

## **LESSON 16**

### **INSOLVENCY – CONCEPTS AND EVOLUTION**

#### **INSOLVENCY/BANKRUPTCY – THE CONCEPT**

- Insolvency is when an individual, corporation, or other organization cannot meet its financial obligations for paying debts.
- Bankruptcy is not exactly the same as insolvency.
- Bankruptcy is a determination of insolvency made by a court of law with resulting legal orders
- Insolvency describes a situation where the debtor is unable to meet his/her obligations. Bankruptcy is a legal scheme in which an insolvent debtor seeks relief.

#### **Reforms in Insolvency Law For Corporate Side**

As India swiftly moves to the centre stage of world economy there has been a consistent effort by the policy makers to undertake comprehensive reforms in the laws and systems to bring them at par with international standards and incentivise the foreign investors to invest in the Indian economy.

#### **Committees on Insolvency**

##### **Tiwari Committee**

- Due to the incidence of industrial sickness there was
  - loss of production,
  - loss of employment,
  - loss of government revenue,
  - blockage of funds advanced by the banks etc,
- A committee was constituted under the Chairmanship of Shri T Tiwari,
- Based on the recommendations of Tiwari Committee SICA was enacted.
- Due to misuse of SICA by erring promoters and others, BIFR failed to fulfill the purpose and mandate as envisaged in SICA.

## **N L Mitra Committee**

- Under Mitra committee, one of the subject area identified is “Bankruptcy Laws”.
- The N. L. Mitra Committee noted that Indian laws on cross border insolvency are outdated and that they are not comparable to any standards set in international legal requirement

## **Justice Eradi Committee**

- A High Level Committee headed by Justice V.B.Eradi was formed.

### **Purpose**

- To make changes in existing law relating to winding up of companies
- Before winding up, it should first look at the possibilities of rehabilitation and revival of companies.
- Power and authority relating to winding up of companies should be vested in a National Company Law Tribunal
- The Committee strongly recommended appointing Insolvency Professionals who are members of (ICAI), (ICSI), (ICMAI), Bar Councils or corporate managers.

### **The Committee addressed and recommended the following key points:**

- The law of insolvency should not only provide for quick disposal of assets but in Indian economic scene, it should first look at the possibilities of rehabilitation and revival of companies.
- The Committee noted that there are three different agencies namely,
  - High Courts,
  - Company Law Board
  - Board for Industrial and Financial Reconstruction (BIFR)

### **The National Company Law Tribunal**

- should have the jurisdiction and power presently exercised by Company Law Board
- should have the power to consider rehabilitation and revival of companies
- should have the jurisdiction and power relating to winding up of companies
- should be headed by a sitting judge or a former judge of a High Court

- shall have such number of member as may be prescribed by the Central Government.
- should be vested with the power to transfer all proceedings from one Private Liquidator to another "Private liquidator" or to the "Official Liquidator".

### **Changes in Company Law**

- Tribunal may continue to have jurisdiction for winding up the companies on grounds stated in Act but following further grounds may be added therein, namely:
  - a company has failed to file balance sheet and profit and loss accounts and/or annual returns for last three years on due dates; or
  - any action of the company has or is likely to threaten the security or integrity of India. Share holder or the Central Government will be entitled to file the petition under on aforesaid grounds.
- There should be two distinct aspects of the liquidation:
  - sale of assets
  - distribution of sale proceeds
- The pending references before BIFR/ AAIFR under SICA should abate in view of repeal of SICA recommendations by the Committee.
- There is a need to encourage voluntary winding up of companies.
- It should be obligatory for a company filing a winding up petition to submit the Statement of Affairs along with the petition for winding up.
- "A Fund for Revival and Rehabilitation" preservation and protection of companies may be created under the supervision and control of the Government.
- Appropriate legislative action must be taken to ensure that the claims of all employees of a company and its secured creditors are ranked "pari-passu".
- Specific provisions may be made in the Companies Act, 1956 that the liquidator may distribute interim dividend.
- The reference to the Tribunal for revival by a company should be voluntary. As already stated the jurisdiction of hearing references of revival and rehabilitation of companies will vest in the Tribunal and not BIFR as at present.
- The committee further favoured the appointment of professionals as the Liquidators from a panel to be prepared by the Government.

## DR. J.J. IRANI EXPERT COMMITTEE ON COMPANY LAW

- Dr. J.J. Irani Expert Committee on Company Law was set up by the Government to recommend a new company law.
- Committee submitted its report to the Government of India on 31 May, 2005.
- The Committee proposed significant changes in the law to make the restructuring and liquidation process speedy, efficient and effective.
- Enactment of Companies (Second Amendment) Act, 2002, which provided for the setting up of a National Company Law Tribunal (NCLT)/Tribunal and its Appellate Body, the National Company Law Appellate Tribunal (NCLAT).
- The highlights of the report of the Committee regarding Restructuring and Liquidation are given below:
  - Corporate insolvency to be addressed in company law. No need for a separate insolvency law.
  - Law to strike a balance between rehabilitation and liquidation process.
  - Rehabilitation and liquidation processes to be time bound.
  - Winding up to be resorted to only when revival is not feasible.
  - Reasonable opportunity for rehabilitation of business before it is decided to be liquidated.
  - Period of one year to be adequate for rehabilitation from commencement of process to sanction of plan.
  - Two years to be feasible for completion of liquidation.
  - Debtors and creditors to have fair access to insolvency system.
  - Rather than net worth erosion principle, test for insolvency should be default in payment of matured debt on demand within a prescribed time [liquidity test].
  - Creditors being at least 3/4th in value may also file rehabilitation scheme.
  - Law to impose certain duties and prohibitions to apply to debtors and creditors on admission of rehabilitation application.
  - There should be a duty cast on companies to convene creditors and shareholders meeting in case of default in payments to creditors.

- Law to provide for treatment of unperformed contracts.
- Qualified Administrator appointed by the Tribunal in consultation with the secured creditors with board authority to administer the estate in the interest of all stakeholders should replace management of the going concern.
- Creditors to actively participate and monitor the insolvency process.
- Avoidance or cancellation of pre-bankruptcy fraudulent and preferential transactions.
- Provisions to be made for ready access to court records, court hearings, debtors, financial data and other public information.
- Insolvency Fund may be set up to meet the costs of the insolvency process.

## **Banking Laws Reforms Committee**

### **The objectives of the Committee were to resolve insolvency with:**

- lesser time involved,
- lesser loss in recovery, and
- higher levels of debt financing across instruments.

The Committee has presented its report in two parts:

- Volume 1, with its rationale and design for legislation, and
- Volume 2, with the Draft Insolvency and Bankruptcy Bill.

The Committee has recommended a consolidation of the existing legal framework, by repealing two laws and amending six others.

### **It has proposed to repeal the**

- Presidency Towns Insolvency Act, 1909 and
- the Provincial Insolvency Act, 1920.

### **In addition, it has proposed to amend:**

- Companies Act, 2013,
- Sick Industrial Companies (Special Provisions) Repeal Act, 2013,
- Limited Liability Partnership Act, 2008,
- Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002,
- Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and
- Indian Partnership Act, 1932.

- The Committee observed that currently creditors have limited power. They are able to recover only 20% of the debt amount on an average.
- The Committee also observed that decisions regarding the defaulting firm are business decisions, and should be taken by the creditors.
- To establish a Creditors committee, where the financial creditors will have votes in proportion to their magnitude of debt. The creditors committee will undertake negotiations with the debtor, to come up with a revival or repayment plan.

### **Insolvency and Bankruptcy Resolution:**

- The report outlines the procedure for insolvency resolution for companies and individuals. The process may be initiated by either the debtor or the creditors.
- Presently, only secured financial creditors (creditors holding collateral against loans), can file an application for declaring a company sick. The Committee has proposed that operational creditors, such as employees whose salaries are due, be allowed to initiate the insolvency resolution process (IRP). The entire IRP will be managed by a licensed insolvency professional.
- During the IRP, the professional will control and manage the assets of the debtor, to ensure that they are protected, while the negotiations take place.
- The Committee has proposed to set up Insolvency Professional Agencies. The agencies will admit insolvency professionals as members and develop a code of conduct. An environment where the agencies compete with each other, to achieve greater efficiency and better performance has been envisioned.
- The report recommends speedy insolvency resolution and time bound negotiations between creditors and the debtors. To ensure this, a 180 day time period for completion of the IRP has been recommended. For cases with high complexity, this time period may be extended by 90 days, if 75% of the creditors agree.

### **Information Utilities:**

The committee has proposed to establish information utilities which will maintain a range of information about firms, and thus avoid delays in the IRP, typically caused by a lack of data.

### **Insolvency regulator:**

- The Committee has proposed to establish the Insolvency and Bankruptcy Board of India.
- The Board will regulate the insolvency professional agencies and information utilities, in addition to making regulations for insolvency resolution in India.

### **Bankruptcy and Insolvency Adjudicator:**

The Committee proposes two tribunals to adjudicate grievances under the law:

- the National Company Law Tribunal will continue to have jurisdiction over insolvency resolution and liquidation of companies and limited liability partnerships; and
- the Debt Recovery Tribunal will have jurisdiction over insolvency and bankruptcy resolution of individuals.

### **Regulatory Framework in India – Corporate Insolvency**

- The Companies Act 2013 provides for regulation of insolvency, including rehabilitation, winding up and liquidation of companies in time bound manner. It incorporates international best practices based on models suggested by the United Nations Commission on International Trade Law (UNCITRAL).
- The purpose of creation of the Tribunal is to avoid multiplicity of litigation before various courts or quasi-judicial bodies or forums regarding revival or rehabilitation or merger and amalgamation, and winding up of companies. NCLT will have-
  - The power to consider revival and rehabilitation of companies
  - The jurisdiction and power relating to winding up of companies presently vested in the High Court.
  - The jurisdiction and power exercised by the Company Law Board.
- The Act also provides for larger role for professionals like Company Secretaries to act as interim administrator/Company administrator and Company liquidators.

### **Securitisation Act**

- The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 (Securitisation Act ) has been enacted. SARFAESIA empowers banks or financial institutions to recover on non-performing assets without court intervention.
- SARFAESIA provides three alternative methods for recovery of non-performing assets, including
  - taking possession,
  - selling and leasing the assets underlying the security interests such as movable property (tangible or intangible, including accounts receivable) and

- immovable property without the intervention of the courts.
- The SARFESIA is not available to secured creditors, which are not Indian banks, or financial institutions notified. The provisions of Securitisation Act are dealt in detail in lesson no. 18.

## **United Kingdom Insolvency Framework**

### **A Brief on Historical background on UK Insolvency Framework**

- In England, the first bankruptcy law was enacted in 1542,
- Under this act a debtor was still looked upon as in a sense an offender, and the law was mainly for the benefit of creditors, providing for an equal distribution of the debtor's assets among his creditors, but not releasing the debtor from his debts.

The Insolvency Act, 1986 deals with the insolvency of individuals and companies. The Act is divided into three groups and 14 Schedules as follows:

- Group 1 deals with Company Insolvency
- Group 2 deals with Insolvency of Individuals and
- Group 3 deals with Miscellaneous Matters Bearing on both Company & Individual Insolvency

Basically, a company in financial difficulties may be made subject to any of five statutory procedures.

- administration;
- company voluntary arrangement;
- scheme of arrangement;
- receivership (including administrative receivership); and
- liquidation (winding-up).

The Insolvency Act 1986 also introduced three new procedures that held out the possibility of a company being brought back to life as a viable entity.

- The first of these procedures – ‘Company Voluntary Arrangements’ (CVAs)
- The second procedure – ‘Administration’
- A third option – ‘Administrative Receivership’

## US Bankruptcy laws

### The evolution of Insolvency Laws in US along with timeline

- As we read earlier, England first established a bankruptcy law in 1542. Under the English law, bankruptcy was treated as a criminal act punishable by imprisonment or death.
- Early American bankruptcy laws were only available to merchants and generally involved imprisonment until debts were paid or until property was liquidated or creditors agreed to the release of the debtor. The laws were enacted by each individual state and were inconsistent and discriminatory.
- The system was not uniform and some states became known as debtor's havens because of their unwillingness to enforce commercial obligations.
- The lack of uniformity in bankruptcy and debt enforcement laws hindered business and commerce between the states.
- Until 1898 there was no bankruptcy law in continuous effect in the United States. The Congress enacted temporary bankruptcy statutes, those laws were temporary measures and were repealed as soon as economic conditions stabilized.
- A permanent bankruptcy statute was not enacted until 1898. Law was amended to provide for the rehabilitation or reorganization of a debtor as an alternative to liquidation of assets.

### Since 1978

The US Congress enacted the "Bankruptcy Code" in 1978.

The procedural aspects of the bankruptcy process are governed by the Federal Rules of Bankruptcy Procedure (often called the "Bankruptcy Rules") and local rules of each bankruptcy court.

Six basic types of bankruptcy cases are provided for under the Bankruptcy Code.

- **Chapter 7** bankruptcy leading to liquidation.
- **Chapter 9** entitled Adjustment of Debts of a Municipality
- **Chapter 11** entitled Reorganization
- **Chapter 12** for family farmer or fisherman

- **Chapter 13** enables individuals

**Chapter15** is to provide effective mechanisms for dealing with insolvency cases.