longer and faces more involvement of the Tribunal than the one under the Code, yet the fine print tells otherwise.

Under section 59 of the Code a condition precedent to the process is that the corporate must not have committed default, while such a condition is not required under section 271 (a). Default is means "*non-payment of debt when whole or any part or instalment of the amount of debt has become due and payable and is not repaid by the debtor or the corporate debtor, as the case may be.*"[20] Debt has been defined as "*a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt.*"[21] Hence, in cases of default, a company cannot voluntarily liquidate itself under the Code, yet by a special resolution may seek winding up under the Act. Interestingly enough section 59 (3) (c) (i) of the Code also requires a special resolution to be passed by the company. Thus why did the Parliament retain the option for members to file for the cumbersome winding up process under the Act, especially since it has no explanation as to when a winding up petition based on Section 271(a) is admitted?[22]

One reason could be to afford the company to liquidate itself even if a default subsists, and the creditors want to continue with the functioning – an academic example with little practical justifiable examples. The other reason could be to give the promoters and management a greater control over the entire process – since the Code substitutes the management of the company with an insolvency professional and the entire process goes in accordance largely with the creditors. Thus, section 271 (a) provides a silver lining to the management to conduct the process with greater Tribunal oversight - translating into greater management oversight and control over the process. In this regard the provisions are somewhat contradictory in themselves, though they are worded as "voluntary" liquidation, the special resolution still has to be approved by two-thirds of the creditors (proviso to section 59 (3)), thereby making the process not exactly "voluntary".

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[20] Insolvency and Bankruptcy Code 2016, s 3 (12).
[21] Ibid s 3 (11).
[22] Anirudh Gotety, 'Winding-up under Section 271(a) of the Companies Act and its Impact on the Insolvency and Bankruptcy Code', (*IndiaCorpLaw*, 18 August 2017) <https://indiacorplaw.in/2017/08/winding-companies-act-impact-insolvency-bankruptcy-code.html> accessed 1 November 2017.

Further, Section 59 (3) (a) provides that majority of directors should ascertain whether the company has any debt or not, and if any, whether it can repay the debt from the proceeds of voluntary liquidation. Thus, this section makes a fine distinction between debt and default, with the latter being debt that is "due". This may be potentially used by the company to its advantage by seeking to liquidate itself before its debt is "due" to be paid. As that would entail voluntary liquidation which in turn would require approval of two-thirds of creditors, against the situation where the debt becomes a default meaning CIRP would be initiated, which requires three-fourth majority of creditors – a significantly more difficult task.

In view of these loopholes, the approach of the Tribunals remains to be seen. Presuming a deference for the process under the Code, the Tribunal may not honour the above approach being taken by the company to circumvent the provisions of the Code – making section 271 (a) irrelevant. Again, this is mere conjecture.

IV. Recommendations and Conclusion

Through this research, an attempt has been made to predict and foresee the possible situations where the Code and the Act may coexist and overlap. The result that emerges is virtual supremacy of the Code vis-à-vis the Act. This begs the question that when the Code was intended to be an overarching legislation covering the entire scope and *an exhaustive code on the subject matter of insolvency in relation to corporate entities*; why were the provisions of Chapter XX of the Act retained. While the previous parts have attempted to provide nuanced solutions to this corundum, yet the overall result is that the remedy provided in Chapter XX is simply less efficient, and subordinate to the one under the Code. While an argument could be made that Chapter XX is meant to give certain exclusive powers to the corporate debtor by excluding the creditor totally, this argument contradicts the reality that the corporate debtors themselves have been favouring the Code. Of the 148 cases approved so far by the NCLT under the Code, more than a third were initiated by the defaulters themselves.[23]

Hence, to answer the central question of this research, one of the recommendation would be a total omission of Chapter XX, to make a leaner and coherent legislative policy for insolvency. Further, since a new legislation is being made for financial sector entities (the Financial Resolution and Deposit Insurance Bill 2017), retaining Chapter XX would be counterproductive when the Code can already provide everything the Act can, albeit in a more efficient fashion.

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[23] Radhika Merwin, 'Debtors have filed over 33% of insolvency cases' *Hindu Business Line* (New Delhi, 23 July 2017) <http://www.thehindubusinessline.com/economy/debtors-have-filed-over-33-of-insolvency-cases/article9785327.ece> accessed 7 November 2017.

Alternatively, more clarity can be provided on section 271 (a), as to what circumstances can trigger it, and limit the opportunity of its misuse as a means to circumvent the process of voluntary liquidation under the Code.

The author further recommends that a waiver must be provided for stamp duty for any merger or amalgamation proposed to encourage stressed companies to adopt this as one of the mode under the resolution plan under the CIRP. Not only do M&As tend to result in a much efficient and smoother result than other restructuring modes; but they also lead to greater public benefit, since the entire industry would be better off due to economies of scale, greater efficiency etc. Moreover, creditors should also benefit from this waiver since any encouragement for M&As would mean that their debts could be paid off much faster by the combined entity, and that the creditors would not have to assume management or ownership of the company in any debt-equity swaps.

Finally, one recommendation would be to encourage the use of "*scheme of arrangement*" as one of the modes of corporate debt restructuring (schemes of arrangements and compromise are provided under section 230 between the company and its members or creditors including any of their respective classes.). Currently, the mode of debt restructuring in India is mainly the various non-judicial schemes launched by the RBI from time to time, the latest being Scheme for Sustainable Structuring of Stressed Assets. Paradoxically, the provisions of scheme of arrangement are used mainly for corporate restructuring, but hardly for debt restructuring. The BLRC acknowledges that schemes of arrangement for debt restructuring have been unpopular due to delays, significant costs, and holdouts by creditors, yet can become a very effective tool for debt restructuring, acknowledging however that such restructurings can also be achieved less formally.[24] The BLRC report further talks about '*pre-packaged rescues*' where the debtor company and its creditors conclude an agreement for the sale of the company's business prior to the initiation of formal insolvency proceedings. Indian law can recognise such a design as part of a scheme of arrangement.

One benefit that schemes of arrangement may provide in cases of debt restructuring is that it can be utilised for both insolvent and solvent companies (particularly to enable early restructuring to help avoid insolvency).[25] Even so, it may be suitable to the debtor since there is no requirement

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[24] BLRC (n5) [78].

[25] Umakanth Varottil, 'The Scheme of Arrangement as a Debt Restructuring Tool in India: Problems and Prospects', (2017) NUS Law Working Paper 5/2017, 7 <http://law.nus.edu.sg/wps/pdfs/005_2017_Umakanth.pdf> accessed 10 November 2017.

to substitute the management, as the Code currently does – helping them in retaining control. Hence, it is recommended that this lesser known mechanism for resolution should be given its due importance as not just an academic reality but also as a viable practical option. To give further impetus for its usage, suitable modifications may be made to prevent creditors construing a class from holding out against the entire scheme and thereby ruining the entire effort (such as a three-fourth majority).[26] Favourable asset classification norms similar to those under the RBI schemes should be introduced to incentivise banks to adopt it.

[26] Ibid [33].