Insolvency and Bankruptcy Code 2016 - Key Implications for Corporate Debtors

The Insolvency and Bankruptcy Code 2016 is a hugely significant legislation, second in importance only to the recent GST law. The Code was passed as an Act in both the Houses of Parliament on 11 May 2016 and finally received the President's assent on 28 May 2016. The preamble to the Act introduces the Act as "An Act to consolidate and amend the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximisation of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues...". In the present article the author has deliberated on the key implications of the Code for Corporate Debtors. Read on to know more...

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As stated in the Government's Press Release of 11 May 2016: The essential idea of the new law, i.e., the Insolvency and Bankruptcy Code, 2016 is that when a firm defaults on its debt, control shifts from the shareholders/promoters to a Committee of Creditors, who have 180 days in which to evaluate proposals from various players about resuscitating the company or taking it into Liquidation. When decisions are taken in a time-bound manner, there is a greater chance that the firm can be saved as a going concern, and the productive resources of the economy (the labour and the capital) can be put to the best use.

The Code covers two types of debtors, (i) Corporates (including LLP's and other limited liability entities) where the minimum amount of default is one lakh rupees and (ii) Others (i.e. Individuals and Partnership Firms). In this article, we'll look at the key implications for corporate/ LLP debtors. This article does not cover the process relating to "Others".

This new law provides significant opportunities for Chartered Accountants in practice, including advising debtors and creditors and playing the role of Insolvency Resolution Professionals. So there is more to learn but fortunately, also more to earn!

Let's start with a hypothetical case study, which could well be a typical situation in the future as the law gets implemented.........

Corporate Insolvency-Case Study

Let's assume that Company X as part of its routine business borrowed money from banks ("financial creditors") and has other creditors like trade payables, employee dues and statutory dues (collectively known as "operational creditors"). Due to unfortunate global economic or local competition or technological factors Company X is going through a downturn and is unable to pay the above dues, i.e. the company is genuinely in difficulty and needs help. A registered Insolvency Resolution Professional (IRP), who happens to be a Chartered Accountant, is appointed to temporarily manage the company's affairs and to seek "insolvency resolution plans" from interested parties. A group of professionals specialising in turnaround strategies provides a plan. The IRP presents the plan to the creditors, who meet to consider the plan. There are now 2 scenarios.

Scenario 1

Based on the specifics of the plan, 75% (in value) of the financial creditors vote to forgive 5% of their dues and to provide the corporate an additional six months to repay the dues. They also vote to change the management of the company, i.e. the promoter group continues in control but the CEO and Chief

In India, the legal and institutional machinery for dealing with debt default has not been in line with global standards. The recovery action by creditors, either through the Indian Contract Act, 1872 or through special laws such as the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, has not had desired outcomes

Marketing Officer are replaced to improve the company's prospects in the tough new environment. Lastly, they vote to sell one of the loss-making units. All of this is coordinated and managed by the Insolvency Resolution Professional. This proposal is presented to the Adjudicating Authority (the National Company Law Tribunal–NCLT). The NCLT approves the proposal. Company X gets back on track.

Scenario 2

The financial creditors are unable to agree on a plan because they believe that Company X may not be able to survive in the new, fast-changing environment. They therefore vote to liquidate the company. All the company's assets and liabilities are valued. The assets are sold and the liabilities are settled in this order: secured creditors, i.e. banks (fully), liquidation costs (fully), employees (fully), trade creditors (fully) and government statutory dues (partially, since there is now insufficient money). Finally, there is nothing left for the shareholders. The company is dissolved and struck-off from the ROC register.

How the Code will help India Inc

As very well articulated in the Government's Press Release......

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Act, 1872 or through special laws such as the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, has not had desired outcomes. Similarly, action through the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) and the winding up provisions of the Companies Act, 1956 have neither been able to aid recovery for lenders nor aid restructuring of firms. Laws dealing with individual insolvency, the Presidential Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920, are almost a century old. This has hampered the confidence of the lenders. When lenders are unconfident, debt access for borrowers is diminished. This reflects in the state of the credit markets in India. Secured credit by banks is the largest component of the credit market in India. The corporate bond market is yet to develop.

The objective of the new law is to promote entrepreneurship, availability of credit, and balance the interests of all stakeholders by consolidating and amending the laws relating to reorganisation and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner and for maximisation of value of assets of such persons and matters connected therewith or incidental thereto.

The law aims to consolidate the laws relating to insolvency of companies and limited liability entities (including limited liability partnerships and other entities with limited liability), unlimited liability partnerships and individuals, presently contained in a number of legislations, into a single legislation. Such consolidation will provide for a greater clarity in law and facilitate the application of consistent and coherent provisions to different stakeholders affected by business failure or inability to pay debt.

This is in complete departure with the experience under the SICA regime where there were delays leading to destruction of the value of the firm.

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A key innovation of the Insolvency and Bankruptcy Code is four pillars of institutional infrastructure.

The first pillar of institutional infrastructure is a class of regulated persons, the 'Insolvency Professionals'. They would play a key role in the efficient working of the bankruptcy process. They would be regulated by 'Insolvency Professional Agencies'.

The second pillar of institutional infrastructure is a new industry of `Information Utilities'. These would store facts about lenders and terms of lending in electronic databases. This would eliminate delays and disputes about facts when default does take place.

The third pillar of institutional infrastructure is in adjudication. The NCLT will be the forum where firm insolvency will be heard and DRTs will be the forum where individual insolvencies will be heard. These institutions, along with their appellate bodies, viz., NCLAT and DRATs will be adequately strengthened so as to achieve world class functioning of the bankruptcy process.

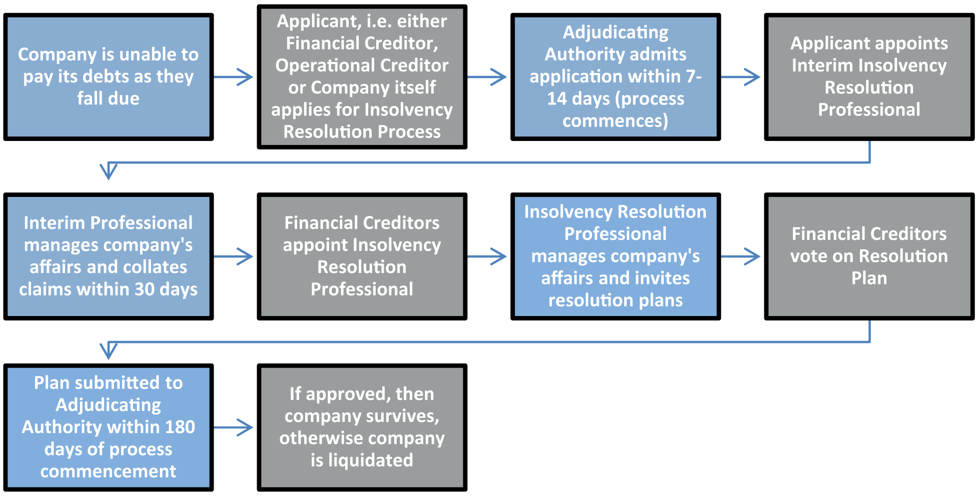
The fourth pillar of institutional infrastructure is a regulator viz., 'The Insolvency and Bankruptcy Board of India'. This body will have regulatory over-sight over the Insolvency Professional, Insolvency Professional agencies and information utilities.

The Insolvency and Bankruptcy Code is thus a comprehensive and systemic reform, which will give a quantum leap to the functioning of the credit market. It would take India from among relatively weak insolvency regimes to becoming one of the world's best insolvency regimes. It lays the foundations for the development of the corporate bond market, which would finance the infrastructure projects of the future. The passing of this Code and implementation of the same will give a big boost to ease of doing business in India."

Let's now review the key features of the Code......as with all laws, we need to get used to new jargon and abbreviations!

Overview of Corporate Insolvency Resolution Process

In the below flowchart, we can see an overview of the Corporate Insolvency Resolution Process.



Let's now see the process in a bit more detail.

Corporate Insolvency Resolution Process– Key Features

- <u>What causes an Insolvency Resolution Process</u>– when a corporate debtor fails to pay its debts (e.g. salaries, trade payables, bank loan installments) there is a default event (i.e. the corporate has become insolvent), which can trigger the Insolvency Resolution Process
- <u>Who can initiate the Insolvency Resolution Process</u>– when a corporate debtor commits a default, a financial creditor, an operational creditor or the corporate debtor itself may initiate the Corporate Insolvency Resolution Process. The initiator would typically do this if they are not convinced about the ability of the corporate to repay its debts in the normal course of business
- <u>How the Insolvency Resolution Process is initiated</u>– an application is made to the Adjudicating Authority (i.e. the National Company Law Tribunal)
- <u>What Happens when the Application is admitted</u>– if the Adjudicating Authority admits the application, they declare a Moratorium, require a Public Announcement and appoint an interim Resolution Professional. The Moratorium prevents proceedings under any suits, prevents sale or mortgage of any asset and prevents enforcement of security interest by any creditor, but allows the corporate to carry on its day-to-day business. The Moratorium thus provides the corporate some breathing space to restructure itself. The Public Announcement gives creditors a chance to formally notify their claims
- <u>Who takes charge of the Insolvency Resolution Process</u>– either the creditors or the corporate (i.e. whichever party initiates the Insolvency Resolution Process) proposes an interim Resolution Professional, who manages the affairs of the corporate (replacing the board of directors!) and does his best to keep the corporate as a going concern
- <u>How the insolvency gets resolved</u>– the interim Resolution Professional collates all the creditor claims and constitutes a Committee of Creditors, which comprises only of the Financial Creditors (i.e. not the Operational Creditors). The Committee immediately appoints a Resolution Professional (who could be the same professional who acted as the interim Resolution Professional). The Resolution Professional now takes charge of the affairs of the corporate and invites prospective lenders, investors and any other person to put forward their resolution plans. He prepares an Information Memorandum to help these parties to understand the financial affairs of the corporate. He then presents the various Resolution Plans at the Committee, which is required to vote with a 75% majority to select the final Resolution Plan. Once approved by the Committee, the Resolution Professional submits the Resolution

The Insolvency Resolution Process is expected to generally conclude within 180 days of commencement of the process (i.e. from the date the Adjudicating Authority admits the Insolvency Resolution Process application). A 90-day extension is granted under the Code if there is adequate justification.

Plan to the Adjudicating Authority. If this is approved, the corporate moves forward to implement the Resolution Plan, which now binds all stakeholders. Effectively, the Insolvency Resolution Plan has succeeded and the corporate gets a new lease of life

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If, however, the Insolvency Resolution Process fails, the corporate is headed for Liquidation, i.e. sale of assets, settlement of liabilities and finally, dissolution. Let's see how the Liquidation process works......

Liquidation Caused by Failure of Insolvency Resolution–Key Features

- <u>What causes a Liquidation</u>– if the Adjudicating Authority does not receive an Insolvency Resolution Plan or rejects the Plan, he passes a Liquidation order *(corporate stakeholders need to approach the insolvency process with a clear vision. This is because if the corporate, creditors and the Insolvency Resolution Professional are unable to fix the problem and keep the corporate running, then the Adjudicating Officer may have other plans!)*; a Liquidation can also be caused by a vote of the Committee of Creditors (this would happen if they do not see a practical survival option emerging from the Insolvency Resolution Process); lastly, if the corporate contravenes the Resolution Plan, then an affected party can apply for Liquidation of the corporate
- <u>Who takes charge of the Liquidation process</u>– the Insolvency Resolution Professional (or any other professional that the Adjudicating Authority appoints) takes over the affairs of the corporate (including the powers of the board of directors) and manages the corporate until the assets are liquidated
- <u>The Liquidation Process</u>– The Liquidator acts as a fiduciary for the benefit of all the creditors, consolidates all claims, verifies them, admits or rejects the claims, values the claims and distributes the assets on the basis of the priority prescribed by the Code
- <u>Distribution Priority</u>– the proceeds from the sale of the Liquidation assets gets distributed in the following order of priority:
  - o Secured Creditors to the extent they are able to realise their security interest
  - o Insolvency Resolution Process Costs and Liquidation Costs (the liquidator's fees will be deducted proportionately from the proceeds payable to the below recipients)
  - o Workmen's dues for the period of twenty-four months preceding the liquidation commencement date and any Secured Creditor who chose to relinquish his security, equally
  - o Employee dues (i.e. other than Workmen) for the period of twelve months preceding the liquidation commencement date
  - o Financial Debt owed to Unsecured Creditors
  - o Central and State Government Dues and amounts still remaining unpaid to Secured Creditors after enforcement of security interest
  - o Other remaining debts and dues
  - o Preference shareholders
  - o Equity shareholders (or partners)
- <u>Dissolution</u>– after liquidating all assets, the Liquidator applies to the Adjudicating Authority to dissolve the Corporate Debtor, after which the corporate is dissolved

One of the weaknesses of the previous laws was the difficulty for companies to voluntarily liquidate themselves. A corporate may choose to do so if, for example, the promoter decides to move on to other ventures or his heirs do not show any interest in continuing the business or he wants to retire. Under the Insolvency and Bankruptcy Code, this process is simplified as we'll now see......

Voluntary Liquidation

- Who is Eligible for Voluntary Liquidation– Under the Code, a corporate can apply for Voluntary Liquidation if the directors provide a declaration that they are not insolvent (i.e. they either do not have any debts or are able to fully pay all debts) and the corporate is not being liquidated to defraud anyone
- Liquidation Process– based on the above declaration, the members of the corporate pass a special resolution; after this, creditors representing two-thirds in value of the corporate's debt approve the resolution; the corporate then notifies the Registrar of Companies to liquidate itself; the Liquidator conducts the liquidation process and liquidates the assets (using the same process explained earlier); finally, the Liquidator applies to the Adjudicating Authority, which passes the order to dissolve the corporate

That was a brief walkthrough of the key features of Corporate Insolvency Resolution and Liquidation. Although the Act is in place, the rules and regulations are awaited, as we see below......

The Road Ahead

The government has already set-up the Insolvency and Bankruptcy Board of India, which will regulate

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insolvency professionals and information utilities (that will centrally store and retrieve corporate financial data).

The MCA has already issued operational guidelines for several of the above topics that can be accessed using this link: http://www.mca.gov.in/MinistryV2/insolvency+and+bankruptcy+code.html

In conclusion, the best situation is for a corporate to not default on its obligations and thus avoid becoming insolvent. However, if there is a default and there is no consensus on resolving the default in the normal course of business, then the lenders, other creditors and the corporate debtor should work through the insolvency resolution process in a constructive manner, to avoid liquidation. To improve navigation through such difficult turns, we now have a path-breaking law that brings us closer to international best practices. As with any new law, successful implementation will depend on (i) adequate regulatory machinery and (ii) proper use rather than abuse of the rules. The government is working on the former. Corporate stakeholders need to ensure the latter! Professionals, particularly Chartered Accountants, will play a major role in determining the degree of success of this Code.

This article presented some of the highlights of this important new law. However, there are quite a few details that need to be studied carefully so that professionals can render valuable support to their clients. ■

You did not wake up today to be mediocre. - Anonymous