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Insolvency and Bankruptcy Board of India

IBC के आठ वर्ष

शोध एवं विश्लेषण

2024

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IIMA Annual Research Workshop on Insolvency and Bankruptcy

PREFACE

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) signifies a major shift in India's legal and economic landscape. Enacted to remedy the shortcomings and fragmentation that plagued the country's insolvency and bankruptcy regime, the Code established a comprehensive and unified framework designed to facilitate timely resolution of distressed entities. Unlike earlier approaches that focused primarily on recovery, the IBC prioritizes maximizing the value of assets and maintaining businesses as going concern in alignment with international best practices. This shift from a debtor-in-possession to a creditor-in-control model introduced strict timelines for each step of the resolution process, which is crucial for preserving assets. The new framework was designed to tackle '*Chakravyuha Challenge*' as emphasized in the Economic Survey of 2015-16 (i.e., the ability to enter but not exit the market) thus, giving them an opportunity to exit honorably from genuine failed business ventures, thereby promoting ease of doing business and encouraging entrepreneurship. The Code aims to address financial distress promptly by mandating that an Insolvency Professional oversees the insolvency process and manages the operations of the distressed corporate debtor. Simultaneously, a committee of creditors drives the resolution process and makes all significant decisions, thus, minimizing further value erosion during the process. The process finally concludes by the judicial approval of the Adjudicating Authority. Through its design and implementation, the Code seeks to balance the interests of all stakeholders.

The establishment of the Insolvency and Bankruptcy Board of India (IBBI/ Board) on October 1, 2016, further strengthened the regulatory framework. Although the IBC is still in its early stages, its impact has already been transformative, marking a significant departure from the shortcomings of the previous insolvency regime.This is evident from the fact that as of June 2024, a total of 7,813 cases have been admitted, with 5,840 reaching closure. Of these closed cases, 3,293 companies—accounting for 56% of the closures—were successfully rescued, while 2,547 resulted in liquidation. Among the rescued companies, 1,192 cases were closed due to appeal, review, or settlement; 1,096 were withdrawn; and 1,005 concluded with the approval of resolution plans. Notably, 40% of the cases that ended with resolution plans had previously been with the Board for Industrial and Financial Reconstruction or were defunct.

While the Code's immediate advantage lies in enhancing the recovery process, its broader and more significant impact comes from the behavioural change it has induced—particularly the shift in the relationship between creditors and borrowers. Notably, even before formal admission, over 28,818 cases having underlying debt of ₹10.22 lakh crore were withdrawn as on March, 2024. When combined with the ₹3.40 lakh crore recovered through resolutions, the IBC has effectively recouped ₹13.62 lakh crore into the economy. This shift in behaviour has fundamentally changed the narrative around non-performing assets (NPAs) or defaults; it is no longer solely a burden on banks but has become a critical concern for borrowers as well. As per RBI's Financial Stability Report, June 2024, the gross-NPA ratio of scheduled commercial banks fell to multi-year lows of 2.8% in March, 2024. The Code was recognized as an effective solution to the twin balance sheet problem, where banks were weighed down by NPAs and corporations were overleveraged and struggling to repay their debts.

The Indian Institute of Management, Ahmedabad conducted a study to review the functioning of firms that had undergone resolution under the Code. This Report analysed the performance of the firms both before and after the resolution process and finds that the IBC framework has yielded, for the resolved firms (i) increased sales, (ii) increased employee expense which could be attributed to increased employment generation, (iii) increase in assets, (iv) increased CAPEX, (v) threefold increase in market valuation of resolved firms, and (vi) significant improvement in liquidity of these resolved firms.

The IBC has emerged as an unprecedented piece of legislation, fundamentally transforming India's insolvency landscape. Its evolution has been marked by ongoing learning and adaptation to changing economic and market conditions. Research is crucial for advancing the IBC's goals, as rigorous data analysis helps uncover new trends and patterns that can guide policymakers in developing evidence-based policies under the Code. This publication marks the sixth consecutive annual release of the IBBI's Annual Publication, coinciding with the completion of eight years since the Code's inception. It delves into the intricate dynamics of IBC, examining the roles and effectiveness of key stakeholders within the framework. It provides an analysis of the evolving insolvency regime, explores the intersection of taxation and insolvency, evolving legal obligations under international conventions, examines the treatment of dues payable to workmen and employees under IBC, highlights the potential of digital transformation tools like AI and blockchain in streamlining insolvency processes, and the need for a stronger valuation framework. Through an international lens, one of the articles discusses the legal obligations of creditors, while others highlight the privacy concerns in data protection, the complexities faced by homebuyers and explore the possibility of direct dissolution during CIRP.

This publication also features nine research papers which were presented at the IIM Ahmedabad Annual Research Workshop on Insolvency and Bankruptcy, in March, 2024. The papers explore the need for tailored solutions to airline insolvencies and questions the relevance of the 'Gibbs Rule' in today's cross-border insolvency landscape. It examines the intricacies of lifting of corporate veil in related party transactions and analyses the bank insolvency resolution through the lens of the UNIDROIT Legislative Guide on Bank Insolvency. Additionally, it explores the evolving journey of operational creditors, the impact of litigation funding, deciphers the complex relationship between government dues and security interests under IBC, uncovers the untapped potential of pre-insolvency resolution procedures and offers a deep dive into the intersection of Environmental, Social, and Governance (ESG) principles with corporate restructuring, drawing lessons from global jurisdictions.

The Code's evolution, marked by numerous unexpected developments, has demonstrated a steady and forward-moving progress over the years. The key to its continued success lies in its ability to adapt to and address future challenges effectively. Looking ahead, the aim is to surpass the achievements of the past, bringing even greater efficiencies and outcomes.

The IBBI extends its sincere thanks to all the authors for generously contributing their valuable insights and expertise to this publication. We also acknowledge and appreciate the ongoing efforts of the Research Division in making this publication possible.

(Jayanti Prasad)
Whole Time Member
Insolvency and Bankruptcy Board of India

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A REFLECTION ON THE ROLE & EFFECTIVENESS OF STAKEHOLDERS UNDER THE IBC FRAMEWORK IN INDIA

Sunil Mehta

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) in its eight years of journey has evolved to be ever-relevant and responding to meet the emerging expectations and needs of the financial ecosystem from time to time. The legislation, in its continuous evolution, has been fulfilling the aspirations of the stakeholders and the journey is promising. In terms of its design and architecture, the Code strived to maximise the value of assets of the corporate debtor (CD) while balancing the interests of all stakeholders during the process.

A few watershed moments in the exciting and eventful journey of the Code, so far, include the introduction of section 29A making defaulting promoters ineligible to re-enter as resolution applicants, recognising homebuyers as financial creditors (FCs), introduction of insolvency resolution process for financial service providers and pre-packaged insolvency resolution process etc., the constant endeavour of the Government and the Insolvency and Bankruptcy Board of India (IBBI) in addressing the upcoming challenges, has transformed IBC into a future ready and relevant in time, legislation.

A CASE FOR REFLECTING ON THE ROLE & EFFECTIVENESS OF STAKEHOLDERS UNDER THE IBC FRAMEWORK IN INDIA

The Code has created an ecosystem where multiple stakeholders are involved, mainly as the FCs, operational creditors (OCs), workmen and employees, Government, the directors of the CD and prospective resolution applicants. As the ecosystem is maturing, there is a need for certain confidence building measures for each of the stakeholders that would enable them to support such an ecosystem more meaningfully and constructively.

While the deliverables of the Code continue to be promising, the expectation on outcomes from the IBC ecosystem also kept raising requiring a close and deeper understanding of the current effectiveness of stakeholders in discharging the expectations from each of them.

Before taking a deep dive into the stakeholder ecosystem, we need to acknowledge and appreciate the pious role each one of these pillars have played over the years and the fruits of their labour enjoyed by the economy. By saying so, the author deeply appreciates and compliments the performance of each of the stakeholders in shaping the IBC today, they deserve the best of the compliments indeed.

Having said so and looking forward, there will always be expectations of and room for improvements as we traverse through the learning curve. Continued efforts are needed to empower the stakeholders for effective functioning in the IBC ecosystem.

This article examines and reflects on the current role of critical stakeholders in the IBC universe and brings out the areas of improvement for enhancing their effectiveness for the outcomes in harmony with the objectives of the Code. The case of each of the key stakeholders is narrated in the following paragraphs:

CORPORATE DEBTOR

The entity undergoing insolvency proceedings is referred to as the CD. The CDs role would be to cooperate with the Resolution Professional (RP), provide the necessary information, and comply with the decisions of the National Company Law Tribunal (NCLT) throughout the resolution process. Major activities expected from a CD are:

Compliance and cooperation

CD is required to adhere to the provisions of the IBC and cooperate fully with the insolvency resolution process. This involves providing accurate and timely financial information, cooperating with the appointed RP, and participating in the proceedings of the committee of creditors (CoC) to facilitate a transparent resolution process.

Financial disclosure and transparency

Transparency plays a crucial role in the insolvency resolution process. The CD undergoing financial distress is required to maintain a standard of openness by providing comprehensive financial details. This entails sharing information on assets, debts, dues to lenders, and other pertinent financial data to ensure informed decision-making by creditors and potential resolution buyers.

Participation in CoC meetings

CDs can participate in CoC meetings, where important decisions related to insolvency resolution are discussed and determined. Through constructive engagement in these meetings, CDs can express their viewpoints, suggest viable resolution strategies, and cooperate with creditors to reach a mutually beneficial outcome for all stakeholders.

Submission of resolution plans

If the CD initiates insolvency, the CD can ensure that it puts the business up for resolution before it is too late. This encourages the CD to propose viable resolution plans for the approval of the CoC. These plans should demonstrate a clear strategy for restructuring debts, reviving the business, and maximizing value for creditors, thereby showcasing the debtor's commitment to sustainably resolving financial distress.

Adherence to timelines

CDs are expected to adhere to the timelines prescribed under the IBC for various stages of the insolvency resolution process. This includes submitting necessary documents and information within specified deadlines, attending hearings and meetings as required, and complying with directives issued by the RP and Adjudicating Authority (AA).

In essence, CDs play a vital role in the insolvency resolution process under the IBC by actively engaging with stakeholders, demonstrating transparency and cooperation, and working towards a consensual resolution of financial distress. By fulfilling their responsibilities diligently and proactively participating in the resolution process, CDs contribute to the effectiveness and success of insolvency proceedings, ultimately facilitating the revival and rehabilitation of distressed businesses in a structured and time-bound manner.

It is gratifying to observe that, today the perception and outlook of business entities have shifted to more responsible and positive entrepreneurship focussing on building the intrinsic value of the enterprise. The attitudinal shift is largely attributable to the existence of the Code. Knowing that there is a robust mechanism in place, business owners are prompted to better manage their finances in better ways and avoid insolvency proceedings. This is evident from the fact that till May 2023, about 25,565 corporate insolvency resolution processes, having underlying default of ₹ 8.23 lakh crore were resolved before their admission. IBC has thus brought about credit discipline amongst businesses and there is a positive behavioural change amongst promoters.

There is a need to continuously strive to promote awareness about the Code in the business circles to maintain/sustain the appreciation in this regard.

FINANCIAL CREDITORS

FCs are entities to whom the CD owes financial debts. They exercise significant influence and responsibility within the insolvency resolution framework established by the Code. As key stakeholders in the insolvency process, the FC plays a pivotal role in initiating insolvency proceedings, forming the CoC, and making critical decisions that impact the outcome of insolvency resolution efforts.

Initiating insolvency proceedings

FCs, including banks, financial institutions, and other entities to whom financial debt is owed, initiate insolvency proceedings against defaulting CDs under the IBC. By filing a petition with the NCLT, FCs trigger the insolvency resolution process and set the stage for the resolution of financial distress.

Forming the CoC

It shall be the duty of FCs to form the CoC – the key stakeholder playing a pivotal role in guiding the insolvency resolution process. The CoC is constituted of the FCs who have the authority to vote on important issues like selecting RPs, examining and endorsing resolution plans, and making other crucial decisions that influence the direction of insolvency proceedings.

Voting on resolution plans

FCs play a critical role in evaluating and voting on resolution plans submitted by resolution applicants to revive the distressed entity. The CoC's approval of a resolution plan is instrumental in determining the fate of the insolvent company, with FCs exercising their voting rights based on the merits of the proposed plan and its alignment with their economic interests.

Distribution of proceeds

In the event of a successful resolution, FCs play a critical role in determining the distribution of proceeds from the sale of assets of the insolvent company. The CoC deliberates on the allocation of funds among creditors, prioritizing claims based on the waterfall mechanism prescribed under the IBC to ensure equitable distribution of proceeds.

Overseeing insolvency proceedings

FCs actively participate in insolvency proceedings, attending CoC meetings, engaging with RPs, and promoting resolutions that maximize recovery of dues owed to them. Their proactive involvement is essential in safeguarding their interests, promoting transparency, and facilitating a swift and efficient resolution of financial distress.

In essence, FCs being key stakeholders hold a responsibility towards other stakeholders in the IBC ecosystem. Upholding the principles and objectives of the Code shall be the highest priority for the FC. The essential objective of the Code being to facilitate the CD as a going concern, the FC shall always endeavour to work towards enhancing the value of the CD. The Code casts on FC a responsibility to facilitate the resolution of the stress rather than merely looking at the Code for recovery of its dues. Addressing the needs of CD for interim finance is one such important aspect an FC shall be concerned with along with the RP.

OPERATIONAL CREDITORS

OCs are entities that provide goods or services to the CD. Their role is similar to FCs in terms of filing claims, participating in CoC meetings, and voting on resolution plans.

Declaring claims and participating in insolvency proceedings

OCs have the right to declare their claims for outstanding dues owed to them by the CD and participate in insolvency proceedings under the IBC. By submitting details of their claims to the RP, OCs ensure their interests are represented in the resolution process and have a say in the distribution of proceeds from asset sales.

Representation in the CoC

While FCs typically play a major role in the CoC, OCs also have a presence in the CoC and play a role in decision-making processes that impact the insolvency resolution. By participating in CoC meetings, OCs share their concerns, advocate for their rights, and contribute to discussions on matters affecting their economic interests.

Approval of resolution plans

OCs have a stake in the approval of resolution plans submitted by resolution applicants to revive the distressed entity. The CoC's decision on the acceptance or rejection of a resolution plan can have significant implications for OCs, as they stand to benefit from resolutions that prioritise the recovery of dues owed to them and ensure the continuity of business relationships.

Ensuring operational continuity

OCs play a critical role in maintaining operational continuity during the insolvency resolution process, particularly in extending essential goods and services that are vital for the functioning of the CD. By collaborating with the RP and CoC, OCs contribute to the preservation of business operations and the viability of the insolvent entity.

Advocating for fair treatment and equitable distribution

OCs advocate for fair treatment and equitable distribution of proceeds from the resolution of the CD, ensuring that their dues are given due consideration alongside FCs. By championing transparency, accountability, and fairness in insolvency proceedings, OCs uphold the principles of economic justice and stakeholder inclusivity under the IBC.

In conclusion, OCs play a vital role in the insolvency resolution ecosystem under the IBC, representing a diverse array of stakeholders who contribute essential goods and services to the CD. Their active participation, advocacy for fair treatment, and commitment to operational continuity are instrumental in fostering a balanced and inclusive approach to insolvency resolution, ultimately aiming to protect the interests of all stakeholders and promote the sustainable revival of distressed businesses.

While the jurisprudence emerged over the last few years and acknowledged the need to address the concerns of OCs, OCs also have a responsibility of striving towards resolution of the stress in CD in the interest of all other stakeholders thus rising above the narrow concerns limited to them.

RESOLUTION PROFESSIONAL

RPs play a crucial part in the insolvency resolution framework established by the IBC, by managing the affairs of distressed entities, facilitating the resolution process, and safeguarding the interests of all stakeholders involved. As licensed insolvency practitioners entrusted with overseeing insolvency proceedings, RPs undertake a diverse array of responsibilities that are instrumental in driving the effective and efficient resolution of financial distress.

Management of CD’s affairs

One of the primary responsibilities of RPs is to take immediate control and management of the affairs of the CD upon their appointment. This involves assuming the reins of the insolvent entity, safeguarding its assets, preserving business operations, and ensuring the continuity of essential services during the insolvency resolution process.

Verification and admittance of claims

RPs are tasked with the critical duty of verifying and admitting claims submitted by creditors, including FCs, OCs, and other stakeholders. By meticulously scrutinizing claims, resolving disputes, and maintaining a transparent claims verification process, RPs uphold the integrity and accuracy of the insolvency resolution framework.

Facilitation of insolvency resolution process

RPs play a central role in facilitating the insolvency resolution process, coordinating interactions between stakeholders, convening meetings of the CoC, and overseeing the submission and evaluation of resolution plans. By acting as intermediaries between creditors, CDs, and regulatory authorities, RPs streamline communication and decision-making processes to advance the resolution agenda.

Compliance with timelines and requirements under the Code

RPs are responsible for ensuring strict compliance with the timelines and procedural requirements stipulated under the IBC. By adhering to prescribed deadlines for various stages of the insolvency resolution process, submitting requisite reports and documents to regulatory authorities, and upholding the highest standards of professional conduct, RPs uphold the sanctity and efficiency of insolvency proceedings.

Negotiation and implementation of resolution plans

One of the key mandates of RPs is to facilitate negotiations between stakeholders and assist in the formulation and implementation of viable resolution plans. By engaging with resolution applicants, creditors, and other parties involved in the resolution process, RPs strive to achieve consensus, maximize value for all stakeholders, and drive the successful revival of the insolvent entity.

Reporting and disclosure requirements

RPs are required to provide accurate and timely reports to the NCLT, CoC, and other relevant authorities regarding the progress of insolvency proceedings. By maintaining transparency, providing regular updates on the status of the resolution process, and disclosing pertinent information to stakeholders, RPs foster trust and accountability in the insolvency resolution ecosystem.

In essence, RPs serve as catalysts for change and transformation in the insolvency resolution landscape, leveraging their expertise, impartiality, and commitment to drive the resolution of financial distress and promote the rehabilitation of distressed businesses. By upholding the principles of professionalism, transparency, and stakeholder engagement, RPs play a vital role in ensuring the integrity, efficiency, and success of insolvency proceedings under the IBC.

The RPs need to adhere to the Code of Conduct expected from them and maintain the highest standards of professionalism while striving to resolve the CD. This can be achieved with the trust and effective coordination with the CoC in the process. It is also important for an RP to understand the nuances of the complex business environment of various sectors. An initiative towards specialising RPs to expertise in various sectors and thereby empanelling sector-specific RPs to handle resolution strategies of such sector-specific IBC cases can help the ecosystem to improve the share of resolution cases.

COMMITTEE OF CREDITORS

The CoC emerges as a central decision-making body within the insolvency resolution framework established by the Code, wielding authority, responsibility, and influence in shaping the outcome of insolvency proceedings. Comprising FCs who hold significant claims against the CD, the CoC plays a crucial role in deliberating on key matters, approving resolution plans, and safeguarding the economic interests of creditors and stakeholders.

Constitution and decision-making

The CoC is formed following the initiation of insolvency proceedings, with FCs coming together to constitute this pivotal forum. As the primary decision-making body in the insolvency resolution process, the CoC deliberates on critical matters such as the appointment of RPs, evaluation of resolution plans, approval of funding arrangements, and distribution of proceeds from the sale of assets.

Voting on resolution plans

One of the key responsibilities of the CoC is to evaluate and vote on resolution plans submitted by resolution applicants seeking to revive the distressed entity. The approval of a resolution plan by the CoC is instrumental in determining the future course of the insolvent company, with FCs exercising their voting rights based on the feasibility, viability, and alignment of the proposed plan with their economic interests.

Protection of creditor interests

The CoC acts as a custodian of creditor interests, ensuring that the resolution process maximizes the recovery of dues owed to creditors, promotes transparency and fairness, and safeguards the economic rights of all stakeholders involved. By advocating for equitable treatment of creditors, adherence to legal norms, and the pursuit of resolutions that optimize value realization, the CoC upholds the principles of creditor protection and economic prudence.

Negotiation and consensus-building

The CoC serves as a platform for negotiation, consensus-building, and collaborative decision-making among FCs, RPs, and other stakeholders. By fostering dialogue, resolving conflicts, and striving for consensus on critical issues, the CoC aims to achieve collective agreement on resolution strategies, ensure the smooth progress of insolvency proceedings, and drive the successful revival of the insolvent entity.

Oversight and monitoring

The CoC assumes a supervisory role in overseeing the insolvency resolution process, monitoring the implementation of approved resolution plans, and ensuring compliance with regulatory requirements. By exercising vigilance, providing guidance to RPs, and upholding the integrity of insolvency proceedings, the CoC contributes to the effective governance and transparency of the resolution framework.

Distribution of proceeds

In the event of a successful resolution, the CoC plays a pivotal role in determining the distribution of proceeds from the sale of assets of the insolvent company. By deliberating on the allocation of funds among creditors, prioritizing claims based on the waterfall mechanism prescribed under the IBC, and ensuring fair and equitable distribution of proceeds, the CoC upholds principles of economic justice and creditor parity.

The Code of Conduct for the CoC is being designed for adoption on a voluntary basis. The Code needs to be adhered to without diluting the principles relating to exercising commercial wisdom.

In conclusion, the CoC stands as a cornerstone of the insolvency resolution architecture under the IBC, embodying collaboration, accountability, and economic prudence in driving the resolution of financial distress. By fulfilling its role with diligence, transparency, and stakeholder engagement, the CoC contributes to the integrity, efficiency, and success of insolvency proceedings, ultimately aiming to protect creditor interests and promote economic revival.

INVESTORS AND RESOLUTION APPLICANTS

Resolution applicants including strategic investors, financial investors, and turnaround specialists, play a vital role in injecting capital, expertise, and resources to support the restructuring and revival of distressed companies. Investors bring financial backing, industry know-how, and operational acumen to the table, driving the turnaround efforts, restructuring initiatives, and growth strategies of insolvent entities. By identifying opportunities, assessing risks, and making strategic investments in insolvent assets, investors catalyse the revitalization of businesses, create value for stakeholders, and contribute to the economic resurgence of the CD.

Capital infusion and turnaround strategies

Resolution applicants and investors play a key role in infusing capital, implementing turnaround strategies, and restructuring operations to revitalize distressed companies. By providing financial resources, strategic direction, and operational expertise, these stakeholders enable insolvent entities to overcome financial challenges, enhance operational efficiency, and chart a path towards sustainable growth and profitability. Through prudent investments, innovative solutions, and collaborative efforts, resolution applicants and investors drive the transformation and rejuvenation of insolvent businesses.

Value maximization and creditor recovery

Resolution applicants and investors focus on maximizing value for creditors, enhancing asset recovery, and ensuring equitable distribution of proceeds from the resolution of distressed companies. By crafting viable resolution plans, optimizing asset utilization, and implementing value-enhancing initiatives, these stakeholders aim to unlock value, generate returns for creditors, and facilitate the successful resolution of insolvency cases. Through strategic investments, prudent financial management, and effective restructuring measures, resolution applicants and investors contribute to the resolution of financial distress and the restoration of economic viability within the corporate ecosystem.

In essence, resolution applicants and investors play instrumental roles in the insolvency resolution process under the IBC, driving the revival, restructuring, and turnaround of distressed companies through capital infusion, strategic vision, and operational expertise. By leveraging their resources, knowledge, and commitment to value creation, these stakeholders can keep the entity as a successful going concern.

ADJUDICATING AUTHORITY / APPELLATE AUTHORITY (NCLT/NCLAT)

The NCLT and the National Company Law Appellate Tribunal (NCLAT) act as AA and Appellate Authority respectively in the IBC process. On admission of the applications for insolvency process, the judicial forums oversee the overall insolvency proceedings including approval of the resolution plans.

Adjudication of insolvency petitions

The NCLT attends to adjudicating insolvency petitions filed by FCs to initiate insolvency proceedings against CDs. By scrutinizing the merits of insolvency applications, determining the existence of default, and passing orders to admit or reject insolvency petitions, the NCLT plays a pivotal role in triggering the insolvency resolution process.

Supervision of insolvency proceedings

The NCLT assumes a supervisory role in overseeing insolvency proceedings, ensuring compliance with the procedural requirements of the IBC, and monitoring the conduct of RPs, CoC, and other stakeholders involved in the resolution process. By providing judicial oversight, resolving disputes, and upholding the rule of law, the NCLT fosters transparency and accountability in insolvency resolution proceedings.

Approval of resolution plans

The NCLT plays a critical role in approving resolution plans submitted by resolution applicants for the revival of distressed entities. By evaluating the feasibility, viability, and compliance of resolution plans with the provisions of the IBC, the NCLT ensures that approved plans align with the interests of creditors, promote the revival of the CD, and comply with legal requirements.

Dispute resolution and adjudication

The NCLT and NCLAT serve as forums for resolving disputes, appeals, and legal challenges arising from insolvency proceedings under the IBC. By adjudicating on contentious issues, interpreting legal provisions, and providing redressal mechanisms for aggrieved parties, the NCLT / NCLAT promotes the resolution of disputes in a judicial manner, upholding the principles of natural justice and legal equity.

Monitoring and enforcement of resolution plans

The NCLT oversees the implementation of approved resolution plans, ensuring that resolution applicants adhere to the terms and conditions prescribed in the plans. By monitoring the progress of insolvency resolution, verifying compliance with regulatory requirements, and enforcing the execution of approved plans, the NCLT safeguards the integrity and efficacy of the resolution process.

Judicial review and appeals

The NCLAT functions as an appellate tribunal, providing a forum for challenging the decisions of the NCLT and seeking judicial review of insolvency-related matters. By adjudicating on appeals, clarifying legal interpretations, and ensuring consistency in judicial decisions, the NCLAT upholds the principles of legal certainty, procedural fairness, and appellate justice within the insolvency resolution framework.

In essence, the NCLT/NCLAT assumes a pivotal role in the insolvency resolution ecosystem under the IBC, embodying judicial oversight, legal adjudication, and dispute resolution in insolvency proceedings. By strict adherence tothe law of the land, ensuring procedural fairness, and promoting the effective administration of insolvency resolution processes, the NCLT / NCLAT contributes to the integrity, efficiency, and fairness of the insolvency resolution framework, ultimately aiming to protect the interests of stakeholders, uphold legal norms, and foster a conducive environment for economic revival.

A few concerns often raised relate to inadequate manpower and infrastructure at these judicial forums to handle the volume of activities. Delays in resolution are often attributed to inadequacies on these aspects. The Government has seized the status and necessary steps have been initiated to address the concerns in this regard.

REGULATORY AUTHORITIES

Regulatory bodies such as the IBBI and the Reserve Bank of India constitute the regulatory backbone of the IBC ecosystem, setting forth guidelines, monitoring adherence to regulatory norms, and fostering a conducive environment for insolvency resolution. The vigilance and oversight exercised in the process ensure the integrity and efficacy of the insolvency resolution process.

Policy formulation and guideline setting

Regulatory authorities such as the IBBI are responsible for formulating policies, rules, and guidelines that govern the insolvency resolution process under the IBC. By establishing regulatory frameworks, procedural norms, and operational guidelines, regulatory authorities provide clarity, consistency, and direction to stakeholders involved in insolvency proceedings.

Supervision and monitoring of insolvency proceedings

Regulatory authorities play a supervisory role in monitoring insolvency proceedings, ensuring compliance with regulatory requirements, and upholding the principles of transparency, fairness, and accountability in insolvency resolution. By overseeing the conduct of RPs, CoCs, and other stakeholders, regulatory authorities promote adherence to legal norms and procedural standards.

Enforcement of compliance and disciplinary action

Regulatory authorities have the authority to enforce compliance with the provisions of the IBC and take disciplinary action against entities or individuals found to be in violation of regulatory norms. By imposing penalties, sanctions, or other remedial measures, regulatory authorities deter misconduct, uphold regulatory integrity, and maintain the credibility of the insolvency resolution framework.

Education and awareness

Regulatory authorities also have a responsibility of educating stakeholders, raising awareness, and disseminating information about the provisions, procedures, and implications of the IBC. By conducting outreach programs, workshops, and capacity-building initiatives, regulatory authorities enhance stakeholder understanding, promote best practices, and foster a culture of compliance within the insolvency ecosystem.

Guidance and support for other stakeholders

Regulatory authorities offer guidance, support, and assistance to stakeholders involved in insolvency proceedings, clarifying legal interpretations, addressing queries, and providing regulatory guidance on complex issues. By offering a reliable source of information, regulatory authorities empower stakeholders to navigate the insolvency resolution process with confidence and clarity.

In conclusion, regulatory authorities play a critical role in ensuring the integrity, efficiency, and effectiveness of the insolvency resolution framework under the IBC. By setting standards, monitoring compliance, and providing guidance to stakeholders, regulatory authorities contribute to the stability, transparency, and credibility of insolvency proceedings, ultimately aiming to create a platform that helps all the stakeholders to maximise the value of their assets.

INFORMATION UTILITIES (IUs)

The presence of information asymmetry has been a major obstacle in the smooth functioning of corporate insolvency and bankruptcy procedures in India. Creditors and other interested parties often face difficulties in obtaining accurate financial details of debtors, leading to delays and inefficiencies in the process. Significant time and resources are required to verify debtor defaults and determine the true financial standing of the company in question.

In order to address this issue, the IBC implemented the establishment of a regulated information sector through the creation of IUs. An IU is described in section 3(21) of the IBC as an individual registered with the IBBI according to section 210. The core functions of IUs include:

Information sharing

One of the main roles of IUs is to enable the smooth exchange of important financial data among creditors, debtors, and various stakeholders participating in insolvency proceedings.

By offering a centralized platform for the storage and sharing of financial information, IUs play a crucial role in expediting the resolution process and avoiding delays that may arise due to gaps in information.

Efficiently managing bankruptcy procedures

IUs are essential in efficiently managing bankruptcy procedures by providing stakeholders with reliable and current financial data. This facilitates a quicker resolution process and reduces the likelihood of disagreements stemming from inadequate or inaccurate information.

Enhancing transparency and accountability

IUs play a significant role in promoting transparency and accountability in insolvency proceedings by offering a secure and trustworthy platform for storing financial information. This allows creditors and stakeholders to access necessary data promptly, ultimately decreasing the chances of fraud and unethical actions in the resolution process.

In summary, IUs play a very significant role in enhancing transparency, accountability, and effectiveness in insolvency procedures governed by the IBC. Through enabling the sharing of vital financial data amongst parties involved, IUs accelerate the resolution process and reduce the chances of disagreements. The existence of IUs is advantageous for all stakeholders, such as creditors and debtors, as they promote well-informed choices and improve the chances of a favorable outcome. As the insolvency environment progresses, IUs will become even more essential in guaranteeing the efficient operation of the IBC framework.

So far there is only one IU platform available in India, the National E-Governance Services Limited (NeSL). A need is also envisaged for multiple IUs in the backdrop of the considerable size of stressed assets in India, and the significant increase in the number of cases reported under the Code by the lenders in the recent past. As the Code evolves and encourages smooth adoption of the process, there could be increased reliance on the IU platforms.

ROLE OF INDIAN BANKS' ASSOCIATION (IBA) IN STRENGTHENING THE IBC FRAMEWORK

The IBA plays a significant role in fortifying the insolvency resolution framework under the Code, leveraging its expertise, influence, and collaborative efforts to enhance the insolvency regime's effectiveness, efficiency, and resilience. As a pivotal industry body representing the banking sector, the IBA contributes to developing, implementing, and refining policies, practices, and mechanisms aimed at streamlining insolvency processes, protecting creditor interests, and fostering a conducive environment for economic revival. IBA played a multifaceted role in strengthening the IBC framework:

Policy advocacy and industry engagement

The IBA engages in policy advocacy, representing the collective interests of banks and financial institutions in shaping regulatory frameworks, legislative reforms, and industry best practices related to insolvency resolution. By collaborating with regulatory authorities, government agencies, and industry stakeholders, the IBA advocates for practical solutions, regulatory enhancements, and policy interventions that promote creditor rights, streamline insolvency procedures and enhance the operational efficiency of the IBC framework. The Standing Committee on Stressed Assets Management at IBA deliberates the emerging issues in implementation of IBC in detail and provides a collective suggestion to the regulator. Most of the suggestions made by IBA have been duly acknowledged and accepted while considering policy amendments.

Capacity building and training initiatives

The IBA with the collaboration of IBBI and SBI, undertakes capacity-building initiatives, training programs, and knowledge-sharing sessions to equip banking professionals with the requisite skills, knowledge, and expertise to navigate insolvency proceedings effectively. By conducting workshops, seminars, the IBA facilitates to enhance the competencies of officials handling IBC matters, empowers them to engage proactively in insolvency cases, and fosters a culture of compliance and professionalism within the banking sector.

Information sharing and best practice dissemination

The IBA facilitates the exchange of information, insights, and best practices among member banks, fostering a collaborative environment for sharing experiences, lessons learned, and success stories in insolvency resolution. By disseminating knowledge, and promoting industry standards, the IBA enables banks to adopt best practices, mitigate risks, and optimize outcomes in insolvency cases, thereby enhancing the overall efficiency and effectiveness of the insolvency resolution process.

Technology adoption and digital transformation

The IBA joins the collaborative initiatives with NeSL, and drives technological innovation, digital transformation, and automation initiatives within the banking sector to streamline insolvency processes and improve operational efficiencies in handling insolvency cases. By promoting the adoption of digital platforms, the IBA facilitates banks to leverage technology to smoothen the IBC procedural aspects.

In summary, the IBA plays a pivotal role in fortifying the IBC framework in India by advocating for creditor interests, enhancing industry capabilities, fostering collaboration among stakeholders, and facilitating technological advancements in insolvency resolution practices. Through its proactive engagement, knowledge-sharing initiatives, and advocacy efforts, the IBA contributes to the resilience, efficiency, and integrity of the insolvency ecosystem, ultimately aiming to protect creditor rights, optimize recovery outcomes, and promote a robust insolvency regime that fosters economic revival and financial stability within the Indian banking sector.

CONCLUSION

IBC has been a crucial reform that has brought very important changes in the insolvency landscape in the country. It is evolving in the right direction and surely over time, will result in substantial improvement in economic efficiency and economic growth by enhancing the willingness and ability of creditors to lend. The successful implementation of the IBC process in India hinges on the active participation and collaboration of various stakeholders, each fulfilling their unique roles and responsibilities to achieve the primary objective of maximizing value for all parties involved in insolvency resolution. By understanding and fulfilling their roles effectively, stakeholders can contribute to a more efficient and transparent insolvency resolution framework in the country.

Source: Reflections from various articles / publications and a collective perspective.

02

STREAMLINING INDIA'S CIRP FOR A WIN-WIN OUTCOME

Atul Kumar Goel

The Indian economy, like any other, witnesses its fair share of corporate struggles. Sometimes, these struggles can lead to financial distress, making it difficult for companies to repay their debts. In such scenarios, the Insolvency and Bankruptcy Code, 2016 (IBC/Code) offers a framework for a fair and efficient resolution process known as the corporate insolvency resolution process (CIRP).

The IBC, introduced in 2016, has transformed how companies in India deal with insolvency. It provides a mechanism for the insolvency resolution of debtors in a time bound manner to enable maximisation of the value of their assets, with a view to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders and to improve the credit culture and business environment in the country.

The Preamble to the Code specifically states that the Code has been enacted to maximise value in the interests of all the stakeholders, and not for some stakeholders at the expense of the others. Thus, the insolvency regime is designed to reduce the possibility of allowing some stakeholders to benefit at the expense of the others.

IMPACT OF IBC

The Code empower the creditors to examine and inspect the viability of the resolution plans before making decisions during CIRP. Further, the delays in disputes are addressed by formulating a time-bound mechanism for resolutions which further helps in promoting entrepreneurship and availability of credit in the market. The quintessence of the IBC is to balance out the interests of all stakeholders and revive the corporate as a going concern by way of timely resolutions.

IBC has significantly changed the resolution landscape in India. Due to the Code, the resolution process of stressed assets of banks has strengthened and banks now have improved asset quality in decades with stronger balance sheets.

Impact of the Code can be categorized in three broad areas which are as under:

Impact of Code on debtor-creditor relationship

The Code has led to behavioural change in the debtor-creditor relationship. Earlier the relationship was debtor oriented. But fear of losing control of the firm on initiation of CIRP, is nudging debtors to settle their dues with the creditors as soon as possible and this relationship is now moving towards a creditor-oriented relationship.

In cases of loan default, out-of-court deals are becoming the preference among creditors and debtors as parties look for ways to avoid initiation of the IBC process. This is attributed to the behavioural change effectuated by the Code. Fear of losing control of their company is being developed among the debtors and pushing them towards financial discipline.

The 'threat of insolvency' ignited by the Code has strengthened the negotiating powers of the creditors, in the absence of which it is most likely that those defaults would have lingered for much longer, resulting in value destruction.

Impact of the Code on resolution of accounts

The IBC has remarkably altered how distressed and defaulting businesses are handled by their stakeholders. The Preamble to the Code emphasizes its purpose as timely corporate reorganization and insolvency resolution, with the goal of maximizing asset value. Unlike traditional recovery-oriented tools, IBC adopts a resolution-oriented approach i.e., it allows a firm to continue as a going concern, despite the default. It has to be stated here that the IBC should not be seen as merely a loan recovery instrument, it has to be seen as an instrument which facilitates preservation of economic value of assets through effective resolution or unlocking of capital which is stuck in unviable businesses. By focusing on the revival and continuity of financially distressed entities, the IBC seeks to preserve jobs, protect investments, and maintain the operational viability of such businesses.

Impact of the Code on realization of value to the financial creditors

Generally, outcomes of IBC are evaluated on the basis of recovery to the creditors as a result of resolution process. Since inception till the end of FY 2024, 947 resolution plans have been approved. These resolution plans resulted in realization of 32% as against the admitted claims and 162% as against the liquidation value. It needs to be emphasized here that significant value destruction would have already happened in these assets prior to their admission under the IBC and admitted claims includes penal charges for irregularity of account, cost incurred during recovery efforts. Due to the above factors, comparison of realized value with admitted claims may not be a reasonable indicator of the effectiveness of the resolution process. Rather, the resolution value may be compared with the liquidation value of stressed assets or the fair value at the time of admission into IBC. When evaluated from the prism of these two parameters, overall realization since inception of IBC, under approved resolution plans (for industry) is as under:

No. of approved resolution plans	Admitted claims	Liquidation value of corporate debtor	Fair value of corporate debtor	Realisation value to creditors	Realized value as % to admitted claims	Realized value as % to liquidation value
(₹ in Lakh Crore)					Percentage	
(A)	(B)	(C)	(D)	(E)	(F=E/B%)	(G=E/C%)
947	10.46	2.08	3.20	3.36	32.10%	161.76%

Source: IBBI Newsletter March-2024 Quarter

a) Till March 31, 2024, the creditors have realized ₹ 3.36 lakh crore in 947 approved resolution plans.

b) The fair value and liquidation value of the assets available with these corporate debtors (CDs), when they entered the CIRP was estimated at ₹ 3.20 lakh crore and ₹ 2.08 lakh crore, respectively, as against the total admitted claims of the creditors worth ₹ 10.46 lakh crore.

c) The creditors have realized 161.76% of the liquidation value and 84.98% of the fair value (based on 850 cases where fair value was estimated).

d) The haircut for creditors relative to the fair value of assets was around 15%, while relative to their admitted claims is around 68%. Furthermore, this realization does not include the CIRP cost, and many probable future realizations such as equity, realization from corporate and personal guarantees, and from avoidance applications.

As per a study conducted by IIM Ahmedabad, average sales of resolved CDs have shown an increase of 76% in three years since resolution. The resolved firms were operationally able to break even in the post-resolution period (operating margin of 4% as of 3rd year of post-IBC period), which is a significant improvement from the pre-resolution period. The average employee expenses in the three years' post-resolution increased by around 50 per cent indicating a higher employment intensity in the resolved firms in the post-resolution period. A significant increase of around 50% in the value of average total assets of resolved firms post resolution was also seen along with 130% increase in the CAPEX, which indicates a build-up of tangible assets in the balance sheet of these firms in the post-resolution period. The trends in the market capitalization of listed resolved firms indicate a significant revival in the average market valuations in the post-resolution period, which is expected given the growth opportunities that will accrue to these firms post the resolution with the creditors. The trends also indicate a significant increase in the liquidity of the resolved firms in the post-resolution period. For instance, the current assets to current liability has improved from 1.01 in the year of bankruptcy to 1.83 in the third year post-resolution.

Thus, it is evident that the IBC has certainly played an inevitable role in improving the health of the corporates in India and has led to an increased optimism in the overall business environment.

SUGGESTIONS TO FURTHER STREAMLINE THE CIRP

CIRP is a mechanism established by the IBC to deal with financial distress in companies. It provides a structured, time-bound approach for reviving a struggling company or recovering dues owed to creditors. If a company is facing mounting debts and struggling to stay afloat, CIRP can be a lifeline. It offers a chance to restructure the company's finances, find new investors, or even sell it as a going concern, potentially saving jobs and preserving value.

However, the CIRP mechanism faces several challenges. First, adherence to strict timelines often falters due to litigation, appeals, and the burden on National Company Law Tribunal (NCLT). Second, the absence of a pre-packaged insolvency resolution framework (PPIRP) for genuine non-MSME CDs delays viable business resolution. Third, the lack of a robust secondary market for stressed assets hinders efficient resolution. Fourth, group insolvency lacks clarity for interlinked companies. Lastly, cross-border insolvency mechanisms need improvement.

To address these challenges, we have suggested a few measures taking cues from global and bank's own experience that will further enhance the effectiveness of CIRP and promote a healthier business environment.

Below are the suggestions and measures based on bank's own experience that may be useful in enhancing the working of IBC.

To resolve issues related to admission of applications under IBC

Firstly, cases took time from couple of months to years for admission under IBC. This delays the resolution process. This is due to limited number of NCLT benches and National Company Law Appellate Tribunal (NCLAT) benches and they are burdened with too many cases. To resolve this issue, number of NCLT and NCLAT benches are required to be increased with adequate resources. Separate benches for IBC cases may be created.

Further, for admission of accounts under IBC, only two requirements should be made mandatory i.e. (i) Compliance of the Limitation Act, 1963 and (ii) National E-Governance Services Limited (NeSL) default certificate. If these two things are in order account should be admitted immediately.

It is also seen that CDs willingly delay the admission under IBC. IBC can also frame suitable provisions for avoiding instances where CD use the opportunity for delaying the admission. If any opportunity is given to CD, it should be only once and reason for rejection of application to be incorporated in the order. Further, reasons for rejections can be predefined in the IBC.

Delay in admission of cases also takes place if the default is not registered with the NeSL. In such cases, Credit Information Companies (CICs) reports can be utilized and it is a well established banking practice that will provide additional tool apart from NeSL default certificate.

Streamlining the resolution process

For further smoothening of the resolution process, few measures are suggested:

a) A utility can be provided for uploading of supporting documents for a case at Insolvency and Bankruptcy Board of India (IBBI) portal by all stakeholders that can expedite the claim verification process.

b) As per the model timelines for CIRP, committee of creditors (CoC) can change the Interim Resolution Professional (IRP) in 1st meeting of CoC (T+30 days). After CoC decision to change the IRP, NCLT approval is also required. Due to the requirement of NCLT approval, the resolution process slows down. Thus, it is suggested that the requirement of NCLT approval for change of IRP/ Resolution Professional (RP) should be dispensed with and instead change of IRP can be informed to NCLT as it will help in expediting the CIRP.

c) During the CIRP, it has been observed that interim applications (IAs) filed by stakeholders remained unresolved/sub-judice for long, which resultantly delays the timely resolution of account and defeats the purpose of IBC. As such, it is suggested that on IA filed during the CIRP, no stay should be granted without allowing the CoC to represent their side. Further, all the applications of similar nature can be merged and once an issue is settled, stakeholders shall not entertain any other application on the similar issue.

As a result, speedy disposal of IAs filed by various stakeholders will streamline the CIRP.

d) Most of the NCLT admitted cases are 4-5 years older non-performing assets (NPAs). In such cases, there are no significant transactions during the existing look back period. As such CoC should be given liberty to decide the look back period for each case based on the requirement and based on the time when the stress of the company started. However, the Code may fix an outer limit say 8 years for look back period. Further CoC should be given liberty to file application for all sort of avoidance transactions, where RP doesn't take such decision or CoC is not satisfied with such decision.

e) For timely conviction and punishment of fraudsters, trial of preferential, undervalued, fraudulent and extortionate (PUFE) applications may be started in a Special Court that will help to recover the funds diverted and siphoned off, from the defaulting and fraudulent directors / promoters and key managerial personnel.

f) The current distribution mechanism has ambiguity on the distribution of proceeds of resolution plan / liquidation and raise disputes among financial creditors (FCs). Industry wide different practices are being followed as regards to distribution of proceeds among assenting / dissenting and secured / unsecured FCs. The same is resulting into disputes among stakeholders. The Code can clearly specify the distribution mechanism amongst the secured/ unsecured and first charge holders/ second /subservient charge holders etc. to avoid conflicts in distribution mechanism.

g) It is seen that in most of the cases, the promoters submit the application for section 12A at the later stage of CIRP when they have already seen the value quoted under the resolution plan. Promoters should not be allowed to submit the application under section 12A after receipt of resolution plans. This practice is harmful for the smooth running of CIRP as after approval of resolution plan by CoC such applications are usually moved by promoters to delay the process. In case promoters are allowed to submit proposal for settlement of debts under section 12A of IBC, a minimum of 25% of the agreed amount should be required to be paid upfront.

h) CIRP cannot be treated over till the resolution plan approved is implemented in true letter and spirit. Monitoring committee comprising of IRP/RP, representative of FCs and successful resolution applicant must submit periodical reports and final report about the implementation of resolution plan to the Adjudicating Authority (AA)/ IBBI and upon their approval only, the CIRP is to be taken as completed. This will further streamline the implementation process.

i) Reserve price in auction of assets of liquidation estate to be fixed as per decision of Stakeholders' Consultation Committee. Further for sale of CD as going concern, Swiss Challenge method should be used along with auction process for value maximization. This will ensure value maximization and price discovery through transparent manner.

j) It is mandated that the liquidator has to update complete information about the auction process at the web portal of IBBI. In case there is failure of auction, fresh auction should be conducted not later than 30 days. Outcome of all auctions should be updated at the IBBI portal as it will improve the overall liquidation process.

Other suggestions

a) Judicial infrastructure, processes like e-filing of applications, rejoinders, affidavits etc. can be automated. The intervention of technological initiatives and case management tools in the process will significantly lead to the reduction of time involved in the administrative task.

b) The Government of India has set up an e-platform namely India Investment Grid (IIG) that showcases investment opportunities in stressed assets to allow purchase of viable stressed assets with a potential to turnaround. The portal is a one-stop solution bringing investors and the projects at one place for ease of acquisition and investment and presents a market for stressed assets in the country. RP can register the account under CIRP with IIG platform to maximize the value of stressed asset.

c) The IBC ecosystem needs to harness the use of information technology (IT) to drive the processes in a more efficient and effective manner. There is need for a comprehensive IT platform that can ensure end-to-end integration and digitization of the processes and serve as a single source of truth. An integrated platform would improve the outcomes of the insolvency process including minimizing delays, increased transparency, increased participation of resolution applicants, facilitation in effective decision making, maximization of value etc. Further IBBI should provide a strong IT infrastructure having online forms & claims submission, platform for showcasing of accounts under CIRP. Bringing more momentum to platform for distressed assets will allow price discovery and also enable increased investments in stressed assets.

d) A dedicated framework for dealing with insolvency of Financial Service Providers and other specialized sectors such as real estate, telecom and power sector, steel & road sector can be framed under IBC.

e) IRP/RP should inform all FCs through electronic means about admission of account in NCLT, at least to all FCs whose charges are filed with Ministry of Corporate Affairs (MCA) or in the books of CD.

f) Legislative provisions for enabling cross-border insolvency, group insolvency and to further streamline the voluntary liquidation process to facilitate ease of exit are required to be inculcated.

g) Amendments enabling PPIRP is also yet to completely take off. Expansion of applicability of PPIRP will help in resolution of genuine cases of distressed CDs. Accordingly, the PPIRP is required to be made applicable to all CDs. A robust PPIRP framework will allow faster resolution, reduce case load of the overburdened NCLTs and allow eligible promoters to submit resolution plans and at the same time retain control of the companies.

While the CIRP has brought much needed structure to corporate insolvency in India, there's room for improvement. Delays and complexities can hinder both company revival and creditor recoveries. Streamlining timelines, like Singapore's approach, can expedite the process. Lessons from the UK, like pre-insolvency rescue options, could offer struggling companies a fighting chance before formal CIRP. Furthermore, by fostering a pool of skilled insolvency professionals, similar to Singapore's model, India can ensure efficient case management. These improvements can create a win-win situation for companies with a chance at revival, creditors who receive faster dues, and a healthier overall business environment.

03

TAXATION AND INSOLVENCY: TOWARDS A FOUNDATIONAL UNDERSTANDING

M P Ram Mohan and Sai Muralidhar K

ABSTRACT

Taxation and insolvency laws, as critical economic legislations, play a key role in regulating economic activities. This article aims to chart a path toward understanding the source of the divergences between these two fields at a foundational level by examining their theoretical roots. The theoretical foundations of tax law that have formed the current principles of taxation have been examined against the backdrop of the creditor's bargain and communitarian theories of insolvency. In India, the right of the State to tax corporations and individuals is espoused by the Constitution of India. This right is examined against the broader objectives of India's Insolvency and Bankruptcy Code, 2016 (IBC/Code). In the last few years, there have been several cases in India, specifically on tax disputes during the insolvency resolution process. Examining the theoretical interplay between tax and insolvency enables us to see how insolvency and taxation laws could synergise and create positive outcomes for stakeholders.

Keywords: Insolvency and Tax, Communitarian Theory, Creditors Bargain Theory

INTRODUCTION

Taxation laws and the Insolvency Code are among the few significant economic legislations whose functioning impinges on a myriad of sectors such as employment, creation and sustaining of enterprises, financial stability, economic growth, etc.

Any insolvency or bankruptcy proceeding involves an attempt to satisfy competing interests and claims with a limited pool of assets. Given the competing interests over limited resources of the insolvent company between a host of other creditors, including taxation authorities, tension exists among various stakeholders in this issue.[1] The government's dual role in raising revenue and aiding financially distressed companies and the underlying competition between these interests is at the forefront of this study. The issue of the treatment of taxation in insolvency merits a more fundamental enquiry into the very nature of these subjects to analyse theoretical inconsistencies and divergences. Understanding the interplay between tax and insolvency laws would be incomplete without understanding their fundamental objectives, goals, and theoretical evolution. Further, any attempt to harmonise their interplay to benefit all the stakeholders, i.e., creditors, tax authorities, society, and the distressed company, would be unsustainable and transient unless the source of this divergence is more deeply examined.

This article looks beyond the statutory conflicts and aims to create a theoretical framework for a corporate insolvency tax system, meeting the broad objectives of both these critical legal fields. Most of the scholarly work in India covers judicial interpretation between specific provisions of the IBC and taxation statutes.[2] The authors take assistance from the work of Dr. Sylvia Villios, which explored the theoretical foundations for corporate insolvency taxation by examining the theoretical perspectives of Australian insolvency and taxation law. [3]

The article is structured as follows: Firstly, the authors discuss the theoretical foundations of tax law and its operation within a contractarian model of insolvency. This is done by analysing the development of taxation and examining its historical justifications and internationally recognised taxation principles. It is followed by examining the operation of the theoretical underpinnings of taxation in the context of a communitarian model of insolvency. The next section analyses the theoretical perspectives of insolvency and taxation in India from the lens of the Indian Constitution to understand better the source of the conflict and friction that exists today. The authors conclude the study with some suggestions on how to move forward to better understand the divergences in the operation of tax in insolvency proceedings.

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TAXATION AND INSOLVENCY: JUSTIFICATION AND GOALS

A tax, simply put, is a compulsory levy imposed by the legislature, payable to the government, intended for a public purpose.[4] Taxation, which defines the state's and citizens' duties in collecting revenue, forms a part of public law.[5] The law of taxation reflects the relationship between the market, the state, and the citizens.[6] Taxation as a concept has existed across different social and political orders since early; it has evolved through feudal, absolutist times and the parliamentary and administrative state.[7]

Taxation in the modern administrative state saw a shift from merely ensuring the security of property to focusing on wealth redistribution and regulation and the creation of enterprises.[8] Collecting taxes is no longer only for defending the state and property rights but also to prioritise fairness, promote social and welfare policies, build infrastructure, and thus enhance the broader economy.[9] Taxes in the administrative state are supported by legal compulsion and legislative competence and operate as a broad public law.[10] Today, it operates through several principles, some discussed below.

Principles of Taxation

The modern taxation system as it exists today is deeply influenced by the canons of taxation laid down by Adam Smith in the celebrated book *An Inquiry into the Nature & Causes of the Wealth of Nations,* in which he conveys:[11]

a) The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.

b) The tax each individual is bound to pay should be certain and not arbitrary. The time of payment, the manner of payment, and the quantity to be paid should all be clear and plain to the contributor and every other person.

c) Every tax ought to be levied at the time or in the manner most likely convenient for the contributor to pay it.

d) Every tax ought to be contrived, both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the state's public treasury.

While Smith's ideas of taxation significantly influenced tax policy and design the world over, an effective administrative state requires control over property rights and their intersection with taxation.[12] Here, Hobbes philosophical backing lays the foundations for the state's dominance over the individual in matters of tax and property rights.[13] Hobbes' theory of taxation postulated that the tax levy is made on man's estate and rightfully justified by the

[6] Allison Christians, *Sovereignty, Taxation and Social Contract* [2009] Minnesota Journal of International Law, https://scholarship.law.umn.edu/mjil/245.
[7] Snape, *supra note* 4.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] Adam Smith, An Inquiry into the Nature & Causes of the Wealth of Nations (Facsimile of 1904 ed edition, University of Chicago Press 1977).
[12] Snape, *supra note* 4.
[13] *Id.*

sovereign as the price for security and the price for certain benefits.[14] Further, he believed in the equal imposition of taxes on all persons.[15] In Hobbes's view, benefits extend beyond security and involvement and are to be assessed based on consumption.[16] Hobbes, therefore, believes that a law of taxation is a combination of prudential and moral rules.[17]

Another key contributor to the principles that govern taxation is classical economist Charles F Bastable, who laid down the Cannons of Taxation, which states that taxation should be productive, economical, justly distributed, an elastic system, certain, and convenient. Bastable believed that the productivity of taxation is to be measured by the amount of revenue collected by the imposition of a tax.[18] He linked the productivity of taxation to the economic nature of tax by arguing that tax collection should be inexpensive and not hurt economic growth.[19] Further, he argued that the elasticity of a tax system was the agency through which the dual goals of productivity and economy could be achieved.[20]

These principles have broadly shaped most tax systems across the world. These are also reflected in the policies adopted by the Organisation for Economic Cooperation and Development (OECD). The OECD identifies the following principles as critical considerations for a country's tax policy and design[21] -

a) **Neutrality** - This principle postulates that taxation systems must apply equally to all forms of business enterprises.

b) **Efficiency** - The efficiency of a taxation system is determined first by the cost of compliance by taxpayers and second by the cost of administration and implementation by the state.

c) **Certainty and Simplicity** – Taxation systems are to be simple and easy to understand.

d) **Effectiveness and Fairness** – Tax systems must be designed to collect the right amount of revenue at the right time while minimising avoidance and evasion.

e) **Flexibility** – Tax systems must be flexible and able to adapt to changing societal, economic, and technological conditions.

f) **Equity** – Equity in taxation involves vertical and horizontal equity. Horizontal equity requires persons who are similarly placed to be similarly taxed. Vertical equity requires more affluent persons to bear a more significant tax burden.[22]

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[14] *Id.*

[15] *Id.*

[16] Dudley Jackson, Thomas Hobbes' Theory of Taxation (1973) 21 Political Studies 175.

[17] *Id.*

[18] Charles Bastable, Public Finance(2nd ed, Macmillan, and Co 1895), https://books.googleusercontent.com/books/content?req=AKW5Qaf5oTtqLC5UQ7HuZDDf5Y_FvwQPwjoHW2i073eZg4PdFLym_QnD7MwMbpbiT31oBsU6Th2rTzRDFb6EDtw8ESm3syPon7GT0xJ3UebBeqiNbzfaoYgvwbprAubyMeI4-iTCniIbN5sWAxLeT5HW-zEUTBqxCL-Td2Uda46B0gBUWCZPyDfeXCOJDTdbv3BQ0-4jysfbQ944-iG_cLXJXJirvaCbbN_JTXRIzyiruA1uz6FlKiaS5LP7Zx2on2BH6Jz5yyj5, (Feb. 12, 2024).

[19] *Id.*

[20] *Id.*

[21] OECD, *Fundamental Principles of Taxation* (OECD 2014), https://www.oecd-ilibrary.org/taxation/addressing-the-tax-challenges-of-the-digital-economy/fundamental-principles-of-taxation_9789264218789-5-en, (Feb. 5, 2024).

[22] David Elkins, *Horizontal Equity as a Principle of Tax Theory* (2006) 24 Yale Law & Policy Review 43; See also Peter J Lambert, *Income Taxation and Equity* (2003) 4 Baltic Journal of Economics 5.

It is important to note that these principles do not operate independently but in a taxation system in consonance with other principles, including the socio-economic policies of the state. For instance, a neutral tax system ensures optimal allocation of resources and thereby aids in improving the efficiency of the state's operation.[23] Similarly, complex taxation systems lead to increased tax planning and strategies that cause greater costs of compliance, extended legal disputes, and hurt the tax system's efficiency.[24]

Modern taxation systems play a vital role in the administrative state. Today, taxes pay for a host of public services and are crucial for funding social programs and development projects.[25] The efficiency of taxation systems is also a determiner of business investment and growth. Tax administration profoundly influences companies' willingness to invest in the nation.[26]

Taxation systems in various countries often reflect the level of priority given to each of the above-discussed factors. The evolution of these principles of taxation, both globally and in the context of India, is key to understanding the underlying friction with the theoretical framework of insolvency laws.

Goals of Insolvency Law

The development of corporate insolvency laws can be traced to several practical problems that emerged as a consequence of the failure of businesses. The failure of a business enterprise in the absence of an insolvency law would be a free-for-all among all the creditors of the business to try and recover as much of their debt as possible within the limited asset pool of the debtor.[27] This would lead to inefficient and unfair outcomes for several creditors, particularly those late to enforce their rights.[28] The core objective of insolvency law is efficient reorganisation, enabling creditors to recover their dues through an orderly debt recovery and collection exercise.[29]

A consensus exists that the goals of modern insolvency law have come through the Report of the Review Committee on Insolvency Law and Practice 1982,[30] chaired by Sir Kenneth Cork.[31] The Cork Committee Report has influenced modern insolvency systems, including the IBC, which adopted a rehabilitative approach to distressed entities.[32] Finch, citing Cork Report, summarises the objectives of a modern insolvency system as follows:[33]

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[23] OECD, *supra note* 21.

[24] *Id.*

[25] 'Why It Matters in Paying Taxes - Doing Business - World Bank Group' <https://subnational.doingbusiness.org/en/data/exploretopics/paying-taxes/why-matters#2> accessed 28 May 2024.

[26] Enterprise Surveys Indicators Data - World Bank Group, https://www.enterprisesurveys.org/en/enterprisesurveys,(May 28, 2024).

[27] Vanessa Finch and David Milman, Corporate Insolvency Law: Perspectives and Principles (3rd edition, Cambridge University Press 2017).

[28] *Id.*

[29] The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design (Bankruptcy Law Reforms Committee 2015), https://ibbi.gov.in/BLRCReportVol1_04112015.pdf,(Dec. 11, 2023).

[30] Department of Trade: Insolvency Law Review Committee: Reports and Papers (1976) files and papers.

[31] Vanessa Finch, *The Measures of Insolvency Law* (1997) 17 Oxford Journal of Legal Studies 227.

[32] Insolvency & Bankruptcy Board of India, *IBC: Idea, Impressions and Implementation* (2022),https://ibbi.gov.in/uploads/whatsnew/b5fba368fbd5c5817333f95fbb0d48bb.pdf, (June 12, 2024).

[33] Finch, *supra note* 31.

1. Support the credit system.
2. To enable early insolvency assessment and resolve it immediately.
3. Prevent conflicts among creditors.
4. Realise value from debtors' assets with minimum delay and expense.
5. Fair distribution of realised proceeds among creditors.
6. Ensuring honest realisation and distribution proceedings.
7. Ascertain the cause of insolvency.
8. Safeguarding the interests of not just debtors and creditors but other members of society affected by such failure.
9. Preserving viable enterprises that can contribute to the nation's economy.

A combination of the various theoretical perspectives guides the goals of modern insolvency law. While several schools of thought exist on insolvency, two schools, the *traditionalist* and the *proceduralist*, have been adopted widely by scholars.

While several theories have evolved from the traditionalist and proceduralist schools of thought, two theories have gained traction. Firstly, the creditor bargain theory was propounded by Baird and Jackson, who rely on proceduralist principles and contractarianism.[34] Secondly, the Communitarian theory of insolvency has developed from traditionalist thinkers. Proceduralists believe in a streamlined bankruptcy system that aims to maximise creditors' recovery. Traditionalists believe that insolvency is a tool to rehabilitate the company and protect the interest of all stakeholders while securing creditor wealth maximisation goals.

While the traditionalists propose a more inclusive approach to resolving corporate insolvency that takes into consideration the interests of all stakeholders, Proceduralists contend that insolvency law should address issues that arise only within bankruptcy and non-insolvency creditors should not be protected by law unless doing so maximises value for creditors. We briefly discuss both these theories below to understand how they interact with the principles of taxation.

TAXATION IN A CONTRACTARIAN MODEL OF INSOLVENCY

To understand how the principles of taxation operate within a contractarian model of insolvency, we explore the creditors' bargain theory of insolvency, which is rooted in the nexus of contracts perspective adopted by proceduralists. Those who view insolvency from a proceduralist perspective have adopted the Creditor's Bargain Theory and the Contractarian Perspective. They view insolvency as a limited process driven by the market to create the optimal outcome for creditor wealth maximisation.

[34] "The contractarian theory posits that the relationship between the managers and shareholders of a public corporation is contractual."Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later* (2007) 31CorpL779 The Journal of Corporation Law, https://law.stanford.edu/wp-content/uploads/2015/06/31JCorpL779.pdf,(May 2, 2024).

Proceduralist Perspective of Insolvency

The proceduralist perspective of insolvency views the existence of a firm as a market-driven process, and bankruptcy should not be a tool for deciding whether firms are to live or die in a market.[35] Proceduralists, as the name suggests, are deeply invested in the manner in which bankruptcy is conducted and its effect on external players' behaviour and investment patterns.[36] Proceduralists also consider the adjudicating authority as a neutral party that considers the biases of creditors, investors, managers, etc., to resolve the dispute optimally.[37] They do not subscribe to traditionalists' redistribution goals of insolvency unless such redistribution is to enhance value for the creditors.[38] They also do not find any inherent value in ensuring that the distressed entity can continue operating as a going concern but focus on preserving the entity's value to allow market solutions to resolve the company's ultimate fate.[39] Professor Ted Janger summarised the determinative factors to differentiate traditionalists from proceduralists –

> According to Douglas Baird, three litmus test questions, or axioms, determine a scholar's affiliation. These questions are (1) whether the Bankruptcy Code should seek to rehabilitate firms; (2) whether bankruptcy judges should alter non-bankruptcy entitlements in order to rehabilitate firms; and (3) whether bankruptcy judges are capable of distinguishing likely candidates for reorganisation from firms that are destined to fail. The paradigmatic proceduralist answers "no" to each question, while the paradigmatic traditionalist answers "yes" to all three.[40]

Baird argues that the objective of insolvency should neither be liquidation nor reorganisation but should ensure that the firm's assets are used optimally.[41] In his view, bankruptcy should exist to ensure that the market decides when a firm fails and that the lack of funds to repay creditors should not determine the failure of a firm. Further, he contends that the bankruptcy law cannot be justified if used to prolong bad companies' lives. Proceduralists largely adopt a contractarian perspective of corporations in insolvency. The creditor's bargain theory adopted by proceduralists is rooted in contractarianism.[42]

Contractarianism in Insolvency: The Creditors Bargain Theory

The creditor's bargain theory is rooted in the nexus of contract perspective,[43] which proceduralists adopt. The nexus of contracts perspective suggests that every corporate entity, at its core, is an amalgamation of bilateral contracts among shareholders, investors, lenders,

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[35] Douglas G Baird, *Bankruptcy's Uncontested Axioms* (1998) 108 The Yale Law Journal 573.Thomas H Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors Bargain* (1982) 91 The Yale Law Journal 857.
[36] Baird *supra note* 39, at 578.
[37] *Id.,* at 579.
[38] Charles W Mooney, *A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure* [2003] SSRN Electronic Journal, http://www.ssrn.com/abstract=425120, (Dec. 11, 2023).
[39] *Id.*
[40] Edward J Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design* [2001] SSRN Electronic Journal, http://www.ssrn.com/abstract=260598,(Feb. 16, 2024).
[41] Baird, *supra note* 39, at 582.
[42] Finch, *supra note* 31.
[43] Christopher F Symes, Statutory Priorities in Corporate Insolvency Law: An Analysis of Preferred Creditor Status (1st edition, Routledge 2016).

directors, managers, etc.[44] The creditor's bargain theory finds utility in a contractarian interpretation of corporations. Contractarianism emphasises shareholder wealth maximisation. Professor Ian Ramsay and Dr Robert Austin expounded on the shareholder primacy envisaged in contractarianism, who argue that a competitive market creates a greater incentive to maximise shareholder wealth than specific legal rules and regulations.[45]

The creditor's bargain theory, as envisaged by Jackson and Baird, acts as a debt collection mechanism in which the creditors of the enterprise agree beforehand on the *collective procedure* to enforce their claims.[46] This reflects a notional agreement that would have been formed had the creditors been given the chance to bargain with each other before granting credit to the debtor.[47] Jackson argues that the cost of transferring the debtor's property to the creditors would be kept to a minimum through an ex-ante pre-determined *collective procedure*.[48] Creditors bargain theory indirectly shows what real-world parties would agree to in such a hypothetical agreement if all parties acted rationally.[49] The ex-ante nature of the creditor's bargain supposes that the existence of such a bargain would lead to the creditors renouncing their independent claims and instead enforcing a single collective claim, thereby addressing the inefficiencies that arise with the 'first in time, first in priority' scheme of asset distribution.[50]

Professor Christopher Symes expounds on the contractarian roots of the creditor's bargain theory –

> However, the notion of shareholder primacy that underpins the contractarian perspective can be substituted in an insolvent corporation by the concept of creditor primacy - a requirement to act in the interests of creditors and to maximise their distribution from the estate.[51]

Symes argues that just as a contractarian view of a corporation exists with a notion of shareholder primacy, a contractarian view of an insolvent corporation would exist with a notion of creditor primacy, which is a crucial element of the IBC.

Criticisms of Creditors Bargain Theory

Nevertheless, the creditor's bargain theory has been criticised for several reasons, including its focus on pre-insolvency rights, lack of consideration of corporate rescue and other non-

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[44] Villios, *supra note* 3.

[45] Ian Ramsay and Robert Austin, Ford, Austin and Ramsay's Principles of Corporations Law, (17th edn, Lexis Nexis Butterworths 2018), https://store.lexisnexis.com.au/products/ford-austin-and-ramsays-principles-of-corporations-law-17th-edition-skuprinciples_of_corporations_law_17th_edition,(Feb. 16, 2024).

[46] Douglas Baird and Thomas Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy* (1984) 51 University of Chicago Law Review, https://chicagounbound.uchicago.edu/uclrev/vol51/iss1/5.

[47] Symes, *supra note* 43.

[48] Baird and Jackson (n 46).

[49] Thomas H Jackson and Robert E Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain* (1989) 75 Virginia Law Review 155.

[50] Ruzita Azmi, Adilah Abd Razak and Siti Nur Samawati Ahmad, *The Theories Underpinning Personal Insolvency Or Bankruptcy Law: A Legal Overview* (2018) Public Law Remedies In Government Procurement: Perspective From Malaysia European Proceedings of Social and Behavioural Sciences, https://www.europeanproceedings.com/article/10.15405/epsbs.2018.12.03.49,(Dec. 11, 2023).

[51] Symes, *supra note* 43.

economic values such as moral, political, social, and personal considerations, as detailed below.[52]

In Finch's view, one of the criticisms of the creditor's bargain theory is that creating a common pool of assets prior to insolvency would not be logical since repayments are ordinarily made on income, not from the asset sale.[53] Furthermore, it is contended that income generated arises not merely from the asset but from the entire structure and network of a particular distressed entity.[54] The creation of a pool of assets arises only from insolvency, and not prior to insolvency, she argues –

> It is, indeed, insolvency law itself that creates an estate or pool of assets and this undermines any assertion that insolvency processes should maximise the value of a pre-existing pool of assets and should not disturb pre-insolvency entitlements.[55]

Finch believes that any ex-ante bargain that takes place would reflect the disparities in the creditors' skill, leverage, and wealth.[56] Such an ex-ante bargain would likely be oppressive to weaker creditors and lead to inefficient outcomes.[57]

The second major criticism of the creditor's bargain theory is its failure to consider the distributional consequences of such an ex-ante bargain. Since the creditor's bargain takes place ex-ante, consensual creditors would be the only category of creditors involved in this bargain who have provided credit through a formal contractual arrangement. This disregards several non-consensual creditors, such as employees, income tax claims, tortious claims, etc, which would not arise at the time of extension of credit by contract creditors. The distributional consequences of the creditor's bargain theory disregard the community interests, which may, in turn, have negative consequences on the economy. According to Korobkin, the creditor's bargain model does not factor in creditors who would exist outside of formal contractual agreements and lack pre-insolvency rights due to being non-consensual creditors. This leads to unfair outcomes, given that those creditors with formal pre-insolvency rights do not bear all the costs of business failure.[58] Korobkin instead posits a "principle of inclusion" –

> Let us call this the "principle of inclusion." The principle of inclusion, it should be emphasised, does not speak at all to which particular demands should ultimately be recognised and which should be denied. It provides only that no persons should be disqualified from pursuing their aims merely by virtue of the position that they occupy.[59]

The creditor's bargain theory is also criticised for its inability to consider corporate rescue in conditions where the economic value of the corporate entity does not exceed the immediate

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[52] Villios. *supra note* 3.
[53] Finch and Milman, *supra note* 27.
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] Villios, *supra note* 3.
[58] Donald R Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law* (1992) 71 Texas Law Review 541.
[59] *Id.*

value that could be obtained by liquidating the company assets.[60] Professor Korobkin argues that corporations are moral, political and social agents and not merely economic agents.[61] He, therefore, says that insolvency by acting in a rehabilitative manner would be able to account for political, moral, and social considerations that the corporation's failure would cause.[62] These criticisms of the creditor's bargain theory led to its evolution and modification.

The modification of the creditor's bargain theory by Scott and Jackson in 1989 addressed some of the concerns that had arisen. They incorporate into the bargain a risk-sharing theory where "Secured creditors would agree that whenever insolvency is triggered by common risks (interrelated technological events with unpredictable effects), they would share with unsecured creditors and equity some of the asset pool otherwise reserved to them. Such an arrangement would provide a method of diversification for those risks that cannot be successfully reduced by individualised risk bearing."[63] Jackson developed the risk-sharing theory as a response to criticism that the creditor's bargain theory does not account for the distributional consequences of bankruptcy. The risk-sharing theory broadly identifies two risks: common economic industry-wide risks and company-specific risks.[64]

Taxation in Creditors Bargain Theory

Having examined the scope and evolution of the creditor's bargain theory, we examine how principles of taxation operate within this theory. The creditor's bargain theory does not provide any standing for statutory dues, including taxation dues that a company owes to tax authorities.[65] The hypothetical bargain conducted by the ex-ante would not include non-consensual creditors who do not have formal rights.[66] The tax authorities, being non-consensual creditors, would not be a part of the ex-antehypothetical bargain in the creditor's bargain theory and, as a result, would not be eligible to recover any money. Jackson argues that taxation losses as a consequence of firms entering insolvency have to be accounted for while setting the rates of taxation –

> Finally, the state is itself likely to be a claimant (oftentimes, as in its taxing capacity, a non-consensual one), in which case the level of priority it provides is a part of the cost calculus it has decided on in setting its rates (whether tax rates or otherwise).[67]

The argument that inconsistencies in revenue collection due to firms entering insolvency are to be resolved by adjustments in tax rates leads to a conflict between the distributional goals of the creditor's bargain theory and the ability of the taxation systems to ensure fiscal adequacy and avoid complex tax systems, which are fundamental principles of effective tax systems.

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[60] Villios, *supra note* 3.
[61] *Donald R Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy* (1991) 91 Columbia Law Review 717.
[62] *Id.*
[63] Jackson and Scott, *supra note* 49.
[64] Medha Shekar and Anuradha Guru, *Theoretical Framework of Insolvency Law.*
[65] Villios, *supra note* 3.
[66] *Id.*
[67] Jackson, *supra note* 35.

The *collective procedure* undertaken by creditors in recovering debt under the creditor's bargain theory is linked to the *pari passu* principle,[68] which prescribes that creditors be awarded an equal stake in the distribution of assets during insolvency.[69] The *pari passu* principle within the creditor bargain model considers equality only among the secured creditors with formal pre-insolvency rights.[70] Equity prescribed in taxation would be defeated by such an application of equity in insolvency as it would effectively mean that the tax burden is not equally distributed among all taxpayers.[71] The *paripasu* principle effectively shifts the tax burden onto society without accounting for the cost of the distribution of assets.[72] Herein arises another source of friction between the creditor's bargain model of insolvency and equitable taxation principles. It has also been theorised that a particular value shift under the creditors' bargain theory imposes costs on middle-class taxpayers and distributes benefits to higher-income taxpayers.[73] Therefore, there exists a theoretical tension between the basis of the creditor bargain theory and modern principles of taxation, with the creditor's bargain model not providing any leeway for the functioning of tax during insolvency. This would inevitably lead to conflicts that would show up during insolvency proceedings.

TAXATION IN COMMUNITARIAN THEORY OF INSOLVENCY

Having examined how the principles of taxation operate within the contractarian perspective of insolvency law based on proceduralism (creditor bargain theory), this section explore show these principles operate within a communitarian perspective of insolvency based on a traditionalist perspective.

The traditionalist perspective sees the role of insolvency as one that enables the rehabilitation of distressed firms.[74] They contend that in the absence of insolvency laws, the distressed firms would likely fail and would cause job losses and economic damage to the community at large.[75] This school of thought maintains that insolvency rules and their design would not affect creditors' behaviour and willingness to enter into arrangements with various business enterprises.[76] They view the insolvency resolution process in its entirety as a self-contained process. Insolvency law, accordingly, must give adjudicating authorities broad and flexible powers, as insolvency law cannot be designed to be applied commonly to different types of communities. From the traditionalist's viewpoint, the underlying objective of insolvency is to enable financially distressed entities to avoid being liquidated and maintain the entity's value as a going concern.[77]

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[68] The Pari Passu principle postulates that creditors appropriate an equal portion rate of the assets of the insolvent. See Andrew Keay, *Insolvency Law: A Matter of Public Interest?* (2000) 51 Northern Ireland Legal Quarterly 509.

[69] Villios, *supra note* 3.

[70] *Id.*

[71] *Id.*

[72] *Id.*

[73] Frances R Hill and Frances A Hill, *Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach* (1996) 50 The Tax Lawyer 103.

[74] Baird, *supra note* 35.

[75] *Id.*

[76] *Id.*

[77] Shekar and Guru, *supra note* 64.

Communitarian Theory

While the creditor's bargain theory follows a contractarian perspective that emphasises the private rights of creditors, the communitarian theory of insolvency views insolvency as public law and considers the interests of multiple stakeholders.[78] Communitarian theory propounds that corporations have a responsibility to multiple stakeholders, including but not limited to creditors, clients, employees, local communities, etc.[79] Finch describes the distributional goals envisaged in the communitarian vision as -

> It accordingly countenances the redistribution of values so that on insolvency high priority claimants may to some extent give way to others, including the community at large, in sharing the value of an insolvent.[80]

Professor Andrew Keay argues that public interest must be essential in insolvency law. Keay refrains from defining the exact scope of public interest but envisions it as:

> For the purposes of insolvency law, that the public interest involves taking into account interests which society has regard for and which are wider than the interests of those parties directly involved in any given insolvency situation, that is, the debtor and the creditors.[81]

Professor Donald Korobkin ascribes to the communitarian vision of insolvency through a value-based theory.[82] The value-based theory suggests that insolvency considers the distributional impacts on those who are not technically creditors or lack formal legal rights in the distressed entity.[83] It is multi-dimensional and looks at economic, social and political challenges that arise from insolvency.[84] Elizabeth Warren, another proponent of a multi-dimensional/multi-value, views insolvency as an elastic and interconnected subject.[85] The Value-based theory outlined by Finch states–

> Multiple values/eclectic approaches as exemplified by Warren and Korobkin see insolvency processes as attempting to achieve such ends as distributing the consequences of financial failure among a wide range of actors; establishing priorities between creditors; protecting the interests of future claimants; offering opportunities for continuation, reorganisation, rehabilitation; providing time for adjustments; serving the interests of those who are not technically creditors but who have an interest in continuation of the business (for example, employees with scant prospect of re-employment, customers, suppliers, neighbouring property owners and state tax authorities); and protecting the investing public, jobs, the public and community interests.[86]

The communitarian perspective received support from the Cork Report in 1982, where the insolvency law was deemed to have three parties, i.e., the creditor, debtor, and society.[87] The

[78] Symes, *supra note* 43.
[79] *Id.*
[80] Finch, *supra note* 31.
[81] Keay, *supra note* 68.
[82] Korobkin, *supra note* 61; Korobkin, *supra note* 58.
[83] *Id.*
[84] Shekar and Guru, *supra note* 64.
[85] Elizabeth Warren, *Bankruptcy Policy* (1987) 54 The University of Chicago Law Review 775.
[86] Finch and Milman, *supra note* 27.
[87] Symes, *supra note* 43.

communitarian perspective also inspired the Indian Insolvency law. The Bankruptcy Law Reforms Committee (BLRC), while preparing the IBC, referred to two design principles, namely, that creditors who were not part of the process must have their interests represented. Secondly, the rights of all creditors must be respected equally.[88] The IBC follows a value-based theory espoused by Korobkin. It adopts a traditionalist approach that considers the interests of all stakeholders to try and ensure the entity retains value as a going concern.[89] The manner in which the principles of taxation operate in the communitarian theory is discussed below to understand the root of theoretical divergences.

Taxation in a communitarian theory of insolvency

Unlike the creditor's bargain theory, the communitarian theory of insolvency allows non-consensual creditors' interests to be considered during the insolvency resolution process.[90] The concern about protecting community interests would effectively require creditors and the company to bear some of the costs of failure, such as tortious claims, environmental damage, etc, instead of passing the burden onto the taxpayers.[91] Further, the communitarian perspective focuses on distributional outcomes and ensures that the costs are not externalised to those who lack formal pre-insolvency rights.[92] The reduction in the costs being externalised itself would benefit the level of tax revenue being collected. The focus on rehabilitation creates the opportunity for future tax revenue to arise from the restructured entity.[93] The notions of equity in tax law (horizontal and vertical equity) are also far more compatible with this theory due to the focus on a more equitable distribution scheme being the focus of insolvency law.[94] Adopting a broader economic model of efficiency that looks beyond ensuring only the highest return for creditors secures the broader interests of the community.[95] The focus on transaction cost efficiency that aims at achieving the results of insolvency at the least cost and effort compliments notions of efficiency in taxation.

Both these theories of insolvency, by their very nature, treat tax dues to the state differently. The communitarian theory is far more harmonised with the broader theoretical and principled frameworks in which taxation exists. This shows the theoretical divergences between various insolvency theories and taxation principles. Given the greater harmonisation with the principles of taxation, the question remains as to why legislations framed with communitarian objectives, such as the IBC, continue to clash with taxation statutes and claims. The answer to this is explored by examining the state's taxation powers in India from the lens of India's Constitution.

[88] Shekar and Guru, *supra note* 64; The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, *supra note* 29.
[89] Shekar and Guru, *supra note* 64.
[90] Villios, *supra note* 3.
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] Finch, *supra note* 31.

APPLICATION OF CONSTITUTIONAL TENETS OF INDIAN TAXATION IN INDIAN INSOLVENCY

In India, the field of taxation is broadly governed by the Income Tax Act of 1961[96] and the Central Goods and Services Act of 2017.[97] The field of Insolvency is governed by the Code.[98]

Tax revenue collection is crucial to the government's ability to redistribute wealth, target inequality, and fund vital public services.[99] Ineffective revenue collection and protracted legal disputes are detrimental to the State and the private sector alike.[100] The number of tax disputes in India is growing at a rate faster than the judicial system can clear.[101] In 2023, the Government stated that its priority was increasing the appeals disposal rate to reduce the burden on taxpayers and the system.[102] The Indian taxation system, for the longest time, was characterised by the compensatory tax theory, which was only recently deemed as a wrong interpretation of the right to tax as granted by the Constitution of India. The compensatory tax theory was developed to reconcile the freedom of trade under Article 301 and the state's sovereign right to tax. Under this theory, a tax would be justified when the state provided some facilities or services commensurate with the tax levied. While the compensatory tax theory never intersected with the IBC in practice, examining its intersection would help better understand the evolving divergences between these two fields.

Communitarian vision of IBC

The earlier Indian insolvency framework, being fragmented, gave rise to forum shopping, and placed greater emphasis on secured financial creditors (FCs),[103] thus leading to a lack of focus on the socio-economic impact of insolvency proceedings. The BLRC tasked with preparing the Indian insolvency resolution framework[104] referred to the UNCITRAL Legislative Guide on Insolvency and suggested that insolvency proceedings should be the least cost imposed on society.[105] The underlying philosophy behind the IBC broadly aligns with a communitarian vision of insolvency.[106]

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[96] The Income Tax Act 1961, https://incometaxindia.gov.in/pages/acts/income-tax-act.aspx.

[97] Central Goods and Services Tax Act 2017, https://www.indiacode.nic.in/handle/123456789/15689.

[98] Insolvency and Bankruptcy Code 2016, https://www.indiacode.nic.in/handle/123456789/2154?sam_handle=123456789/1362.

[99] Taxes & Government Revenue, World Bank,https://www.worldbank.org/en/topic/taxes-and-government-revenue, (June 12, 2024).

[100] IMF, *How Can an Excessive Volume of Tax Disputes Be Dealt With?,* https://www.imf.org/external/np/leg/tlaw/2013/eng/tdisputes.pdf, (June 24, 2024).

[101] Tax Department Sets Strict Targets to Resolve Appeals: Sources, CNBCTV18, https://www.cnbctv18.com/finance/tax-department-sets-strict-targets-to-resolve-appeals-sources-18368031.htm, (Feb. 9, 2024).

[102] *Id.*, Dhirendra Kumar, *Budget 2024: Govt to Withdraw Outstanding Disputed Tax Demand to de-Clog Recover,* Mint, https://www.livemint.com/budget/news/budget-2024-govt-to-withdraw-outstanding-disputed-tax-demand-to-de-clog-recovery-11706774550860.html, (Feb. 9, 2024).

[103] Rajeswari Sengupta, Anjali Sharma and Susan Thomas, *Evolution of the Insolvency Framework for Non-Financial Firms in India,* http://www.igidr.ac.in/pdf/publication/WP-2016-018.pdf, (May 8, 2024); Aparna Ravi, The Indian Insolvency Regime in Practice-An Analysis of Insolvency and Debt Recovery Proceedings, http://igidr.ac.in/newspdf/publication/WP-2015-027.pdf, (May 8, 2024).

[104] The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, *supra note* 29.

[105] *Id.*

[106] Shekar and Guru, *supra note* 64.

The BLRC noted that the following primary objectives were to be met by the new insolvency framework[107] –

1. Low time to resolution
2. Low loss in recovery
3. High levels of debt financing across a variety of debt instruments

The IBC was enacted to promote business reorganisation and retain corporate entities' value as a going concern to promote growth and efficiency in the market.[108]

The overall objective of the IBC was to create information symmetry between creditors and debtors to enable creditor wealth maximisation. It aimed to assess the viability of the business to enable resolving the entity while maintaining it as a going concern.[109] These are also the modern goals and objectives of insolvency law. The IBC is reflective of the value-based theory espoused by Korobkin and Warren. This is evidenced in the BLRC Report, which expounds the principles that the IBC:

> These principles are derived from three core features that most well developed bankruptcy and insolvency resolution regimes share: a linear process that both creditors and debtors follow when insolvency is triggered; a collective mechanism for resolving insolvency within a framework of equity and fairness to all stakeholders to preserve economic value in the process; a time-bound process either ends in keeping the firm as a going enterprise or liquidates and distributes the assets to the various stakeholders. These features are common across widespread differences in structure and content, present either through statutory provisions or their implementation in practice.[110]

Constitutional Perspective of Taxation

In India, after independence, the right of the state to tax its citizens emerged from the Constitution of India. Article 366 (28) of the Constitution of India defines taxation as follows –

> "taxation" includes the imposition of any tax or impost, whether general or local or special, and "tax" shall be construed accordingly [111]

The Supreme Court has held that the right to tax exists as a sovereign right of the state. The court held –

> The power to levy taxes has been recognised as an essential attribute of sovereignty. The power to tax is a necessary incident of sovereign authority (imperium) but not an incident of proprietary rights (dominium). …… The assertion of authority to collect a duty or tax is in the realm of the sovereign authority, but not a proprietary right. [112]

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[107] The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design, *supra note* 29.
[108] *Id.*
[109] *Id.*
[110] *Id.*
[111] The Constitution of India 1950, Article 366(28).
[112] Thressiamma Jacob v. Dept of Mining & Geology 2013 9 SCC 725 (Supreme Court of India).

Taxation, therefore, while being an extension of the sovereign right of the state, is not an extension by the government into the proprietary rights of persons or corporations. While tax is understood as a means to raise revenue to meet the state's expenditure, courts have held that today, taxation also exists to achieve certain fiscal and social objectives.[113] It is important to note that despite taxation being a state sovereign right, any tax levied has to conform with all other provisions of the Constitution of India.[114]

Against this backdrop, the *compensatory tax theory* emerged in India through the court's interpretation of Part XIII of the Indian Constitution, which regulates trade and commerce. Article 301 of Part XIII states –

> 301. Freedom of trade, commerce and intercourse. —Subject to the other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free.[115]

The Supreme Court, in one instance, was tasked with interpreting whether taxation statutes would be ultra vires of Article 301due to the resultant restriction on trade and commerce.[116] In *Automobile (Rajasthan) Transport Ltd. v. State of Rajasthan,*[117] the court was tasked with determining the validity of the Rajasthan Motor Vehicles Taxation Act of 1951. While analysing whether the said legislation and imposition of tax was a restriction on trade and commerce, the court held that the Act was valid and carved out an exception under Article 301 that would exempt compensatory taxes. The court expounded the scope of taxes being compensatory as follows -

> It seems to us that a working test for deciding whether a tax is compensatory or not is to enquire whether the trades people are having the use of certain facilities for the better conduct of their business and paying not patently much more than what is required for providing the facilities. It would be impossible to judge the compensatory nature of a tax by a meticulous test, and in the nature of things that cannot be done.[118]

If a court determined that a particular tax levied was compensatory, it could not be said to be *ultra vires* of the Constitution of India. In this case, the court noted that the tax does not restrict trade but instead facilitates the maintenance and provision of roads, which was a constitutionally sound law.[119] The compensatory tax theory was widened and held that "some link between the tax and facilities extended to such dealers directly or indirectly" would be sufficient for a taxing statute to be exempt from scrutiny under Article 301.[120] The broad interpretation of the compensatory tax theory led to difficulties distinguishing taxes from fees, which traditionally had a quid pro quo relationship wherein payment was made for particular services rendered.[121] Over time, the broad interpretation of the compensatory tax theory was gradually narrowed through a series of judicial decisions.[122]

[113] Elel Hotels & Investments Ltd v. Union of India1989 3 SCC 698 (Supreme Court of India).

[114] Karthik Sundaram, Tax, Constitution, and the Supreme Court Analysing the Evolution of Taxation Law in India (Oakbridge Publishing Private Limited 2019).

[115] The Constitution of India, Article 301.

[116] Atiabari Tea Co v. the State of Assam1961 1 SCR 809 (Supreme Court of India).

[117] Automobile (Rajasthan) Transport Ltd v State of Rajasthan 1962 SCC OnLine SC 21 (Supreme Court of India).

[118] *Id.*

[119] *Id.*

[120] Bhagatram Rajeevkumar v. CST 1995 Supp 1 SCC 673 (Supreme Court of India).

[121] Neha Pathakji, *Slippery Slopes of Compensatory Tax and Fee* (2014) 56 Journal of the Indian Law Institute 78.

[122] *Id.*

In 2017, the Supreme Court in *Jindal Stainless Ltd. (2) v. State of Haryana*[123] held that the compensatory tax theory was not rooted in constitutional jurisprudence and, as a result, was no longer a good law. The court reasoned that categorising taxes as compensatory effectively obliterates the difference between a fee and a tax.[124] The court relied on Thomas M Cooley's definition of tax as "a compulsory exaction of money for general public good".[125] The court held that since all taxes are collected with the broader objective of serving a public purpose, then all taxes would effectively be compensatory when looked at broadly.[126] The court, while analysing whether taxes could be construed as affecting the freedom of trade, held –

> Taxes simpliciter are not within the contemplation of Part XIII of the Constitution of India. The word 'Free' used in Article 301 does not mean "free from taxation"[127]

The court, therefore, effectively held that a non-discriminatory tax could not be construed as a restrictive or violative of the rights to free trade enshrined under Part XIII of the Constitution of India. The evolving jurisprudence has done away with the compensatory theory of taxation and reaffirmed taxation's traditional notions and underpinnings as a sovereign function to serve the public good.[128] To understand how the constitutional notions of taxation are at a crossroads with the IBC, we look at the objectives of the IBC that were sought to be achieved at the time of drafting.

Friction between Taxation and Insolvency Objectives

The friction between taxation and insolvency laws is most apparent in insolvency proceedings wherein claims/debts owed to the tax authorities often become points of contention during the resolution process. While courts have attempted to interpret these statutes harmoniously, we see a continued discordant judicial interpretation.[129] In the past few years, there have been several cases that have looked at the nature of income tax dues, i. e. whether it is operational or financial debt,[130] the priority of tax dues within the waterfall mechanism under the IBC,[131] the taxation of loan/interest waivers during the restructuring of the company

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[123] Jindal Stainless Ltd v. State of Haryana, 2017 12 SCC 1 (Supreme Court of India).

[124] *Id.*

[125] *Id.*

[126] Sundaram, *supra note* 114.

[127] Jindal Stainless Ltd. v. State of Haryana, *supra note* 123.

[128] Sundaram, *supra note* 114.

[129] In the interpretation of certain aspects of taxation dues within the insolvency resolution process, there have been discordant notes wherein judges have attempted to limit the precedential value of prior judgement to harmoniously balance the interests of all stakeholders involved. An example of this can be seen in the Supreme court's judgements on the issue of priority of tax debts in insolvency resolution. In *State Tax Officer v. Rainbow Papers Ltd,* (2022 SCC OnLine SC 1162), the court held that the State would be treated as a financial creditor in respect of dues that were pending under the Gujarat Value Added Tax Act of 2003. Subsequently, in Paschimanchal Vidyut Vitran Nigam Ltd. v. Rarman Ispat Private Limited & Ors (2023 SCC OnLine SC 842), the court without overruling the judgement in Rainbow held that the judgement was passed without considering the waterfall mechanism established under the IBC and limited the use of the case to its specific facts and circumstances.

[130] Ghanashyam Mishra and Sons Private v. Edelweiss Asset Reconstruction Company Pvt Ltd 2021 SCC Online SC 313 (Supreme Court of India). (Supreme Court, India).

[131] State Tax Officer v. Rainbow Papers Ltd, 2022 SCC OnLine SC 1162 (Supreme Court of India); Paschimanchal Vidyut Vitran Nigam Ltd v. Rarman Ispat Private Limited & Ors 2023 SCC On Line SC 842 (Supreme Court of India).

through resolution plans passed by the Committee of Creditors, recovery of customs dues after moratorium etc.[132]

The priority of these claims and the friction between these legislations can be viewed through the lens of the Constitution of India, which grants the right to tax, and the underlying objectives sought to be achieved by the IBC and insolvency law in general. Given that the IBC is being modelled with a communitarian vision, the question remains how these theoretical frameworks operate within the Indian legal framework. Although the communitarian theory of insolvency accounts for the competing interests of both consensual and non-consensual creditors and broader society,[133] the priority ascribed to these interests under the communitarian theory and taxation theory varies and leads to tension.

The core objective of taxation is to raise revenue for an array of purposes. Principally, the existence of a priority in taxation dues is consistent with meeting the fiscal adequacy objectives of tax law.[134] The argument favouring the same is that tax revenue is ultimately used to serve the community's interests. Therefore, a communitarian vision of insolvency must enable taxation dues to be recovered before other secured and unsecured debts owed to various creditors.[135] The prioritisation of tax debt was expounded in *Dena Bank v. Bhikhabhai Prabhudas Parekh & Co*[136]–

> The principle of priority of government debts is founded on the rule of necessity and of public policy. The basic justification for the claim for priority of State debts rests on the well-recognised principle that the State is entitled to raise money by taxation because unless adequate revenue is received by the State, it would not be able to function as a sovereign Government at all..................
>
> the arrears of tax due to the State can claim priority over private debts and that this rule of common law amounts to law in force in the territory of British India at the relevant time within the meaning of Article 372(1) of the Constitution of India and therefore continues to be in force thereafter. On the very principle on which the rule is founded, the priority would be available only to such debts as are incurred by the subjects of the Crown by reference to the State's sovereign power of compulsory exaction.

Therefore, it is argued that the priority of tax dues over the creditor's interests during insolvency is but an extension of the state's sovereignty and fulfils the community interest as

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[132] Vinod Kothari, Sikha Bansal and Vinod Kothari, *Income Tax Issues in Insolvency, Insolvent Liquidation and Voluntary Liquidation,* https://vinodkothari.com/wp-content/uploads/2023/04/Income-tax-issues-in-insolvency-insolvent-liquidation_final-1.pdf; Prachi Bhardwaj, *IBC Prevails over Customs Act Once Moratorium Is Imposed; CBIC Has Limited Jurisdiction, Cannot Initiate Recovery of Dues: Supreme Court,* SCC Times,https://www.scconline.com/blog/post/2022/08/29/ibc-prevails-over-customs-once-moratoriumimposed-cbic-has-limited-jurisdiction-supreme-court-legal-updates-research-news/, (June 24, 2024).

[133] Villios, *supra note* 3.

[134] *Id.*

[135] *Id.*

[136] The present case was a recovery suit filed by Dena Bank for recovery of monies granted to a partnership firm in a mortgage agreement by deposit of title deeds. The suit sought enforcement of the mortgage security. During this time, the State of Karnataka sought to recover sales tax from the partnership firm arrears. One of the issues the Court was tasked with ascertaining was whether recovery of tax by the State would have priority over the Banks right to recover against mortgaged property. See Dena Bank v Bhikhabhai Prabhudas Parekh & Co 2000 5 SCC 694 (Supreme Court of India).

well. However, neither the BLRC nor the Financial Sector Legislative Reforms Commission have adopted this view.[137] While the issue of priority of tax debt has always been analysed from the lens of the state's sovereignty, if we analyse the same from the lens of compensatory tax theory, there would be considerable inconsistencies. An argument favouring priority under the compensatory tax would be that since they have availed specific benefits for which the tax is due, they would have to be treated as unsecured creditors. The compensatory tax theory examines whether "some link between the tax and facilities extended to such dealers directly or indirectly"[138] exists. If we substitute the same notion of compensatory taxation while ascribing priority, there would not be any positive link between ascribing priority to the state in insolvency proceedings and meeting the broader objectives of reorganisation/revival of the corporate entity. Therefore, theoretically, the issue of priority would be in greater flux if the compensatory tax theory continued to subsist as opposed to a claim of priority under the right of state sovereignty.

The claim for a priority as an extension of the state's sovereignty has also been criticised. The criticism of tax priority over the debts of other creditors is twofold. First, it is argued that the state could focus on the administration of tax regimes to ensure better compliance in the short-medium term. The Committee on Financial Sector Reforms elucidates this –

> The government, which has substantial powers to recover arrears to it prior to bankruptcy, should not stand ahead of secured creditors.[139]

It is argued that by focusing on tax administration, they could limit the loss to their revenue base without placing an additional burden on financially distressed companies at the time of insolvency resolution.[140] The second criticism is that an increased priority of tax dues could lead stakeholders who are required to revive the distressed company to be less motivated to pursue reorganisation.[141] In 1999, the IMF, while analysing the best manner to conduct orderly insolvency resolution, argued that tax priority in insolvency may have some unintended consequences that diverge from the basic tenets and principles that govern a modern taxation system -

> The second category relates to tax claims of the government. This latter privilege has been justified on the grounds that giving the government priority with respect to tax claims can be beneficial to the rehabilitation process in that it gives the tax authorities an incentive to delay the collection of taxes from a troubled company. However, the creation of such incentives can in fact be counterproductive. Not only does failure to collect taxes compromise the uniform enforcement of the tax laws, but it also constitutes a form of state subsidy and, thereby, undermines the disciplinary forces that an effective insolvency law is designed to support.[142]

[137] Interim Report of The Bankruptcy Law Reform Committee (Bankruptcy Law Reforms Committee 2015), https://msme.gov.in/sites/default/files/Interim_Report_BLRC.pdf, (Feb. 18, 2024); 'Report of the Financial Sector Legislative Reforms Commission, Volume I: Analysis and Recommendations' (Financial Sector Legislative Reforms Commission, 2013), https://dea.gov.in/sites/default/files/fslrc_report_vol1_1.pdf, (Feb. 18, 2024).

[138] Bhagatram Rajeevkumar v. CST, *supra note* 120.

[139] A Hundred Small Steps: Report of the Committee on Financial Sector Reforms, Planning Commission, Government of India,(SAGE Publications 2009); Report of the Financial Sector Legislative Reforms Commission, Volume I: Analysis and Recommendations, *supra note* 138.

[140] Villios, *supra note* 3.

[141] Interim Report of The Bankruptcy Law Reform Committee, *supra note* 137; Villios, *supra note* 3.

Therefore, while the communitarian vision of insolvency aims to include several other stakeholders, such inclusion under the theory cannot compromise economic efficiency.[143] Thus, the theoretical and principled underpinnings of insolvency and tax legislation inherently have tension, reflected in the legislative frameworks and judicial decisions. This can only be resolved by states determining the trade-offs between some of the objectives of these legislations in the context of the broader interest of the community. The wider interest of the community is the underlying principle that commonly runs below a communitarian vision of insolvency law and modern taxation systems. From this perspective, any broader policy-based solution may be generated to resolve the tension between taxation and insolvency laws.

CONCLUSION

The intersection of insolvency and taxation law is a considerable source of tension in India and worldwide. This is evidenced by multiple countries having varied and continuously evolving stances on treating tax dues within insolvency resolution processes. The Raghuram Rajan Committee described the treatment of various stakeholders in an insolvency resolution process as "a compromise between political and economic considerations."[144] This description summarises the tension between insolvency and taxation statutes. The tension exists not merely due to conflicting provisions but at a deeper and more foundational level at their theoretical intersection. As evidenced in the creditor's bargain theory, the contractarian perspective of insolvency law provides little to no flexibility in treating tax dues and little opportunity to resolve this tension.

On the other hand, a communitarian vision of insolvency that has been increasingly adopted in several countries provides a degree of flexibility by providing some standing to non-consensual creditors such as tax authorities. From the Indian perspective, the constitutionally granted sovereign right of taxation also experiences considerable divergence when applied in insolvency resolution. Creating a consistent and efficient manner to treat tax dues in insolvency proceedings is vital to fulfilling the principles and ideals of both modern taxation and insolvency systems. A better understanding of the fundamental nature of these two essential fields of law is essential to achieve this.

[142] International Monetary Fund, *Orderly and Effective Insolvency Procedures, Orderly and Effective Insolvency Procedures* (International Monetary Fund 1999), https://www.elibrary.imf.org/display/book/9781557758200/9781557758200.xml, (Feb. 18,2024).

[143] Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay* (1994) 72 Washington University Law Review 1031.

[144] A Hundred Small Steps: Report of the Committee on Financial Sector Reforms, *supra note* 139.

04

INCREASING RESOLUTIONS IS KEY TO IBC'S SUCCESS

Sidharth Sharma

In Too Big To Fail, Andrew Ross Sorkin's book giving an engrossing account of the global financial crisis, there is an interesting passage about the court proceedings after Lehman Brothers filed for bankruptcy. The bankruptcy court in New York was presented with a deal in which Barclays was paying $1.75 billion for Lehman's North American operations. The plan was opposed vehemently by several creditors and investors who questioned whether the price Barclays was paying represented the fair value of Lehman's assets. The bankruptcy judge was opposed to any delay, and finally, after a marathon hearing, he signed off on the transaction at midnight. Approving the deal, he observed somberly: "*This is not approving the transaction because I know it's the best available transaction. I have to approve the transaction because it's the only available transaction.*"[1]

This, in a way, tells us the role that a bankruptcy court has to play. A company in insolvency is like a melting ice cube. With each passing day, the company's value gets chipped away. While trying for the best deal and what is fair to everybody is ideal, it is often an elusive target. What is important, perhaps more important, is to reach a resolution swiftly in a time bound manner.

RESOLUTION, NOT RECOVERY, IS THE PRIMARY GOAL OF IBC

Any business venture – small, large, new or conventional – has a risk of failure. And this risk is shared by all stakeholders (including lenders). With the best of intentions, planning, people and resources, businesses can, and do fail. This is a reality. But if there is any chance to rescue the business and make it viable and profitable then that must be pursued. Liquidation is not the preferred outcome for all failing businesses. This is not to say that closure of businesses is not desirable. Promoters do close down businesses and the legal regime should facilitate voluntary closure of businesses. In fact, the time taken to start or close a company (i.e. the ease of exit) is an indicator of the ease of doing business and the Ministry of Corporate Affairs has been taking steps in this regard.[2]

The closure of a running business (i.e. a going concern) because of its inability to pay debts, however, poses a different question, especially when liquidation and distribution of assets will not ensure repayment of all outstanding debts, i.e. when the liquidation value of the

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* *Views are personal.The author would like to thank Ayush Dhawan and Rushali Bhat for their research assistance.*

[1] Andrew Ross Sorkin, *Too Big to Fail – Inside the Battle to Save Wall Street*, 2009 (published by the Penguin Group).

[2] Banikinkar Pattanayak, *Voluntary business closure time down to 93 days from 499 in FY22: Ministry of Corporate Affairs*, Economic Times (Aug. 8, 2024).

corporate debtor (CD) is less than the outstanding debts. If each debtor were to pursue its own individual interest and recovery of the outstanding dues, then that would result in chaos. This situation gives rise to the need for a collective process, streamlined by a law and monitored by a judicial authority – to explore the possibility of a resolution without liquidation of the CD facing insolvency. A deal which can help the company survive would be in the interest of all stakeholders than the alternative of the company meeting its corporate death by going into liquidation. In certain cases, liquidation itself can be a better resolution, but if the business case of the CD is viable and has potential to be brought back on its feet, then ensuring survival of the company is certainly a better option and ought to be the legislative goal.

The Insolvency and Bankruptcy Code (IBC/Code), which was operationalized in 2016, introduced a new regime exactly for this purpose – to facilitate corporate insolvency resolution. However, while evaluating the working or efficacy of IBC, the discourse often looks at it from the prism of recovery – *how much of their dues creditors have been able to recover through the corporate insolvency resolution process (CIRP)*? The 'haircut' creditors have to take is seen as a sort of failure. However, this would not be the correct approach to look at this law or at the reforms this law may need going forward.

The IBC, which brought in the much-needed reform to the legal regime for insolvency resolution, is premised on this principle. In the words of the former Chairman of Insolvency and Bankruptcy Board of India (IBBI), Dr. Sahoo – "*The soul of the Code is resolution of insolvency of a firm by (a) a collective effort (b) to keep it going (c) to maximise the value of its assets, and (d) to balance the interests of all stakeholders.*"[3]

This policy objective behind the IBC has been recognized, reaffirmed and repeatedly highlighted by the courts as well.

In the *Swiss Ribbons case* (2019), the Supreme Court had underlined this aspect by unequivocally stating that the "*primary focus of the [IBC] is to ensure revival and continuation of the corporate debtor by protecting….. it from a corporate death by liquidation*". The Court further nuanced it by adding that "*[the IBC] is a* ***beneficial legislation which puts the corporate debtor back on its feet.***"[4] (emphasis added).

A recovery-centric approach misses the point and ignores the equally important public interest / beneficial legislation feature which is hardwired into IBC.

In the *Binani Industries* case (2018), the National Company Law Appellate Tribunal(NCLAT) had emphasised the 'resolution' goal of the IBC. The NCLAT emphasised it by noting that -

> [t]he purpose of Resolution is for maximisation of value of assets of the Corporate Debtor' and thereby for all creditors. It is not maximisation of value for a 'stakeholder' or 'a set of stakeholders' such as Creditors and to promote entrepreneurship, availability of credit and balance the interests. **The first order objective is "resolution".** The second order objective is "maximisation of value of assets

[3] Dr. M.S. Sahoo, *Resolution: The Soul of IBC*, IBBI Newsletter, Oct-Dec 2017.

[4] Swiss Ribbons (P) Ltd. v. Union of India - (2019) 4 SCC 17, para 28.

> of the 'Corporate Debtor" and the third order objective is "promoting entrepreneurship, availability of credit and balancing the interests". This order of objective is sacrosanct.[5] (emphasis added)

In *Invent Asset v. GirnarFibres,*[6] the Supreme Court reiterated IBC's primary goal by observing: "*time and again, it has been expressed and explained by this Court that the provisions of the Code are essentially intended to bring the corporate debtor to its feet and are not of money recovery proceedings as such.*"

In *Asset Reconstruction,*[7] the apex court once again reminded that IBC is not just a statute for recovery of debts or a law prescribing the modalities of liquidation of a corporate body, rather "*it is essentially a statute which works towards the revival of a corporate body, unable to pay its debts.*"

Resolution of corporate insolvency is critical, especially in a developing economy like ours where capital is scarce and must be put to efficient use. As the 2021 'Report of the Working Group on Tracking Outcomes under the IBC' noted -

> Unused or underused productive resources is anathema for the growth of a country and people. By rescuing viable businesses through the insolvency process and closing non-viable ones through liquidation, it is releasing resources, including entrepreneurs. The reallocation of resources to more efficient use is essential to optimise the economic cycle.

In a research paper (August 2023) titled "Report of Study on Effectiveness of the Resolution Process: Firm Outcomes in the Post-IBC period" authored by two professors of IIM Ahmedabad, it is concluded, based on their data-based analysis and also qualitative analysis, that performance of the resolved firms has reverted to being productive and efficient and that resolved firms contribute to job creation, capital investments and efficient utilization of resources.[8]

Of course, "maximisation of value of the assets" (of the CD) is an objective, but resolution is and should always remain the primary focus. And maximisation of value does not mean just maximisation of recovery for the creditors.

CIRP must be seen from the point of view of all stakeholders and not just from the perspective of 'a stakeholder' or 'a set of stakeholders.' The CD also consists of several employees and workmen whose livelihood is dependent on the outcome of the CIRP. If there is a resolution applicant who can continue to run the CD as a going concern, every effort must be made to try and see that this is made possible.

Ultimately, CIRP is largely a creditor-led, commercial process. It is the wisdom of the creditors that decides whether a CD will have a resolution plan or will go into liquidation. The CIRP must attract resolution plans from third parties (who until they submit a plan have no skin in the game in so far as the insolvent CD is concerned) and to do so will always involve a compromise.

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[5] Binani Industries Limited v. Bank of Baroda & Anr, 2018 SCC OnLine NCLAT 565, para 17.2.

[6] M/s. Invent Asset Securitisation and Reconstruction Pvt. Ltd. v. M/s. Girnar Fibres Ltd. – 2022 SCC OnLine SC 808, para 4.

[7] Asset Reconstruction Company (India) Limited v. Tulip Star Hotels Limited & Ors – 2022 SCC OnLine SC 944, para 55.

[8] Prof. M.P. Ram Mohan and Prof. B. Gopalakrishnan, *Report of Study on Effectiveness of the Resolution Process: Firm Outcomes in the Post-IBC Period*, IIM-Ahmedabad (Aug. 2023).

Unfortunately, we cannot say that IBC has met its resolution goal optimally. While the reasons for it can be several, research shows that since the inception of the law, "*for every one case resolved under the Code, four cases end up in liquidation*".[9] It cannot be pinpointed whether the recovery-centric approach caused liquidations, but researchers have pointed out that "*the COC focuses on the upfront payment and hence tends towards rejection of [Resolution Plans] where the haircut is high*". This tendency of creditors to focus on higher upfront amounts rather than the ability or capacity of the resolution plan to revive the company, requires a more qualitative assessment.[10].

DELAYS IN CIRP: A BIG STUMBLING BLOCK TO SUCCESSFUL RESOLUTION

The desire to maximise value is often seen as maximisation of recovery for the creditors and in the process, the primary focus gets mired in protracted litigation. The sanctity of the process and the timelines get short shrift. But it is important to remember that the part in the statement of objects and reasons of IBC which highlights "maximization of value" is preceded by an equally important consideration – that it should happen "in a time bound manner".

It cannot be gainsaid that currently most CIRPs get unduly delayed. A research study undertaken under IBBI's research initiative reveals that the main reasons for delays in CIRP are: (i) inadequate capacity of National Company Law Tribunal (NCLT); (ii) difficulty in marketing stressed assets; (iii) non-cooperation by CDs; and (iv) improper documentation model of companies.[11]

In the initial years of IBC, many cases took time to achieve finality due to a debate – and the resulting litigation cycle in NCLT, NCLAT and the Supreme Court – about the rights of operational creditors. Cases involving dues of the Government, including tax authorities, would often make finality and a successful resolution at the end of the CIRP tunnel elusive. However, swift legislative amendments[12] and supportive interpretation by the courts clarified the issue and cleared this bottleneck. It was recognised that in most cases, CIRP will not – it cannot – ensure payment of all dues. In *Ghanashyam Mishra v. Edelweiss* (2021),[13] the Supreme Court quashed tax demands of hundreds of crores which were being pursued by the Central and State revenue authorities against companies which had undergone CIRP in terms of an approved resolution plan. The apex court held that all dues owed to the government, including tax dues, that are not part of the resolution plan shall stand extinguished and no proceedings in respect of such dues could be continued.

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[9] Neeti Shikha and Urvashi Sinha, *Assessment of Corporate Insolvency and Resolution Timeline*, IBBI Research Initiative (RP-01/2021) (Feb. 2021).

[10] *Id.*

[11] *Id.*

[12] See, Insolvency and Bankruptcy Code (Amendment) Act, 2019. (Amendment to Section 31 of IBC as made to clarify binding effect of approved resolution plans on Central and State Government authorities to whom any statutory dues are owed by the corporate debtor).

[13] See, Ghanashyam Mishra & Sons (P) Ltd. v. Edelweiss Asset Reconstruction Co. Ltd. - (2021) 9 SCC 657. [Note: Owing to some subsequent conflicting judgments (in Rainbow Papers (2022) and Paschimanchal Vidyut (2023), ambiguities still remain on priority of dues under state laws which create statutory charge, and which can be held to be in the nature of secured financial debt. In the author's respectful view, Ghanashyam Mishra and Paschimanchal lay down the correct law. This is however not the subject matter of this article].

While delays in CIRP due to repeated issuance of 'Expression of Interest', numerous modifications to 'Request for Resolution Plans', iterations in the resolution plan, and consideration of unsolicited plans have been addressed by the IBBI through amendments to the rules, delays in the judicial process – at the stage of admitting cases and appellate proceedings at almost of every stage of CIRP – is a serious issue. The 2024 Report of the Standing Committee on Finance on 'Implementation of Insolvency and Bankruptcy Code (IBC) – Pitfalls and solutions' noted that "*13,170 IBC cases pending with the NCLT involve an approximate amount of Rs. 9,00,000 crore and that 71% of these cases have been pending for more than 180 days*".[14]

Much of the delay at the NCLT and NCLAT level is symptomatic of the larger problem of judicial delays in our country, but it is unfortunate that despite vesting the jurisdiction in specialised Tribunals, such delays continue. It is important to note there is no IBC-exclusive Tribunal. NCLT, and particularly the NCLAT today, is undoubtedly the most important commercial court in the country, with jurisdiction to adjudicate appeals under the Companies Act, Competition Act and the IBC – the three most important corporate-commercial laws. The infrastructure and manpower for this specialised Tribunal, therefore, has to be proportionately beefed up. This is an area that should be the focus of the next reform cycle for the efficient and efficacious working of the IBC.

Speed is of the essence in CIRP. If it is not followed, there is bound to be reduction in value of the CD and that will be mutually destructive for all stakeholders. Former IBBI Chairman, Dr. Sahoo, recognising that timeline is a foundational pillar of IBC, had articulated the fallout of delays in CIRP -

> In early days of default, enterprise value of a firm is usually higher than its liquidation value and hence the CoC is motivated to resolve insolvency to preserve its value rather than to liquidate it. However, the enterprise value of the firm reduces exponentially with time, as prolonged uncertainty about its ownership and control and generally apprehension surrounding insolvency leads to a flight of customers, vendors, workers, etc. The Code, therefore, mandates closure of the process ordinarily at the latest by 180th day.[15]

It is an acknowledged fact that delays have a direct bearing on the potential of rescuing the CD from liquidation. Studies show that delays, in fact, not only lead to lesser recovery but also reduce the chances of maintaining and resuscitating the CD as a going concern. Statistics collated by the IBBI show that delays in completion of the CIRP reduce the rate of recovery for creditors. Data of 947 resolved cases as of March, 2024 indicates a direct correlation between the length of the CIRP and the recovery rate. As per the data, the recovery rate for creditors stands at 49.2% if the CIRP is concluded within 330 days. It reduces to 36%, if the CIRP process concludes between 330-599 days; and beyond 600 days, the recovery rate stands at a mere 26.1%.[16]

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[14] PRS Legislative Research, *Standing Committee Report Summary: Implementation of Insolvency and Bankruptcy Code (IBC) – Pitfalls and Solutions* (Aug. 5, 2021).

[15] Dr. M.S. Sahoo, *supra note* 3.

[16] Source: IBBI Newsletter, Jan-Mar 2024.

There is also a direct correlation between the speed of CIRP and enhancement of recovery. Recent studies have shown that delays in the CIRP significantly reduces recovery, and the chances of resolution and bringing the CD back on its feet. In the January-March 2024 edition of the IBBI Newsletter, the current IBBI Chairman, Mr. Mital has aptly acknowledged that -

> The delays often due to litigations by multiple stakeholders with competing interests, erodes the value of already distressed CD further, and minimises the recovery value to the creditors.....Hence, it is important for all the stakeholders to expedite decision making.[17]

To conclude, it is now widely recognised that survival of CDs serves larger interests. All attempts, therefore, should be made for resolution and in a time bound manner. Resolution plans, once approved by the committee of creditors (CoC) in their commercial wisdom should be brought to finality.

It is nobody's case that to achieve resolution somehow, resolution applicants can be allowed to hoodwink the process. The Courts and the CIRP rules must ensure procedural integrity and safeguard against plans that deceive and shortchange stakeholders.[18] Similarly, any action or decision during the CIRP which is based on extraneous considerations, corruption or collusion must not be countenanced. However, any attempt to go on a path of equitable considerations or fairness of the price offered by the resolution applicant will be like going on a slippery slope and must be eschewed. In CIRP, the perfect need not be the enemy of the good.

In commercial transactions it is said that 'no deal is better than having a bad deal'. But in the context of the 'resolution' goal of IBC, which depends on a collective effort, it is important to remember that having a deal is more desirable than waiting for the elusive 'better' deal and ending up with no deal!

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[17] Ravi Mital, *Record Resolutions by NCLT*, IBBI Newsletter, Jan-Mar 2024.

[18] IBC and the IBBI's rules contain safeguards such as mandating priority payments to operational creditors and dissenting creditors; and such payment by a resolution applicant cannot be less than the liquidation value of the corporate debtor. To foster more effective and time bound decision making by the CoC members, and to stem value erosion, procedural delays and to enhance transparency and coordinated approach of decision making by the members of the CoC, the IBBI has recently come out with a set of new Guidelines for Committee of Creditors (Aug. 6, 2024).

05

EVOLVING INSOLVENCY REGIME AND LEGAL OBLIGATIONS UNDER INTERNATIONAL CONVENTIONS

Sudhaker Shukla and Raghav Maheshwari

"*Claims of right and insistence upon obligations may depend upon treaty stipulations, or upon the rules of international law, or upon the sense of natural justice applied to the circumstances of a particular case, or upon disputed facts.*"

- Elihu Root

INTRODUCTION

The interaction between international law and domestic legal systems has long been a subject of scholarly debate, often framed in terms of dualist and monist theories. While monists view international and domestic law as part of a single legal system with international law holding a superior position, dualists see them as separate systems where international norms require adoption into domestic law to have effect. In practice, most nations adopt a nuanced approach that doesn't strictly adhere to either extreme.

The Indian legal system, grounded in the supremacy of its Constitution, exemplifies a sovereign nation's careful balancing of domestic priorities with international commitments. As a sovereign republic, India's participation in various international legal arrangements is a deliberate choice, reflecting its engagement with the global community while maintaining the primacy of its constitutional framework. This approach to some extent aligns with the dualist perspective articulated by scholars like Triepel, who likened international law to a commander-in-chief whose orders reach the troops (domestic legal systems) only through the generals (states).

Several instruments such as treaties, customs and conventions etc. set the contours of the international legal order spelled out through binding and voluntary commitments. This article focuses on far-reaching impact of international conventions that they often have on business operations and, by extension, on insolvency resolution processes. They can affect various aspects of business, from contract enforcement to asset protection, which become particularly pertinent when a company faces financial distress. In the context of insolvency, these conventions can influence creditor rights, asset recovery procedures and cross-border insolvency processes.

IBC: A MARKET-WISE LAW VIS-À-VIS SECTORAL CONVENTIONS

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) stands as a comprehensive, market-oriented law designed to address insolvency issues across sectors. A key feature of the IBC is its sector-neutral approach, which is fundamental to its effectiveness and fairness in resource allocation. This sector-neutrality ensures a level playing field for all businesses, preventing the distortion of market dynamics that could occur if certain sectors were given special considerations. By avoiding preferential treatment, the IBC contributes to the efficient allocation of resources in the economy, as any sector-specific preference could lead to misallocation, potentially impeding overall economic growth.

The IBC's approach is rooted in trust in the market's capacity to understand and value businesses across various sectors. This market-driven philosophy allows for more accurate and fair valuations during insolvency proceedings. Furthermore, the law empowers Insolvency Professionals (IPs) to appoint any necessary experts to assist in understanding sector-specific nuances. This flexibility ensures that even highly specialized businesses can be properly managed during insolvency proceedings without requiring sector-specific provisions in the law itself.

Importantly, the sector-neutral approach of the IBC aligns with other crucial laws governing resource allocation, such as competition and securities laws. This alignment creates a cohesive legal framework that supports fair market practices across the economy. It's worth noting that the sector-neutral nature of the IBC does not mean it ignores sector-specific challenges. Rather, it provides a flexible framework that can accommodate these challenges without compromising its core principles.

While sectoral conventions often focus on specific industries or types of assets, the IBC provides a broader, more adaptable framework applicable to various business entities. This difference in scope creates an interesting interplay between the IBC and sectoral conventions, necessitating careful navigation to ensure compliance with both domestic law and international obligations. Even at the domestic level, there is significant interplay between the IBC and sectoral laws. For instance, the Indian Telecommunication Bill, 2022 and the Protection and Enforcement of Interests in Aircraft Objects Bill, 2022 contain provisions that address certain aspects of insolvency within their respective sectors.

This intersection highlights the need for a balanced approach that respects both the overarching principles of the IBC and the specific requirements of different sectors, while maintaining the fundamental sector-neutrality of the insolvency process. The challenge lies in harmonizing these sector-specific considerations with the underlying principles of the IBC, ensuring that the integrity of the insolvency process is maintained while still addressing unique sectoral needs. This balancing act is crucial for the continued effectiveness of India's insolvency regime in a complex, globalized economy.

SECTORAL CONVENTIONS AND THEIR IMPACT

Cape Town Convention and Protocol

The Convention on International Interests in Mobile Equipment (Cape Town Convention) and its Protocol on Matters Specific to Aircraft Equipment, collectively known as the Cape Town Convention,[1] have a significant impact on the treatment of aircraft-related assets under insolvency regimes. These international instruments aim to facilitate the financing of high-value mobile equipment by providing a uniform international legal framework for the creation, registration, and enforcement of security interests in such equipment.

India ratified the Cape Town Convention and its Protocol on March 31, 2008. This ratification signifies India's commitment to align its domestic laws with international standards in the realm of aviation finance. The interface between the Cape Town Convention and India's IBC has been further clarified by a recent notification from the Ministry of Corporate Affairs dated October 3, 2023.[2] This notification, issued under the powers conferred by clause (a) of sub-section (3) of section 14 of the IBC, explicitly states that the provisions of sub-section (1) of section 14 of the IBC shall not apply to transactions, arrangements, or agreements under the Convention and Protocol relating to aircraft, aircraft engines, airframes, and helicopters.

This exemption is significant as it effectively carves out these specific aviation assets from the moratorium provisions of the IBC. Under normal circumstances, section 14(1) of the IBC imposes a moratorium during the corporate insolvency resolution process, which prohibits certain actions against the corporate debtor (CD), including the recovery of property by an owner or lessor where such property is occupied by or in the possession of the CD. However, with this notification, such restrictions will not apply to the aforementioned aviation assets. The implications of this notification are far-reaching for the aviation sector and creditors involved in aircraft financing. Creditors and lessors of aircraft and related equipment will have rights to repossess these assets in certain circumstances in the event of insolvency, aligning with the protections provided under the Cape Town Convention.

This development underscores the evolving nature of India's insolvency regime and its efforts to harmonize domestic laws with international conventions. It also highlights the challenges in balancing sector-specific needs with the overarching principles of the IBC. As India's aviation sector continues to grow, the interplay between the Cape Town Convention and the IBC will remain a crucial area of focus for stakeholders. The careful navigation of these intersecting legal frameworks will be essential for maintaining a robust and internationally aligned insolvency regime that can effectively address the unique needs of the aviation industry while upholding the broader objectives of insolvency law.

[1] Convention on International Interests in Mobile Equipment, Nov. 16, 2001, 2307 U.N.T.S. 285; Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment, Nov. 16, 2001, 2367 U.N.T.S. 517, https://www.icao.int/sustainability/Pages/Capetown-Convention.aspx.

[2] Ministry of Corporate Affairs, Government of India, Notification S.O. 4321(E) (Oct. 3, 2023), https://ibbi.gov.in/uploads/legalframwork/8273e42bb4de11d39f37ab81f96f93ec.pdf.

Proposed UNCITRAL rules on digital assets

As the digital economy continues to grow, the United Nations Commission on International Trade Law (UNCITRAL) is currently developing rules for the treatment of digital assets in insolvency proceedings. While these rules are still in the proposal stage, they are likely to have significant implications for insolvency regimes once finalized and adopted. The proposed rules aim to address challenges unique to digital assets, such as identification and valuation of digital assets, jurisdictional issues in cross-border insolvency cases involving digital assets, treatment of cryptocurrencies and other virtual currencies in insolvency proceedings, and protection of digital asset holders' rights.

UNIDROIT Principles on digital assets and private law

The International Institute for the Unification of Private Law (UNIDROIT) has developed Principles on Digital Assets and Private Law[3] to address the legal challenges posed by digital assets in private transactions. These principles aim to provide a harmonized legal framework for dealing with digital assets, covering aspects such as control, transfer, and security interests. While not specifically focused on insolvency, the UNIDROIT Principles may have implications for insolvency regimes worldwide, potentially influencing how digital assets are treated in proceedings.

The treatment of crypto currency constitutes heart of the discussions on UNIDROIT Principles. Consensus is alluding the nations as its status as legal currency is shrouded in mystery. Proposing the way forward, the G20 New Delhi Leaders' Declaration 2023[4] endorsed the Financial Stability Board's (FSB's) high-level recommendations for the regulation, supervision and oversight of crypto-assets activities and markets and of global stablecoin arrangements. This global consensus could significantly influence how digital assets are to be handled. In moving forward, it appears that consensus on global standards has to evolve first before individual jurisdictions take appropriate decision to adapt and align with international best practices in handling digital assets during insolvency and bankruptcy proceedings.

Environmental conventions

India has been a significant contributor to the development of multilateral environmental legislation, consistently advocating for a balanced approach that harmonizes developmental needs with environmental protection. This commitment is reflected in India's domestic legislations, which aligns with international environmental laws and commitments. The interface between environmental laws and the IBC becomes particularly relevant in cases involving companies with significant environmental liabilities.

The intersection of Environmental, Social, and Governance (ESG) criteria with insolvency and restructuring practices is garnering global attention due to its profound implications for sustainability and societal impact. Further, the Companies Act, 2013[5] recognizes the need

[3] International Institute for the Unification of Private Law [UNIDROIT], *Principles on Digital Assets and Private Law* (2023), https://www.unidroit.org/wp-content/uploads/2024/01/Principles-on-Digital-Assets-and-Private-Law-linked.pdf.

[4] G20, New Delhi Leaders' Declaration (Sept. 9-10, 2023), https://www.mea.gov.in/Images/CPV/G20-New-Delhi-Leaders-Declaration.pdf.

[5] Companies Act, No. 18 of 2013, India Code (2013).

for promoting ESG norms by the corporates. SEBI has also made it compulsory for the top 500 listed companies (ranked by market capitalization) to provide information on business responsibility and sustainability, through Business Responsibility Reporting (BRRs).[6] Furthermore, the World Bank is implementing a new corporate flagship, Business Ready (B-READY) Index.[7] The Business Enabling Environment which will provide a new benchmarking exercise will also address environmental obligations in bankruptcy and review good environmental regulatory practices within insolvency proceedings. As mother earth is taking massive green (hair) cut, focusing on environmental claims as proposed in the B-Ready Framework alone would not suffice; rather each jurisdiction has to eventually find global cost effective solutions for promotion of greener, efficient and zero emission technologies through suitable integration of these options in the resolution plans and its implementation.

Without any explicit mention of environmental trade-offs, the Code has a nuanced approach towards dovetailing environmental issues by way of having provision of respecting provisions of all the laws. Under the Code, the IP is mandated to take all necessary steps to ensure that the corporate person undergoing any process under the Code complies with all applicable laws. However, moving forward, in the long run, the key considerations may include the treatment of environmental clean-up costs in insolvency proceedings, priority of environmental claims in the distribution of assets, responsibility for ongoing environmental compliance during insolvency proceedings, and balancing environmental obligations with the goals of business rescue and creditor satisfaction. As India continues to be front runner in upholding its international environmental commitments, such as those under the United Nations Framework Convention on Climate Change (UNFCCC)[8] and Paris Agreement, the insolvency regime must also evolve to address the unique challenges posed by environmental liabilities in insolvency scenarios.

Maritime-related conventions

There are several international maritime conventions that potentially have implications for insolvency proceedings involving shipping companies or maritime assets. Key conventions in this area include the International Convention on Maritime Liens and Mortgages, 1993[9], the International Convention on Arrest of Ships, 1999[10], and the Nairobi International Convention on the Removal of Wrecks, 2007.[11] The Convention on Maritime Liens and Mortgages establishes uniform rules relating to maritime liens and mortgages, providing for their recognition and enforcement across jurisdictions and setting out priority rules for competing claims against vessels. The Arrest of Ships Convention provides a framework for the arrest of ships as a means of obtaining security for maritime claims, setting out the types of claims for which a

[6] Ministry of Corporate Affairs, Govt. of India, *Report of the Committee on Business Responsibility Reporting* (2020), https://www.mca.gov.in/Ministry/pdf/BRR_11082020.pdf.

[7] World Bank Group, B READY Index, https://www.worldbank.org/en/businessready.

[8] United Nations Framework Convention on Climate Change, May 9, 1992, S. Treaty Doc No. 102-38, 1771 U.N.T.S. 107, https://unfccc.int/.

[9] International Convention on Maritime Liens and Mortgages, May 6, 1993, 2276 U.N.T.S. 39, https://unctad.org/system/files/official-document/aconf162d7_en.pdf.

[10] International Convention on Arrest of Ships, Mar. 12, 1999, 2797 U.N.T.S. 3, https://unctad.org/system/files/official-document/aconf188d6_en.pdf.

[11] Nairobi International Convention on the Removal of Wrecks, May 18, 2007, 46 I.L.M. 697, https://www.imo.org/

ship may be arrested and the procedures for arrest and release of vessels. The Wreck Removal Convention provides a legal basis for states to remove shipwrecks that may be hazardous to navigation or the marine environment, addressing issues of liability and compensation for wreck removal.

Further, the United Nations Convention on the International Effects of Judicial Sales of Ships,[12] also known as the Beijing Convention on the Judicial Sale of Ships, marks a significant development in maritime law with potential implications for insolvency proceedings. Opened for signature on September 5, 2023, this convention aims to establish a harmonized regime for giving international effect to judicial sales of ships. While preserving domestic laws governing the procedure of judicial sales, it aims to ensure legal certainty regarding the title acquired by purchasers in international navigation. This convention is particularly relevant to the IBC's interface with maritime law, as it could impact the treatment of ships in cross-border insolvency cases. It could impact the price a ship can attract in the international market. As and when India considers its position on this convention, suitably, its interaction with the IBC's provisions on moratorium and asset sales in insolvency proceedings may require careful consideration.

These conventions affect various aspects of maritime insolvency, including recognition and enforcement of maritime liens, arrest and judicial sale of vessels, and treatment of wreck removal costs in insolvency proceedings. The IBC should be interpreted and applied in a manner that respects India's obligations under these maritime conventions, ensuring a consistent approach to maritime insolvencies that aligns with international standards. This requires carefully balancing the objectives of insolvency law with the specialized regime for maritime claims and liens established by these conventions.

As India's maritime sector continues to grow, the interplay between these international maritime conventions and domestic insolvency law will remain an important area of focus. Ultimately, a harmonized approach that respects both insolvency and maritime law principles will be crucial for maintaining India's competitiveness in the global shipping industry while providing certainty and fairness to all stakeholders involved in maritime insolvencies.

Other important conventions interfacing with IBC

The IBC operates within a complex web of international conventions and treaties that significantly impact cross-border insolvency cases. The United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention), 1958[13], to which India is also a signatory, plays a crucial role in ensuring that foreign arbitral awards are recognized and enforceable in member countries. This becomes particularly relevant in the context of insolvency when dealing with cross-border disputes or enforcing arbitral awards against companies undergoing insolvency proceedings. The convention's provisions may sometimes conflict with the moratorium imposed under the IBC, necessitating a careful

[12] United Nations Convention on the International Effects of Judicial Sales of Ships, Dec. 7, 2022, https://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=X-21&chapter=10&clang=_en.

[13] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 3, https://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=XXII-1&chapter=22&clang=_en.

balancing act between honouring international commitments and preserving the integrity of domestic insolvency processes.

Although India is not yet a party to the United Nations Convention on Contracts for the International Sale of Goods (CISG), 1980,[14] its principles are frequently incorporated into international commercial contracts. The interaction between the CISG and the IBC becomes significant in cases involving international trade disputes and insolvency proceedings.

Bilateral Investment Promotion Agreements (BIPAs) form another critical layer of international agreements that interface with the IBC. India has also pursued a policy of entering into BIPAs with a view to providing predictable investment climate to foreign investment in India as well as to protect Indian investments abroad.[15] These treaties often contain provisions related to investor protection in case of expropriation or nationalization, which can intersect with insolvency proceedings involving foreign investments. The challenge lies in reconciling the investor protection guarantees under BIPAs with the collective proceedings nature of insolvency, especially when it comes to the treatment of foreign creditors and the potential for investor-state dispute settlement proceedings.

Double Taxation Avoidance Agreements (DTAAs) signed by India with multiple nations[16] to prevent double taxation of income also have significant implications for cross-border insolvency cases. These agreements can affect the tax treatment of assets and income during insolvency proceedings, potentially influencing the overall value of the insolvency estate and the returns to creditors. IPs must navigate the complex interplay between DTAAs and the IBC to ensure fair and efficient resolution of insolvency cases involving cross-border element while complying with international tax obligations.

CONCLUSION

The interface between the IBC and these various international conventions and treaties presents both challenges and opportunities for India's insolvency regime. As India continues to integrate into the global economy, maintaining a balance between the principles of insolvency law and international commitments becomes increasingly crucial. This balancing act requires continuous monitoring of international developments in insolvency law and related fields, as well as regular review and updating of the IBC framework to ensure alignment with international best practices.

To effectively navigate this intricate legal tapestry dealing with complex economic landscape, India must develop specialized expertise within its insolvency ecosystem perfectly aligned with the nuances of both domestic and international insolvency regimes. This may involve development of state of art insolvency ecosystem, technologically agile (IT and AI) with inbuilt

[14] United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, S. Treaty Doc. No. 98-9 (1983), 1489 U.N.T.S. 3, https://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=X-10&chapter=10&clang=_en.

[15] Govt. of India, Ministry of Commerce & Industry, *Stocktaking of India Bilateral Agreements for the Promotion and Protection of Investments,* https://www.commerce.gov.in/international-trade/india-and-world-trade-organization-wto/indian-submissions-in-wto/investment/stocktaking-of-india-bilateral-agreements-for-the-promotion-and-protection-of-investments/.

[16] Income Tax Department, Govt. of India, *Double Taxation Avoidance Agreement (DTAA)*, https://incometaxindia.gov.in/pages/international-taxation/dtaa.aspx.

tools to suggest credible and swift response to stresses and opportunities emerging from international conventions and their interaction with domestic insolvency law. For a harmonized international approach it is imperative to foster enhanced cooperation between domestic and international regulatory bodies incharge of piloting the initiatives; prioritizing sector specific intervention.

Enhanced cooperation with international bodies, reflecting the spirit of *'Vasudhaiva Kutumbakam'* (the world is one family), will also be crucial in addressing the challenges of forum shopping and regulatory arbitrage in cross-border insolvency cases. By successfully managing the interplay between the IBC and international conventions, India can create a robust, internationally aligned insolvency regime that promotes investor confidence, meets sector specific obligations, facilitates cross-border trade, and supports sustainable economic growth.

Ultimately, the goal should be to create an insolvency framework flexible enough to cater to emerging domestic economic needs and also able to respond to enforcement issues related to international legal norms. The Code provide enough flexibility for carving out needed exception to avert any compliance issues. This enhances India's attractiveness as a destination for foreign investment.

As India continues its trajectory towards becoming a $5 trillion economy, the adept management of the intersection between domestic insolvency law and international conventions will be pivotal. By fostering a legal environment that harmoniously blends domestic priorities with global best practices, India is poised to not only maintain its competitive edge in the global marketplace but also to emerge as a thought leader in shaping the future of international insolvency law.

06

TREATMENT OF DUES TO ANY WORKMAN AND EMPLOYEE FROM THE PROVIDENT FUND, PENSION FUND AND GRATUITY FUND UNDER IBC

Sandip Garg, Anshul Agrawal and Vishal Rajpurohit

This paper explores the legal framework regarding the treatment of dues of workmen and employees related to provident fund, gratuity, and pension fund under the Insolvency and Bankruptcy Code, 2016 (IBC/Code). It traces the evolution of entitlements of workmen and employees under IBC. It delves into the legislative intent of section 18(1)(f) and section 36(4)(a) of the Code regarding exclusion of third-party owned assets in possession of the corporate debtor (CD) from corporate insolvency resolution process (CIRP) and liquidation process under IBC. It also delves into the legislative intent behind creating an exclusion for provident funds, pension funds and gratuity funds under sub-clause (iii) of section 36(4)(a) of IBC.

The paper also compares section 36 and section 53 of the IBC as they both deal with workmen dues and employee dues from the provident fund, gratuity and pension fund and distinguishes the legislative intent behind both these provisions. However, they deal with them in different context i.e. section 36 deals with 'assets' which form and do not form part of liquidation estate, while section 53 deals with the priority of payment of liabilities of different categories. It argues that section 36(4)(a)(iii) is applicable when the funds are available and are in possession of the CD. However, there is no such restriction in section 53 of IBC where sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund again find place there, as it refers to the definition of 'workmen's dues' as transported from section 326 of the Companies Act. It attempts to critically analyse the trends in judicial interpretations about the repayment of workmen and employee dues from these funds and whether these interpretations are in line with the provisions, their legislative intent and the objectives as enshrined in the long title of IBC.

The paper also examines as to whether the obligation cast on the successful resolution applicant (SRA) for payment of all past workmen and employee dues above the amount available in these funds, is violative of the 'clean slate' principle. Lastly, the paper also lays emphasis on the need to distinguish between dues owed to employees vis-à-vis amount due from employer payable to statutory authority like Employees' Provident Fund Organisation (EPFO) under the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 (EPF Act). It argues that amounts claimed by statutory authorities like EPFO in nature of penal interest, damages and penalties levied should get treatment alike other Government dues under IBC.

LEGAL FRAMEWORK UNDER IBC

Background

The objective of the Code is as follows –

> 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 **maximization 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** and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto.

The Code completely replaces the earlier framework for insolvency and bankruptcy resolution that was inadequate, ineffective and guilty of causing undue delays. The enactment of the Code and the amendments thereafter are a consequence of detailed consultation and deliberations by several committees, commissions and experts, in a matter which deals with the economy of the country as a whole.[1]

The Report of the Bankruptcy Law Reforms Committee (BLRC) marked a significant shift in arguing about changing the priorities of payments as appearing in the Companies Act. Earlier all unsecured creditors other than government were at a lower pedestal. In the Report of the BLRC[2], higher priority was given to unsecured financial creditors by placing them above Government dues. Operational creditors (OCs) were placed lower than government dues. This is also evident from the long title of the IBC which focuses on better availability of credit and lowers the priority to the dues of the Government.

Further, the BLRC had recommended that 3 months of workmen's dues were to be treated at par with secured creditors, which was increased in the Bill to 12 months and then by the Joint Committee on the Insolvency and Bankruptcy Code (JPC)[3] to 24 months. The treatment of priority of workmen and employee dues, by various forums, can be seen from the table below:

Priority of	BLRC	Bill	JPC	Companies Act
Workmen's dues for **this duration** rank equally with secured creditors	3 months	12 months	24 months	No limit
Thereafter, employee dues for **this duration** are ranked	3 months	12 months	12 months	4 months

So, it can be seen that BLRC tried to emphasise on prioritising the rights of financial creditors, (FCs) over other stakeholders, for promoting the availability of credit and developing a market for unsecured financing (including the development of bond markets). They also argued for substantial reduction of duration of workmen and employees which are placed on priority. Though, the reduced rights of workmen and employees, as outlined by the BLRC, were significantly improved in the Bill and later by the JPC, it may be noted that IBC still lowered the priority of Government dues as well as dues of workmen compared to their priority in Companies Act, 2013.

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[1] Moser Baer Karamchari Union thr. President Mahesh Chand Sharma v. Union of India and Ors. [Writ Petition no. 421 of 2019].

[2] The Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design (November 2015).

[3] Lok Sabha, *The Report of the Joint Committee on the Insolvency and Bankruptcy Code, 2015* (April 2016).

Determination of estate of the CD

An insolvency law deals with assets of the debtor. What does or does not constitute an asset for the debtor for the purposes of the liquidation are determined by the general principles of property and contract law applicable to solvent parties.[4] The assets which do not belong to the debtor or over which the debtor has no ownership rights (i.e. the third party assets) are excluded. The BLRC[5] also noted the need to establish the assets of the debtor and therefore, in its Report it noted the following –

> **Not all assets that are present within the entity, from the start of the IRP, can be considered for Liquidation**....following sets of assets must be kept out of the liquidation process:
>
> a. Assets held by **the entity in trust** (such as employee pensions).
>
> b. Assets held as **collateral**....
>
> c. Assets held as part of operational transactions where the entity **has rights over the asset but is not the owner of the title of the asset**. For example, there could be goods belonging to third parties given to the debtor for processing or value addition.....[emphasis supplied]

Accordingly, section 18(1)(f) of IBC provides for Interim Resolution Professional (IRP) to take control and custody of 'assets' of the CD and not of the third-party assets. It reads as follows –

> (1) The interim resolution professional shall perform the following duties, namely: -
>
> ...
>
> (f) **take control and custody of any asset over which the corporate debtor has ownership rights** as recorded in the balance sheet of the corporate debtor... including -...
>
> **Explanation**. – For the purposes of this section, the term "assets" shall not include the following, namely: - (a) **assets owned by a third party in possession of the corporate debtor** held under trust or under contractual arrangements including bailment;...[emphasis supplied]

Similarly, section 36(1) provides for creation of an estate comprising the 'assets' of the CD. The liquidator holds these 'assets' for the benefit of all the creditors and is a fiduciary of the liquidation estate. Section 36(3) list out various 'assets' (such as tangible, intangible, etc.) which are part of liquidation estate. An exception has been carved out under section 36(4) which clarifies as to what assets will not form part of the liquidation estate. It reads as follows–

> ... (4) The following shall **not** be included in the liquidation estate assets and shall not be used for recovery in the liquidation:-
>
> (a) **<u>assets owned</u> by a <u>third party</u> which are in <u>possession</u> of the corporate debtor, including –**
>
> (i) assets held in **trust** for any third party;
>
> (ii) bailment contracts;
>
> (iii) all sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund;
>
> (iv) other contractual arrangements which do not stipulate transfer of title but only use of the assets; and
>
> (v) such other assets as may be notified ....;
>
> ...[emphasis supplied]

[4] Wadhwa Brothers, Guide to the Insolvency and Bankruptcy Code 1887(Wadhwa Law Chambers, 3d ed. 2024).

[5] Bankruptcy Law Reforms Committee, *supra* note 3, para 5.5.5.

Thus, the scheme of the Code follows a consistent structure in both processes i.e. CIRP and liquidation process, making it clear that third-party assets (over which the CD has no ownership rights) cannot be treated as assets of the CD. Both these provisions [i.e. explanation to section 18(1)(f) and section 36(4)(a)] are merely stating the obvious, i.e. the third-party assets on which CD has no ownership rights cannot be part of the estate of CD. Even in the absence of these provisions, the third-party assets would not have become part of estate of the CD.

Exclusion of workmen and employee related funds in CD from estate of CD

As per the Insolvency and Bankruptcy Bill, 2015 introduced in the Parliament, section 36(4)(a)(iii) read as '*contributions in respect of employee pensions'*. As per the Report of the JPC, submitted to the Lok Sabha on April 28, 2016, representatives of the EPFO expressed concerns about the re-prioritization of debt payments under IBC, which placed PF dues at a lower priority. They highlighted that the Eleventh Schedule of IBC proposes to exclude sections 326 and 327 in the event of liquidation, effectively nullifying section 11 of the EPF Act. The representatives referenced a Supreme Court judgment that established the precedence in payment of PF dues over all other debts, including those of secured creditors. Considering these representations, section 36(4)(a)(iii) was modified to include '*all sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund*'.

However, though change was made to section 36(4)(a)(iii) to include provident fund and gratuity besides pension funds, the qualifying part in clause (a) i.e. '*assets owned by a third party which are in possession of the corporate debtor'*, was kept intact and it always remained a pre-requisite for application of the various sub-clauses of clause (a). The third-party assets, for this purpose, are assets in the nature of the pension funds, gratuity funds or provident funds which are in 'possession' of the CD. Accordingly, where any of such funds, if they are not in possession of CD, but are in possession and control of any other authority including EPFO, then clause (a) won't be applicable. Such funds not in possession of CD, would anyway, can never be part of estate of CD and therefore they will never be considered while discussing liquidation estate of the CD.

Further, even when such funds are in possession of the CD, only a part of such funds i.e. workmen and employee dues have been excluded from liquidation estate under sub-clause (iii) – i.e. workmen and employee dues have been envisaged as a sub-set of third-party assets which are in possession of the CD and not the other way round where the entire workmen and employee dues are considered outside liquidation estate irrespective of whether the funds for them exist or not. Therefore, the amendments to section 36(4)(a)(iii) by the JPC did not alter the underlying intention to exclude only those assets which are in possession of the CD but are owned by third parties. Therefore, section 36(4)(a)(iii) relates to non-government provident funds, pension funds and gratuity funds, being maintained by the CD and in possession of the CD as the funds managed by the Government authorities are not in possession of the CD.

Section 17 of the EPF Act allows for exemption to CDs from provisions of the EPF Act, provided they have schemes which offer favourable return to employees in comparison to the scheme under the EPF Act. Reliance Industries Limited is one of the companies whose provident fund has been exempted under section 17 of EPF Act.[6] Also, section 16A of the EPF Act provides for authorising an employer for maintenance of a provident fund by the employer.[7] Thus, only such funds, which are in possession of the CD, are intended to be covered under section 36(4)(a)(iii). Accordingly, unless a fund is maintained by CD and the CD is in possession of such fund, the question of application of section 36(4)(a)(iii) does not arise.

The waterfall mechanism in section 53 is based on a structured mathematical formula, and the hierarchy is created in terms of payment of debts in order of priority with several qualifications. The Code is based on the organic evolution of law and is a product of an extensive consultative process to meet the requirements of the Code governing liquidation. It introduced a comprehensive and time-bound framework to maximise the value of assets of all persons and balance the interest of the stakeholders. The guiding principle for the Code in setting the priority of payments in liquidation was to bring the practices in India in line with global practices. In the waterfall mechanism, after the costs of the insolvency resolution process and liquidation, secured creditors share the highest priority along with a defined period of dues of the workmen. The unpaid dues of the workmen are adequately and significantly protected in line with the objectives sought to be achieved by the Code and in terms of the waterfall mechanism prescribed by section 53 of the Code. In fact, the secured creditors are taking significant hair-cut and workmen are being compensated on an equitable basis in a just and proper manner as per section 53 of the Code. The Code balances the rights of the secured creditors, who are financial institutions in which the general public has invested money, and also ensures that the economic activity and revival of a viable company is not hindered because it has suffered or fallen into a financial crisis. The Code focuses on bringing additional gains to both the economy and the exchequer through efficiency enhancement and consequent greater value capture.[8]

The dues of workmen and employees may fall under various clauses of section 53 depending upon whether the same are due to them or to a Government department, and for which period do they belong. The limbs of section 53 where these dues may fall are quoted below: -

> (a) ….
>
> (b) the following debts which shall rank <u>equally</u> between and among the following:
>
> > (i) **workmen's dues** for the period of **twenty-four months** preceding the liquidation commencement date; and
> >
> > (ii) debts owed to a secured creditor in the event …;
>
> (c) **wages and any unpaid dues owed to employees** other than workmen for the period of **twelve months** preceding the liquidation commencement date;
>
> (d) ….
>
> (e) the following dues shall rank equally between and among the following: -
>
> > (i) any amount due to the **Central Government and the State Government** …, in respect of the whole or any part of the period of **two years** preceding the liquidation commencement date;
> >
> > (ii) …;
>
> (f) **any remaining debts and dues**;
>
> ….[emphasis supplied]

For workmen, the dues pertaining to 24 months prior to the liquidation commencement date have been given priority and are placed at same priority as that of secured creditors [section

[6] Integrated Annual Report 2023-24 for Reliance Industries Limited, https://www.ril.com/ar2023-24/pdf/RIL_IAR_2024pdf, 85.

[7] Not yet in force.

[8] Moser Baer Karamchari Union Thr. President Mahesh Chand Sharma v. Union of India and Ors. [Writ Petition no. 421 of 2019].

53(1)(b)(i)]. Thereafter, the dues pertaining to employees other than workmen, for 12 months from the liquidation commencement date, have been placed [section 53(1)(c)]. Thereafter, the dues of the Government for two years (i.e. dues not owed to the workmen / employee) like penalty, damages and interest payable by the employer to the Government (including Government organisations like EPFO), beyond what is payable to workmen / employee, will be covered [section 53(1)(e)(i)]. Any dues of the workmen / employee / Government or otherwise, beyond the periods covered above, have the lowest priority [section 53(1)(f)].

As per explanation (ii) to section 53 of IBC, the term 'workmen's dues' has been assigned the same meaning as in section 326 of the Companies Act 2013, which reads as follows –

> (b) "workmen's dues", in relation to a company, means the **aggregate** of the following sums due from the company **to its workmen**, namely:—
>
> (i) all wages or salary ...;
>
> (ii) all accrued holiday remuneration ....;
>
> (iii) ....;
>
> (iv) **all sums due to any workman from the provident fund, the pension fund, the gratuity fund or any other fund for the welfare of the workmen, maintained by the company**;[emphasis supplied]

The phrase *'all sums due to any workman from the provident fund, the pension fund, the gratuity fund',* also finds place in section 36(4)(a)(iii). However, the protection accorded under each of these provisions is different. Under section 36(4)(a)(iii), the funds which are available, being third-party assets do not become part of the liquidation estate of the CD and the dues of workmen and employees are to be paid out of such funds. Section 53 applies after proceeds have been received from sale of liquidation estate [i.e. assets owned by the CD beyond the funds which are available under section 36(4)(a)(iii)], and therefore, under section 53(1)(b)(i) and 53(1)(c), the dues of workmen and employee from these funds, pertain to a situation where the funds are not available, because had the funds been available, same would have been covered under section 36(4)(a)(iii). Accordingly, there appears to be no inconsistency between section 53(1)(b)(i) and section 36(4)(a)(iii). Further, even if any inconsistency is noticed, section 53 will have to prevail over section 36, as it contains a *non-obstante clause*.

Different priorities have been envisaged under section 53 for different types of workmen's dues – whether to workman or employee and for different durations. In such a scenario,if a view is taken that section 36(4)(a)(iii) is wide enough to incorporate all dues of workmen and employees, irrespective of funds being available or not, it goes directly against the express legislative intent in section 53 for giving different priorities to workmen's dues and employee dues and for different durations.

This is further affirmed by the fact that the JPC had on one hand, modified section 36(4)(a)(iii) to state '*all sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund*', and on the other hand, while increasing the time-limit from 12 to 24 months for workmen dues under section 53, had noted the following –

> Some of the stakeholders in the memoranda submitted to the Committee/views presented before the Committee were of the view that restriction of period of twelve months with regard to dues to workers and employees should be removed. **It was also pointed out that as per section 325(3)(b) of the Companies Act, 2013, workmen dues means all the unpaid dues comprising of earned salary including all accrued holiday remuneration, provident fund, pension fund, the gratuity etc. maintained by the Company in the event of its winding up.**[emphasis supplied]

The JPC was thus aware that sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund are appearing at two places once in section 36(4)(a)(iii) and the again in the definition of 'workmen's dues' under section 53. This repetition is with a purpose. In section 36(4)(a)(iii), the sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund are in respect of funds which are existing as third-party funds in possession of the CD. However, there is no such restriction in section 53 of IBC where sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund again find place there, as it refers to the definition of 'workmen's dues' as transported from section 326 of the Companies Act. So, the legislature was aware of the same language being used at two places but it was consciously kept as it was aware that two different sets of dues are being dealt at the two places – dues to the extent covered by funds which are third party asset and in possession of the CD in section 36(4)(a)(iii), and dues if not so covered fully by funds and in such a case for a restricted duration under section 53(1)(b)(i) or 53(1)(c), or 53(1)(f), as the case may be.

Also, it can be seen from the above discussion that section 36 deals with 'assets' which form and do not form part of liquidation estate, while section 53 deals with the priority of payment of liabilities of different categories. Though both are dealing with dues owed to workmen and employees from the provident fund, gratuity fund and pension fund, they are dealing with them in different context.

Further, these differing priorities will also apply in a CIRP, as a resolution plan in CIRP has to ensure a minimum protection to all OCs (including workmen and employees) under section 30(2)(b). This minimum entitlement to OCs is higher of the - (i) the amount to be paid to such creditors in the event of a liquidation of the CD under section 53; or (ii) the amount that would have been paid to such creditors, if the amount to be distributed under the resolution plan had been distributed in accordance with the order of priority in sub-section (1) of section 53. Therefore, even in CIRP as the determination of minimum threshold is dependent on priorities under section 53, section 53 is applicable.

APPROACH OF SC AND NCLAT IN DEALING WITH ABOVE PROVISIONS

The following important judgments of Hon'ble Supreme Court (SC) and Hon'ble National Company Law Appellate Tribunal (NCLAT) have interpreted the provisions of IBC discussed above -

Case Name	Date of order	Forum	Findings	Stage
State Bank of India v. Moser Baer Karamchari Union & Anr.	19.08.19	NCLAT	All sums due to workmen and employees from provident fund, pension funds and gratuity fund are outside of the liquidation estate. (para13)	Liquidation
	07.02.23	SC	NCLAT order was affirmed, and appeal was dismissed.	
Tourism Finance Corporation of India Ltd. v. Rainbow Papers Ltd. & Ors.	19.12.19	NCLAT	As no provisions of the EPF Act are in conflict with any of the provisions of the IBC and, on the other hand, in terms of section 36(4)(iii), the 'provident fund' and the 'gratuity fund' are not the assets of the 'CD', there being specific provisions, the application of section 238 of the IBC does not arise. (para 44)	CIRP
	22.05.20	SC	Appeal dismissed.	

Mr. Savan Godiwala, the liquidator of Lanco Infratech Limited v. Apalla Siva Kumar	14.02.20	NCLAT	Relies and builds on NCLAT judgement in *Moser Baer* Case. Where no fund is available, liquidator cannot be directed to pay. (pg. 15)	Liquidation
	07.02.23	SC	Set-aside the order relying on affirmation given to NCLAT order in *Moser Baer* Case.	
Sunil Kumar Jain v. Sundaresh Bhatt	19.04.22	SC	Payment to be made out of such funds, if available. [para 14(ii)]	Liquidation
Sikander Singh Jamuwal v. Vinay Talwar & Ors.	11.03.22	NCLAT	Section 17B of EPF Act requires payment upto the date of transfer by the transferee. Non-compliance of this section makes the plan violative of section 30(2)(e) of IBC. This section is not in conflict with any provision of IBC and will therefore prevail. [para 13(c)]	CIRP
	23.09.22	SC	Appeal dismissed.	
Jet Aircraft Maintenance Engineers Welfare Association v. Ashish Chhawchharia & Ors.	21.10.22	NCLAT	(a) Employees and Workmen are entitled to full payment of the entire provident fund and gratuity, relying on *Tourism Corporation* and *Moser Baer* case. (para 71) (b) Non-payment will invalidate the plan as being violative of section 30(2)(e), relying on *Sikander Singh Jamuwal* case. (para 97)	CIRP
	30.01.23	SC	Appeal dismissed.	
Moser Baer Karamchari Union thr. President Mahesh Chand Sharma v. Union of India and Ors.	02.05.23	SC	Section 327(7) of the Companies Act, 2013 which provides that instead of sections 326 and 327, section 53 of IBC shall be applicable in the event of liquidation under the IBC, is not violative of Article 21 of the Constitution....In case of liquidation of a company under IBC, the distribution of the assets shall have to be made as per section 53 of the IBC subject to section 36(4) of the IBC. (para 18)	-

Analysis of case-laws on exclusion of provident fund, gratuity and pension fund dues from liquidation estate

These decisions were analysed to find the reasoning which supports each decision. It was seen that in most cases, reliance was placed on other decisions and in SC, special leave petitions were summarily dismissed. So, independent reasoning in support of the issue was found only in above cases, which are now being discussed in detail: -

Tourism Finance Corporation of India Ltd. v. Rainbow Papers Ltd. & Ors. [CA(AT) (Ins.) No. 354 of 2019]

In this matter, when an argument was raised by SRA that section 7Q and 14B of the EPF Act cannot be relied upon as the provision of the IBC has overriding effect, the NCLAT had observed as follows –

> 44. However, as no provisions of the 'Employees Provident Funds and Miscellaneous Provision Act, 1952' is in conflict with any of the provisions of the 'I&B Code' and, on the other hand, in terms of Section 36(4)(iii), **the 'provident fund' and the 'gratuity fund' are not the assets of the 'Corporate Debtor', there being specific provisions, the application of Section 238 of the 'I&B Code' does not arise**… Therefore, we direct the 'Successful Resolution Applicant' … to release full provident fund and interest thereof in terms of the provisions of the 'Employees Provident Funds and Miscellaneous Provision Act, 1952' immediately, **as it does not include as an asset of the 'Corporate Debtor'**. The impugned order dated 27th February, 2019 approving the 'Resolution Plan' stands modified to the extent above.[emphasis supplied]

However, it is not clear as to what provisions of EPF were held to be consistent with IBC. The appeal against this order was also summarily dismissed by SC. Inquiry about the latest status of the case revealed that an application for liquidation of the CD has been filed. The NCLAT, in this matter, has read section 36(4)(a)(iii) – '*all sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund*' first, without considering the pre-condition in section 36(4)(a) – '*assets owned by a third party which are in possession of the corporate debtor, including*', and has in fact interpreted it in a reverse manner that these dues will not be the assets of the CD. However, when we read sub-clause (iii) and clause (a) of section 36(4) together, it does explicitly recognise the situation where the dues are from the funds, and same are third-party assets which are existing and are in possession of the CD.

State Bank of India v. Moser Baer Karamchari Union & Anr.[9] ***and Mr Savan Godiwala v. Mr. Apalla Siva Kumar***[10]

In *Moser Baer case*, the NCLT had observed, "*It is made clear that if there is any deficiency to the provident fund, pension fund and gratuity fund, then the liquidator shall ensure that the fund is made available in the aforesaid accounts, even if their employer has not diverted the requisite amount.*"

The NCLAT quoted section 36(4)(a)(iii) and observed the following from literal reading of the section –

> 13. From sub-section (4) (a) (iii) of Section 36, it is clear that all sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund, shall not be included in the liquidation estate assets and cannot be used for recovery in the liquidation.
>
> ….
>
> 24. Once the liquidation estate/ assets of the 'Corporate Debtor' under Section 36(1) read with Section 36 (3), do not include all sum due to any workman and employees from the provident fund, the pension fund and the gratuity fund, **for the purpose of distribution of assets under Section 53, the provident fund, the pension fund and the gratuity fund cannot be included.**[emphasis supplied]

The appeal against this order was summarily dismissed by SC. There were following two key takeaways from this order: -

Takeaway A - On examination of this order of NCLAT, it is found that if this order is read in isolation, it does not seem to suggest that in cases where the funds are not available or are insufficient, same have to be paid in priority of other dues. However, only when the NCLT order dated March 19, 2019 is read with order of NCLAT, one comes to understand that the NCLAT is covering even those dues where the funds are non-existing or are insufficient.

[9] State Bank of India v. Moser Baer Karamchari Union and Anr. (CA (AT) (Ins.) No. 396 of 2019) (19th August 2019).

[10] Company Appeal (AT) (Insolvency) No. 1229 of 2019.

Takeaway B - The order also reasoned that the dues of the workmen pertaining to provident fund, pension fund, etc. will not fall under section 53 as the 'workmen's dues' are defined in terms of section 325(3)(b) of the Companies Act, 2013 which does not prescribe any duration while section 53(1)(b)(i) prescribes duration of 24 months. It also argued that since these dues are already excluded under section 36(4)(a)(iii), these cannot be distributed under 53(1)(b)(i). However, this reasoning suffers from a defect, as in section 36(4)(a)(iii), the dues of workmen and employees are qualified with a pre-condition of existence of certain funds which are third party assets and are in possession of the CD, while no such qualification exists in section 53(1)(b). Also, the reasoning does not consider the *non-obstante* clause of section 53. Lastly, it has also not been considered that it is section 53 which prioritises certain category of claims over other claims, while section 36(4)(a) merely defines the obvious i.e. liquidation estate of CD will not include the third-party assets which are not owned by the CD but are in possession of CD, therefore, section 36 of IBC cannot override section 53 in terms of priority of distribution.

In fact **Takeaway A** is so prominent, that even in *Savan Godiwala*'s case, the NCLAT had relied on the observations made by NCLAT in *Moser Baer* case as they appear to be in line with what is written in the section 36(4)(a)(iii). Only when the NCLT orderisread together with NCLAT order in *Moser Baer* case, one comes to know of its true purport. The NCLAT in *Savan Godiwala*'s case, after relying on NCLAT's observations in *Moser Baer* case, had observed that –

> **Thus it is the settled position of law**, that the provident fund, the pension fund and the gratuity fund, do not come within the purview of liquidation estate' for the purpose of distribution of assets under Section 53 of the Code. Based on this, **the only inference which can be drawn is that Pension Fund, Gratuity Fund and Provident Fund can't be utilised, attached or distributed by the liquidator, to satisfy the claim of other creditors. Sec 36(2) of the I B Code 2016 provides that the Liquidator shall hold the Liquidation Estate in fiduciary for the benefit of all the Creditors.** The Liquidator has no domain to deal with any other property of the corporate debtor, which is not the part of the Liquidation Estate. **In a case, where no fund is created by a company, in violation of the Statutory provision of the Sec 4 of the Payment of Gratuity Act, 1972, then in that situation also, the Liquidator cannot be directed to make the payment of gratuity to the employees because the Liquidator has no domain to deal with the properties of the Corporate Debtor, which are not part of the liquidation estate**.[emphasis supplied]

The appeals against both *Moser Baer* and *Savan Godiwala* were being heard together by SC. This was perhaps a great opportunity before the SC to clarify the position considering all the aspects (as highlighted above), however, the appeal against *Savan Godiawala* also got summarily dismissed stating that it goes against NCLAT order of *Moser Baer*, without considering that the NCLAT's order in *Savan Godiawala* had in fact quoted NCLAT's order in *Moser Baer* and had further built on it.

Sunil Kumar Jain and others v. Sundaresh Bhatt and Ors.[11]

The only judgment of SC which has interpreted section 36(4)(a) and has provided an independent view is *Sundaresh Bhatt's* case, wherein the SC has *inter-alia* observed :–

> 13. Now so far as the dues of the workmen/employees on account of provident fund, gratuity and pension are concerned, they shall be governed by Section 36(4) of the IB Code. Section 36(4)(iii) of

[11] Civil Appeal No. 5910 of 2019.

> the IB Code specifically excludes "all sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund", from the ambit of "liquidation estate assets". **Therefore, Section 53(1) of the IB Code shall not be applicable to such dues, which are to be treated outside the liquidation process and liquidation estate assets under the IB Code. Thus, Section 36(4) of the IB Code has clearly given outright protection to workmen's dues under provident fund, gratuity fund and pension fund which are not to be treated as liquidation estate assets and the Liquidator shall have no claim over such dues.** Therefore, the concerned workmen/employees shall be entitled to provident fund, gratuity fund and pension fund from such funds which are specifically kept out of liquidation estate assets and as per Section 36(4) of the IB Code, they are not to be used for recovery in the liquidation.
>
> ….
>
> ii) considering Section 36(4) of the IB code and when the provident fund, gratuity fund and pension fund are kept out of the liquidation estate assets, the share of the workmen dues shall be kept outside the liquidation process and the concerned workmen/employees shall **have to be paid the same out of such provident fund**, gratuity fund and pension fund**, if any, available** and the Liquidator shall not have any claim over such funds.[emphasis supplied]

It suggests that section 53(1) does not apply to provident fund, gratuity, and pension dues as these dues are considered outside the scope of the liquidation estate and section 36(4)(a)(iii) clearly protects them. However, the non-application of section 53 is limited to the extent of such funds being available, as payment has to be made out of such funds. If the funds are not available, the question of application of section 36(4)(a)(iii) does not arise. This line of reasoning aligns with exclusion provided to third party assets under section 18(1)(f) and section 36(4)(a) of IBC, only to the extent of their availability and with a pre-condition of them being in possession of the CD.

Jet Aircraft Maintenance Engineers Welfare Association v. Ashish Chhawchharia, Resolution Professional of Jet Airways (India) Ltd. & Ors. [CA (AT)(Ins.) 752 of 2021]

The NCLAT in this matter had relied on *Tourism Finance Corporation* case and *Moser Baer* case and observed that provident fund dues are not subject to distribution under section 53(1) of IBC. It further observed that it is bound by the *Tourism Finance Corporation* case where direction was issued to the SRA to release full provident fund and interest thereof in terms the EPF Act.

Further, when the argument on the basis of observations of SC in *Sundaresh Bhatt's* case regarding the payment being dependent on the funds being ***available***, was raised before NCLAT, it had observed -

> Learned counsel for the Respondent has relied on words "if any, available" occurring in direction (ii). **The above words cannot be read to mean that the workmen and employees are not entitled for provident fund, gratuity fund and pension fund if not available with the Liquidator.**
>
> **69. The present is a case where resolution plan has been approved; present is not a case of liquidation.**[emphasis supplied]

Thus, it appears that the NCLAT has dismissed the argument without giving any counter reasoning. It appears that the whole judgment of *Sundaresh Bhatt*, was not seen in perspective. It was not merely the words '*if any, available*' which were relevant, rather, the words – '*have to be paid the same out of* ***such*** *provident fund*' were also pointing out that payment can be made only from those funds which were available with CD.

The NCLAT, however, in the next para, had distinguished *Sundaresh Bhatt's* case as being a liquidation case and *Jet Airways* case being a resolution case. This distinction may not be true since in CIRP also, minimum entitlement of all OCs flows from priorities under section 53. Further, as stated above, there is clear parity between exclusion of third-party assets from the estate of CD in section 18(1)(f) during CIRP and section 36(4)(a)(iii) during liquidation. Therefore, the minimum entitlement during both the processes flow from section 53 after exclusion of third-party assets in possession of the CD.

As may be noted that various appeals were filed against the orders of NCLAT quoted above, however, the appeals got summarily dismissed. In SC and NCLAT, the provisions have not been discussed holistically, considering the aspects highlighted in this paper. It would be of interest, when the legislative intent and the provisions as analysed above are considered in a case.

Moser Baer Karamchari Union thr. President Mahesh Chand Sharma v. Union of India and Ors. [Writ Petition no. 421 of 2019]

In this case, (i) the constitutionality of section 327(7) of Companies Act, 2013 which provides that section 326 and 327 of Companies Act 2013 will not be applicable in the event of liquidation under IBC, was challenged, and (ii) it was prayed for leaving the statutory claims of the 'workmen's dues' out of the purview of waterfall mechanism under section 53 under IBC. The SC highlighted the importance of section 53 and the treatment given to workmen's dues under section 53. It had *inter-alia* observed -

> **6.2**.....a conscious decision has been taken by the Parliament... in its wisdom to keep out of all sums due to any workman/employee from the provident fund, the pension fund and the gratuity fund from the liquidation estate assets [as per Section 36(4)] and that the workmen's dues for the period of twenty-four months preceding the liquidation commencement date shall rank equally between the workmen's dues to the said extent and the dues to the secured creditor. Therefore, the same cannot be said to be arbitrary and violative of Article 21 of the Constitution of India as contended on behalf of the petitioner. As per the settled position of law, IBC is a complete Code and the object and purpose of IBC is altogether different than that of the Act, 1956/2013. <u>The IBC is a new insolvency mechanism, therefore, the provisions under the IBC cannot be compared with that of the earlier regime, namely, the Companies Act, 1956/2013...</u>
>
> **9.** ...The workmen also have a stake and benefit from the revival of the company, and therefore unless it is found that the sacrifices envisaged for the workmen, which certainly form a separate class, are onerous and burdensome so as to be manifestly unjust and arbitrary, we will not set aside the legislation, solely on the ground that some or marginal sacrifice is to be made by the workers....
>
> **15.**...<u>Section 53 of the Code is the complete and comprehensive code which ensures collection of assets and then provides the manner in which the creditors are to be paid. Even the rights of the secured creditor falling under Section 53 of the Code to enforce, realise, settle, compromise or deal with the secured assets as applicable to the security interest are diluted and compromised.</u>...
>
> **18.** In view of the above and for the reasons stated above and as sub-section (7) of Section 327 of the Act, 2013 provides that Sections 326 and 327 of the Act, 2013 shall not be applicable in the event of liquidation under the IBC, which has been necessitated in view of the enactment of IBC and it applies with respect to the liquidation of a company under the IBC, Section 327(7) of the Act, 2013 <u>cannot be said to be arbitrary and/or violative of Article 21 of the Constitution of India.In case of the liquidation of a company under the IBC, the distribution of the assets shall have to be made as per Section 53 of the IBC subject to Section 36(4) of the IBC, in case of liquidation of company under IBC...</u>.[emphasis supplied]

Though, this case does not directly deal with interpretation of section 36(4)(a)(iii), however, the importance of hierarchy in payments under section 53 has been discussed in detail while upholding of constitutionality of sub-section (7) of section 327 of the Companies Act, 2013.

Non-payment of workmen and employee dues relating to provident fund, gratuity and pension dues by SRA leads to invalidity of resolution plan

In the case of *Sikander Singh Jamuwal*[12]*,* the NCLAT relied on section 7B of EPF Act which makes the transferor and transferee liable, jointly and severally, for paying contribution and other sums due from the employer under EPF Act, pension scheme, insurance scheme. It observed that –

> … From the above stated provisions of the PF Act that the Resolution Applicant is also liable to pay the contribution and other sums due from the employer under any provisions of this act as the case may be in respect of the period up to the date of such transfer. **All this requires that the explicit provisions of the above said PF Act needs to be complied with. This aspect is justiciable as a duty has been casted on the Resolution Professional/Adjudicating Authority/ on this Tribunal. This is not a commercial wisdom as compliance of law is a must.** The aspect of parity for payment of Finance Creditors and Operational creditors are not being looked into by this Tribunal as it is a commercial wisdom of CoC.[emphasis supplied]

The appeal against this order was summarily dismissed by the SC.

Similar reasoning has been taken by the NCLAT in the matter of *Jet Airways Limited*[13], wherein the NCLAT had observed that -

> … It is an admitted case that Corporate Debtor was covered by 1952 Act and Employees Provident Fund Scheme and it was statutory obligation of the Corporate Debtor to deposit provident fund contribution to EPFO. Resolution Professional in its affidavit dated25.07.2022 has stated that no contribution was deposited after February,2019, thus depositing of the provident fund contribution till 20.06.2019was statutory obligation of Corporate Debtor and **making no provision in plan for unpaid provident fund dues may lead to breach of Section 30(2)(e).**
>
> Further, the payment of Gratuity Act, 1972 **also cast a statutory obligation** on Corporate Debtor to make payment of Gratuity for those workmen and employee for which it became due till insolvency commencement date.
>
> ….
>
> **97. The above deficiencies in the plan need to be remedied by issuing appropriate direction to the Successful Resolution Applicant to make requisite plan so that plan may become compliant of Section 30(2)(e).**[emphasis supplied]

The appeal against this order was summarily dismissed by SC.[14] Inquiry about the latest status revealed that the resolution plan is yet to be implemented in *Jet Airways* case. Both the above decisions emphasise on statutory compliance under EPF Act and the Gratuity Act, 1972. However, the reasoning provided that non-payment of full provident fund and gratuity shall lead to violation of section 30(2)(e), doesn't seem logical. As per this reasoning, all the resolution plans will have to satisfy all statutory dues in full. Same reasoning can be extended to other statutory dues like GST dues, income-tax dues, electricity dues, etc. and with this reasoning all statutory dues will get super-priority under IBC, which is not the legislative intent.

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[12] Sikander Singh Jamuwal v. Vinay Talwar & Ors. [CA (AT) (Ins) No. 483 of 2019] (11th March 2022) (Para F).

[13] Jet Aircraft Maintenance Engineers Welfare Association v. Ashish Chhawchharia [I.A. No. 4355 of 2022 In Company Appeal (AT) (Insolvency) No. 752 of 2021].

[14] Jalan Fritsch Consortium v. Regional Provident Fund Commissioner [Civil Appeal No. 407 of 2023].

It appears that the courts have taken a sympathetic view considering the interests of workmen and employees. However, the objective of the IBC is maximisation of value of the CD and balancing the interest of all the stakeholders. In any insolvency, all the stakeholders accept a haircut to recognise the financial realities of an insolvency situation and participate in the resolution process for the overall benefit of all parties involved. Therefore, placing priority of employee/workmen dues in full goes against the objective of the IBC especially when the priority of government dues and workmen and employee dues (beyond 24 months and 12 months, respectively) has been given lower priority than that of FCs as seen in section 53 as well as in the longtitle of IBC.

A case where such dues are very high (like the case of *Kiran Udyog Pvt. Ltd.* covered below), may not even find a resolution applicant, if such dues need to be paid in full. Further, since such dues have to be paid even in priority to insolvency resolution process costs (CIRP costs), carrying on a CIRP may not be feasible in such cases, leading to a situation where no genuine attempt is made to carry out the CIRP, in absence of any incentives. Liquidation in few such cases may offset the entire benefit given to the EPFO, as in liquidation, the workers lose any chance whatsoever of being gainfully employed.

Further, under section 53, the priority is for claims of 24 months (for workmen) before the liquidation commencement date (LCD). However, in case of CIRP, there is no LCD and therefore, such date is being read as insolvency commencement date (ICD) for fixing minimum entitlement under section 30(2)(b). In a case, where there are no operations of CD during CIRP, the entitlement for workmen and employees in section 53 will actually be much less than that in CIRP, because of the shift in the date from ICD to LCD. So, if any case where resolution is not achieved, the workmen / employees stand to lose, as all their entitlements come down significantly because of change in date from which 24 / 12 months are being counted.

Further, as per this reasoning, the obligation is cast upon the SRA, and it goes against the well- established 'clean slate' theory, whereby, an SRA is allowed to continue the business of the CD on a clean slate basis extinguishing past liabilities of the CD.

Dues of employer under EPF Act vs dues payable to employees under IBC

As per section 6 of the EPF Act, certain percentage of basic wages, dearness allowance and retaining allowance, has to be contributed by both employer and employee. Section 7A of the EPF Act empowers the provident fund commissioners, to determine the '*amount due from any employer*' under the Act, pension scheme or insurance scheme. Section 7Q imposes interest '*payable by the employer*' @ 12% on the amount so due, till the date of actual payment. Section 14B empowers provident commissioner to '*recover from the employer*' by way of penalty / damages, when an employer makes default in the payment of any contribution to the funds. Section 11 provides for (i) statutory priority to '*amount due from the employer*' in the insolvency or winding up of the company, (ii) first charge on the assets of the CD.

The IBC has given priority to the dues which are owed to the workmen and employees and therefore, uses expressions like 'workmen's dues' and 'dues owed to employees'.[15] It does not give the same priority to the dues owed by the employer to statutory authorities like EPFO

[15] Insolvency and Bankruptcy Code, 2016, § 36(4)(a)(iii), §53(1)(b)(i) and §53(1)(c).

which are not directly owed to the workmen or employees. In fact, dues to workmen and employees beyond periods of 24 months and 12 months respectively have even lower priority than the priority of government dues of 24 months i.e. under section 53(1)(f) of IBC. So, different priorities have been envisaged for different set of dues depending on whether they are due to workman or employee and for which duration they are due for.

The NCLT (in the matters of *Diyesh Desai*[16], *Shri Addanki Haresh*[17] and *Excel Glass Limited*[18])has been treating dues in the nature of penal interest, penal damages and penalties payable by employer to EPFO as government dues under section 53 as these are not dues of the employees or workmen but are amounts due from the employer under EPF Act. However, recently, the NCLAT in the matter of *Anuj Bajpai*[19], had observed that –

> … the EPFO Authorities have powers to levy damages. It is also significant to note that **damages is in relation to non- payment or delayed payment of contribution under Section 7A of the EPF Act by the employer (the Corporate Debtor herein) therefore, the damages in a sense is to be treated as extended part of the contribution**.
>
> … an amendment was be made in the EPF Act vie amendment Act, 33 of 1988 w.r.f. 01.08.1988 which describes that without prejudice to the provision of sub-section 1 of **Section 11 of the EPF Act, "if any amount is due from an employer" amount so due shall be due to be first charge** on the assets of the establishment….[emphasis supplied]

For interpreting the phrase – '*if any amount is due from an employer*' under section 11 of the EPF Act, the NCLAT referred to the SC order wherein it was held that there is no reason to give a restricted meaning to the same and confine it to the amount determined under section 7A or the contribution payable under section 8. It was held that it will 'also' include the interest payable by the employer under section 7Q and damages levied under section 14B of EPF Act.[20] The NCLAT has observed -

> We note that in the present appeal the amount which has been claimed by the employer are covered under Section 7A, 7Q and 14B of the EPF Act and therefore are **fully governed by the judgement Maharashtra State Cooperative Bank (Supra)**.[emphasis supplied]

The order of NCLAT in *Anuj Bajpai case*is equating dues owed to the workmen and employee and payable to them under section 36 to mean dues 'owed by employer' under section 7A, 7Q, 14B of the EPF Act. It has relied on the SC interpretation of phrase '*any amount due from the employer*' in section 11 of the EPF Act. However, no such phrase has been used in the IBC. The IBC intends a different priority for dues of workmen and employees in section 53(1)(b)(i) and 53(1)(c) and accordingly, uses expressions like 'workmen's dues' and 'dues owed to employees'.[21] These phrases cannot be interpreted to mean '*any amount due from the employer*'

[16] Mr. Divyesh Desai v. Employees Provident Fund Organisation (I.A. 53 of 2022 in C.P.(IB) No. 619/MB/ 2018) (09th February 2024).

[17] Shri Addanki Haresh v. Recovery Officer, Employees Provident Fund Organisation [I.A NO. 232/2022 in C.P (IB) No.320/BB/2019] (20th July 2023).

[18] Regional Fund Commissioner v. Excel Glass Limited and Anr. [IA(IBC)/127/KOB/2023 in IBA/258/ CB/2019] (2nd August 2023)

[19] Mr. Anuj Bajpai (Liquidator) v. EPFO, Coimbatore & Ors. [CA (AT) (Ins.) No. 114 of 2023] (10th July 2024).

[20] Maharashtra State Cooperative Bank v. Assistant Provident Fund Commissioner & Ors. [Civil appeal no.6893 of 2009 (arising out of SLP (c) no.15243 of 2007)].

[21] Insolvency and Bankruptcy Code, 2016, § 53(1)(b)(i) and §53(1)(c).

and include penal interest, damages and penalties imposed. These essentially are the dues owed to the Government having a different priority under IBC.

In the matter of Kiran Udyog Pvt. Ltd.

In this matter, the EPFO submitted claim of approx. ₹9.21 crore.[22] Insolvency Professional did not receive any claims from workmen / employees, probably in view of the full and final settlement done by CD with employees in August 2021, which was almost 2 years before the ICD i.e. May 24, 2023. However, EPFO based its claims on the basis of information available with them.

The fair value of CD is approx. ₹0.9 crore. Two resolution plans were received with one of them offering less than fair value and another one offering more than double the fair value. Since all dues of EPFO (which include penal interest, damages and penalties) were required to be paid under the resolution plan in terms of order of NCLAT in *Jet Airways* case, and since none of the plans could provide for full payment of aforesaid dues, an application has now been filed for liquidation of the CD.

Hence, the EPFO may get money, out of whatever is received from proceeds of liquidation of the CD, but this money may lie unclaimed as it is highly unlikely that workers will ever claim their dues from EPFO, in view of the full and final settlement. These funds may ultimately end up being used for benefit of employees in general, and not by the employees of the CD.

CONCLUSION

The executive and legislature have provided a differential treatment to different classes of creditors under IBC, keeping in view the overall objective of IBC of promoting the availability of credit and balancing the interests of all stakeholders. When a CD comes into CIRP, the proceedings are *in rem* proceedings and the interests of all stakeholders need to be protected.

From the analysis done, the following treatment of dues of workmen and employees from the provident fund, gratuity fund and pension fund, appears to be in line with the legislative intent -

(a) **Where CD has maintained any specific provident fund, pension fund and gratuity fund which are in its control and possession**: When a company undergoes CIRP / liquidation, the first thing required is determination of the estate of the CD. What does not belong to the CD, cannot be part of the estate of the CD. Accordingly, the third-party assets have been excluded under section 18(1)(f) and section 36(4)(a). In fact, even if they had not been specifically mentioned in these sections, yet such assets would not have ever become part of estate of CD. They are merely clarificatory in nature. Section 36(4)(a)(iii) which excludes dues of workmen and employees from the provident funds, pension funds and gratuity funds, is subject to section 36(4)(a) which excludes only such assets which are in possession of the CD. Hence, only such provident funds, pension funds and gratuity funds which are maintained by the CD and are in

[22] The Employees' Provident Funds and Miscellaneous Provisions Act, 1952, § 7A (4.45 cr.), § 7Q (1.58 cr.) and § 14B (3.18 cr.)

possession of the CD, are to be excluded from liquidation estate under section 36(4) and dues from such funds would be payable to workmen/employees.

It appears that clause (a) of section 36(4), has not been considered by courts, while considering the exclusion of these funds from the estate of the CD under sub-clause (iii). The interpretation that all dues of workmen and employees are covered under section 36(4)(a)(iii) – '*all sums due to any workman or employee from the provident fund, the pension fund and the gratuity fund*', without referring to the pre-condition in section 36(4)(a) – '*assets owned by a third party which are in possession of the corporate debtor, including*', has made clause (a) redundant. It is only when we read sub-clause (iii) and clause (a) of section 36(4) together, the correct interpretation of exclusion of those dues for which the funds are available with the CD as third-party assets, can be arrived.

(b) Where CD has not maintained any specific provident fund, gratuity fund or pension fund or the funds are insufficient to meet the dues: When these funds are not available or there is deficit or are not in possession of CD, the operation of section 36(4)(a) cannot make these unavailable funds, available for workmen and employee. In such a scenario, the protection is accorded under section 53(1)(b)(i) and 53(1)(c) which covers these dues under workmen's dues and employee's dues for a definite period. Any dues beyond such period have been given lower priority.

Section 36 deals with 'assets' which form and do not form part of liquidation estate, while section 53 deals with the priority of payment of liabilities of different categories. Though both are dealing with dues owed to workmen and employees from the provident fund, gratuity fund and pension fund, they are dealing with them in different context.

The above treatment must also be common for both CIRP and liquidation, since in CIRP also (i) the minimum entitlement of all OC sunder section 30(2)(b), flows from priorities under section 53, and (ii) there is parity between exclusion of third-party assets from the estate of CD in section 18(1)(f) during CIRP and section 36(4)(a)(iii) during liquidation.

Also, the view that the SRA is liable to pay the past statutory dues of the CD under EPF Act and Gratuity Act to save the resolution plan from invalidity, goes against the 'clean slate principle'. The intent of section 30(2)(e) is not to cover all past statutory dues and make the resolution applicant to pay for such dues. If this view is adopted, all government dues will get super-priority under IBC which is not the legislative intent.

Further, when the 'dues payable to workmen and employees' from these funds are determined, same should not be equated with 'dues owed by the employer' to statutory authorities like EPFO under the EPF Act. While interpreting these terms, the ultimate beneficiary of these dues has to be kept in mind. The dues which will not be available to workmen / employees and will remain with the Government department must not be treated as dues payable / owed to the workmen / employees. Such dues should be treated alike other Government dues.

The paper has attempted to analyse the provisions holistically along-with their legislative intent and the overarching objective as evident in the long title of IBC. The authors sincerely believe that it will be in fitness of things if considering the arguments raised in this paper, jurisprudence is further developed on the subject matter.

07

STRENGTHENING VALUATION FRAMEWORK UNDER IBC: ENHANCING CREDIBILITY, CONSISTENCY, AND COMPETENCE

Satish Sethi and Archana Sharma

"Accurate valuation is the backbone of effective financial decision-making. Without it, markets cannot function properly, and resources are misallocated."

-Robert Shiller, Nobel Laureate in Economics and Professor at Yale University

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) marked a paradigm shift in India's approach to insolvency resolution, with its core objectives centered on the timely resolution while maximizing the value of assets of the debtor. At the heart of this transformative framework lies the critical process of valuation, which plays a pivotal role in determining the fate of debtor and realisation prospects for the creditors.

Valuation under the IBC is not merely a numerical exercise; it is a complex process that requires a delicate balance of financial acumen, legal understanding, and ethical considerations. The accuracy and fairness of valuations can significantly impact the outcomes of insolvency proceedings, affecting stakeholders ranging from financial creditors to operational creditors (OCs) and from resolution applicants to the wider economy.

This article delves into the intricate aspects of valuation under the IBC, exploring its evolution since 2016, analysing key challenges and developments, and drawing insights from international perspectives. It also outlines the path forward for strengthening and enhancing India's insolvency valuation framework.

Since its inception in 2016, the valuation framework under the IBC has undergone significant evolution, reflecting the dynamic nature of insolvency proceedings and need for a robust valuation ecosystem.

As per the legal architectural scheme, in 2017, the Companies Act, 2013 notified the concept of 'Registered Valuers' (RVs) under section 247 of Chapter XVII to conduct valuation, and regulate the practice ensuring transparency, accountability and better governance during a valuation exercise. The Central Government, thereafter, designated the Insolvency and Bankruptcy Board of India (IBBI/ Board/ Authority) as the 'Authority' under section 458 of the Companies Act, 2013 and notified the Companies (Registered Valuers and Valuation) Rules, 2017 (Valuation Rules) to provide a comprehensive framework for development and regulation of the profession of valuers through a two-tier regulatory structure involving registered valuer organisations (RVOs) as front-line regulators. In essence, the power to notify standards for the valuation profession rest with the Central Government while the responsibility of registration, regulation and development of valuers is entrusted with the Authority.

VALUATION IN THE CONTEXT OF IBC

The IBC established a new institutional framework, transitioning from a 'debtor in possession' model to a 'creditor in control' model. The critical role of valuation, valuers and interpretation of various provisions has been underscored by Hon'ble Courts, Appellate Tribunal and the Adjudicating Authority (AA) in several judgements.

In the extant IBC framework, there are two types of valuations - Fair Value (FV) and Liquidation Value (LV). While the Code itself does not explicitly define these terms, the initially notified regulations[1] for the corporate insolvency resolution process (CIRP) referred to LV without providing a definition. However, the amendments to the CIRP Regulations in February 2018[2] introduced the concept of FV and clearly defined both the FV and LV. FV is the estimated realizable value of the corporate debtor's (CD's) assets if exchanged on the insolvency commencement date between a willing buyer and a willing seller in an arm's-length transaction, with proper marketing and knowledgeable, prudent, and non-compulsory actions by both parties. LV, on the other hand, is the estimated realizable value of the CD's assets if the CD were liquidated on the insolvency commencement date.

In the CIRP, valuation plays a multi-faceted role. It aids the committee of creditors (CoC) in determining viability of business as a going concern, evaluating the feasibility of resolution plans, and deciding whether to proceed with resolution or liquidation of the CD. Jurisprudence has settled that the valuation exercise is conducted to facilitate the CoC's decision-making process. Therefore, the existence of a valid and accurate valuation report is *sine qua non* for the CoC to exercise its commercial wisdom objectively. A valuation consisting of mere naked values without a detailed report is not valid.[3]

Additionally, it ensures transparency, fairness, and equitable distribution among stakeholders, particularly OCs and dissenting creditors in a resolution plan. Even for other creditors, valuation helps in determine their nature and extent of security interest. In a landmark judgement, the Hon'ble Supreme Court emphasized the importance of equitable treatment of different classes of creditors.[4] The Insolvency and Bankruptcy Code (Amendment) Act, 2019, further clarified the position of OCs in the distribution waterfall, leading to more nuanced valuation approaches.

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[1] Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016, notified on 30.11.2026, w.e.f. 01.12.2016.

[2] Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations, 2018, notified on 06.02.2018.

[3] Periasamy Palani Gounder v. Radhakrishnan Dharmarajan & Anr. [CA (AT) (CH) (Ins.) No. 164, 176, 218 & 219 of 2021], NCLAT, 17.02.2022.

[4] Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta / Ors. [Civil Appeal No. 8766-67 of 2019], Supreme Court, 15.11.2019.

For prospective resolution applicants, valuation is essential for assessing the worth of the CD and plays a key role in determining appropriate bid amounts or formulating resolution plans. An accurate valuation ensures that applicants can make informed decisions, balancing potential risks and returns while aligning their proposals with potential viability of the CD.

Valuation further assists Insolvency Professionals (IPs) in assessing and reporting on any avoidance transactions.

During the liquidation process, valuation provides the benchmark for selling the CD as a going concern or for selling its assets through various modes. In a voluntary liquidation process, the declaration to initiate the process must be accompanied by a valuation report prepared by a RV, ensuring that the assets are accurately assessed and that stakeholders have a reliable basis for making informed decisions.

For individuals involved in the bankruptcy process as personal guarantors to a CD, valuation is essential for estimating the realisable value of the assets, which may or may not form part of the bankrupt's estate.

KEY ASPECTS OF VALUATION FRAMEWORK IN IBC

The IBC has established a robust framework for valuation and valuers, encompassing a detailed regulatory architecture for RVs and RVOs. These features collectively ensure the effectiveness of the valuation framework under the IBC. Key aspects of this framework are discussed in the ensuing paragraphs.

Requirement of Registered Valuers

Valuation under the IBC must be conducted by RVs regulated under the Companies Act, 2013. The valuation conducted by RVs during the CIRP is a statutory valuation and holds a distinct role. It cannot be altered by the Resolution Professional (RP) or the resolution applicant or ignored by the CoC. While the CoC may request a fresh valuation under valid circumstances, the valuation performed by RVs serves a specific and critical purpose and cannot be disregarded.[5]

Adherence to International Standards

RVs must conduct the valuations in accordance with the valuation standards notified by the Central Government. However, until notification of such valuation standards, RVs are required to follow internationally accepted valuation standards or valuation standards adopted by any RVO. The process regulations under the IBC aim to standardise the valuation process by mandating RVs to assess the value of a CD in accordance with internationally accepted valuation standards. This approach ensures that valuations are accurate and reliable, adhering to an internationally accepted framework.

[5] Kotak Mahindra Bank Ltd. and Anr. v. RP of Universal Buildwell Pvt. Ltd. And Anr. [CA (AT) (Insolvency) No. 661 of 2021], NCLAT, 11.04.2023.

Dual valuer requirement

Currently, the IBC regulations mandate the RP to appoint two RVs to determine the fair and liquidation values of the CD. This dual-valuation system is formulated to address any subjectivity in the valuation estimates, enhancing the integrity of the valuation report.

The 2018 amendments to the Liquidation Regulations[6] improved practices by eliminating the requirement to appoint two RVs to value assets, allowing for consideration of valuations conducted during the insolvency resolution process. This change aimed to reduce process costs and expedite proceedings.

Valuation by a third valuer - addressing significant variations

In case of a significant differences between the two valuation estimates i.e., difference which exceeds 25%, a third valuer may be appointed. The final valuation is then determined by averaging the two closest estimates. This multi-tiered approach aims to address potential biases and ensure more accurate outcomes.

Physical verification of assets by RVs

Valuers are required to conduct physical verification of the assets of the CD during the valuation process, adding a layer of credibility and authenticity to the valuations.

Code of Conduct for RVs and robust monitoring mechanisms

The Valuation Rules set standards of professional conduct and performance for the valuation profession in the interest of stakeholders. These Rules mandate RVs to adhere to a strict code of conduct, enforced by their respective self-regulatory organizations (the RVOs). Additionally, these rules provide oversight by both the Authority and the RVOs. A peer review mechanism is also laid down to further enhance the credibility of the valuation process, ensuring that valuations are conducted with a high level of accuracy, consistency, and adherence to best practices.

Disclosure requirements

Under the IBC, transparency and accuracy in the valuation of assets are critical for ensuring fair outcomes in the insolvency cases. Various provisions require disclosure of FV and LV to ensure that all relevant parties have access to accurate and relevant information. For instance, in the CIRP, creditors are entitled to receive information regarding the FV and LV of the assets, subject to a confidential undertaking. FV disclosure for prospective resolution applicants is included in the information memorandum (IM), at the discretion of the CoC. Similarly, in the liquidation process, disclosure of value is required in the asset memorandum while in the bankruptcy process, it is required in the preliminary report.

[6] Insolvency and Bankruptcy Board of India (Liquidation Process) (Second Amendment) Regulations, 2018, notified on 22.10.2018.

Robustness of valuation reports: Guidelines on use of caveats, limitations and disclaimers by RVs[7]

The Rules mandate that RVs must include caveats, limitations, and disclaimers in their valuation reports to explain any constraints faced during the valuation process. However, these should not limit the RV's responsibility, thereby ensuring accountability and maintaining the valuation's suitability for its intended purpose. Despite this, the scope of what constitutes appropriate caveats, limitations, and disclaimers is not always clear to RVs or users, leading to inconsistent practices in how these are presented in valuation reports. To address this, the Authority has issued guidelines providing clear instructions on the use of caveats, limitations, and disclaimers. These guidelines enhance the credibility of valuation reports by offering specific guidance to RVs and include an illustrative list of caveats, limitations, and disclaimers that should not be used in a valuation report.

CONTEMPORARY ISSUES IN IBC VALUATION LANDSCAPE

Valuations play a critical role in the IBC regime, as they directly influence the decision-making of the CoC, prospective resolution applicants and other stakeholders. However, despite the evolving regulatory framework, certain areas require attention and targeted interventions.

Information asymmetry

One of the foremost challenges faced by valuers is the difficulty in accessing complete and accurate information about the distressed company. Valuers often rely on the data provided by the IPs, which may be incomplete or received in a staggered manner due to various inherent limitations and biases. This lack of reliable information can result in inaccurate valuations, which, in turn, may lead to suboptimal resolution outcomes. The information asymmetry also creates an imbalance among stakeholders, as some may have access to more detailed information than others, further complicating the valuation process. Consequently, the ability to complete valuations within the prescribed timelines is adversely affected.

Industry-specific and asset-specific nuances

Each industry and asset class has unique characteristics that can significantly impact valuation. In the current valuation framework under IBC, the FV and LV are to be determined for a CD. The Authority registers valuers in three broad asset classes viz., Land and Building, Plant and Machinery and Securities & Financial Assets. The current valuation framework may not fully account for the industry-specific nuances and also asset-specific peculiarities. For instance, the valuation of distressed assets in the real estate sector differs greatly from that in the manufacturing or technology sectors.

Additionally, there can be confusion regarding the correct asset class categorization for valuations, particularly when conducted by a RV registered in a specific asset class. For example, the inventory of flats held by a real estate company may be valued by a RV registered for the Land and Building asset class. Conversely, if the same inventory belongs to a company outside the real estate sector, it might be valued by a RV registered for Securities & Financial

[7] IBBI (Use of Caveats, Limitations, and Disclaimers in Valuation Reports) Guidelines, 2020, 01.09.2020.

Assets class. Consequently, a one-size-fits-all approach can lead to improper valuations that fail to capture the true value of the assets, potentially causing disagreements among stakeholders and resulting in misleading outcomes.

Inconsistencies in valuation methodologies

Under the IBC framework, RVs are required to compute FV and LV according to internationally accepted standards, after physically verifying the inventory and fixed assets of the CD. However, the Central Government has not yet notified specific valuation standards for the Indian IBC framework. This leaves RVs with the discretion to choose from various international standards, which may lead to discrepancies in valuation outcomes.

Moreover, the valuation framework does not address the subjectivity involved in valuation assumptions or the choice of methodologies. This lack of standardisation can cause significant variations in valuation reports, as different valuers may use different approaches. Such inconsistencies can confuse stakeholders, lead to disputes among creditors, delay the resolution process, and potentially hinder successful outcomes. Establishing standardised methodologies specifically for distressed assets could help mitigate these issues and enhance the reliability of the valuation process.

Independence and objectivity of valuers

Ensuring the independence and objectivity of valuers is crucial for maintaining the credibility of the insolvency process. The valuers are mandated to adhere to the laid down code of conduct. At the time of appointments, there are specific eligibility requirements to ensure independence and avoid conflict of interest. Additionally, there are relationship disclosure obligations on the IPs while making such appointments. However, there have been concerns regarding potential conflicts of interest, particularly when valuers have prior associations with certain stakeholders, such as creditors or the distressed company itself. Such conflicts can compromise the objectivity of the valuation, leading to biased outcomes that favour specific parties over others. Strengthening the regulatory framework to enforce greater independence and mitigate conflicts of interest is essential for enhancing trust in the valuation process.

EMERGING AREAS IN IBC VALUATION

As a relatively recent economic legislation, the IBC necessitates ongoing adjustments to the insolvency landscape. Several emerging areas are anticipated to impact valuations significantly while also creating opportunities for the professionals. Below, we explore some of these future considerations and their potential effects on the valuation process.

Technology adoption in valuation processes

There is a need for integrating technology into valuation processes to facilitate the efficient valuation of diverse asset types, which may be spread across various geographies. The IBC process involves multiple stakeholders, and without appropriate technology tools, discussions around valuation reports can become time-consuming. Therefore, for efficient valuation and effective stakeholder engagement, the use of technology is imperative. Data analytics and artificial intelligence can enhance valuation accuracy, while blockchain technology can improve transparency and reduce information asymmetry. However, implementing these technologies requires well-defined guidelines to address accessibility, privacy, security, storage, and other cyber security concerns related to handling sensitive financial data. Additionally, geo-tagging of assets can further improve accuracy and management. Guidance can be drawn from various government schemes[8] using geo-tagging technologies.

Valuation in cross-border insolvency cases

As India moves towards adopting cross-border insolvency provisions, valuers will have new opportunities. The cross-border insolvencies would entail requirement of dealing with assets located in multiple jurisdictions. The involvement of multiple jurisdictions would eventually require thorough understanding and navigation through different accounting standards and valuation practices. The country-specific risks and regulations will have a deeper impact on the valuations. Owing to the inherent vastness and complexities, the 'Report on the rules and regulations for cross-border insolvency resolution'[9] has recommended that the AA may grant any discretionary relief that may be available to a RP or liquidator under the Code, including permitting the foreign representative to conduct a valuation of the CD.

Valuation in group insolvency cases

In Group Insolvencies, the web of inter-connected transactions between the group entities would entail requirement of dealing with assets with a nuanced approach. This inter-connectedness opens new avenues for professional growth, offering RVs opportunities to expand their expertise. The involvement of multiple entities would eventually require careful consideration of ownership of assets and navigation through different accounting standards and valuation practices. In group coordination proceedings, a group strategy may provide measures to coordinate and synchronise different aspects of the insolvency proceedings of participating group members and may include undertaking a combined valuation of all or any of the assets of the participating group members.[10]

Environmental, social, and governance (ESG) considerations

There is a growing recognition of the need to incorporate ESG factors in insolvency domain and valuations.[11] The ESG aspects include assessment of environmental liabilities and sustainability of business models, impact of social factors like labour practices and community relations and evaluating governance structures and their impact on long-term value.

COMPARATIVE INSIGHTS FROM INTERNATIONAL JURISDICTIONS: INTERNATIONAL PERSPECTIVES

Examining international best practices can provide valuable insights for improving India's valuation framework under the IBC.

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[8] Rashtriya Krishi Vikash Yojana (RKVY), Pradhan Mantri Awas Yojana Housing for All (Urban), Pradhan Mantri Jan Vikas Karyakram (PMJVK), Pradhan Mantri Awaas Yojana-Gramin, Shyama Prasad Mukherji Rurban Mission, Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS), Pradhan Mantri Gram Sadak Yojana (PMGSY) and several others.

[9] Cross Border Insolvency Rules/ Regulations Committee (CBIRC), *Report on the Rules and Regulations for Cross-border Insolvency Resolution*, (June. 2020).

[10] Cross Border Insolvency Rules/Regulations Committee (CBIRC-II), *Report of CBIRC-II on Group Insolvency*, (Dec. 2021).

[11] The World Bank, Business Ready (B-Ready), *Concept Note on Business Enabling Environment*, (2023-2024).

To understand how India can enhance its valuation framework under the IBC, it is useful to examine the valuation practices adopted by other jurisdictions, such as the United Kingdom, Singapore, the United States, and Australia.

United States

The US bankruptcy framework places significant emphasis on the credibility and transparency of the valuation process through the determination of "fair market value" of assets. The concept of "cramdown" in Chapter 11 proceedings, where a reorganization plan can be confirmed over the objections of certain creditors, relies heavily on accurate valuations. The valuations also hold importance to assess the reorganization value of the company which is crucial for determining the feasibility of reorganization plans. Valuers are required to provide detailed explanations of the methodologies and assumptions used in their valuations, and there are stringent requirements for disclosure and documentation.

In the US, the valuation process during bankruptcy proceedings is governed by a combination of federal bankruptcy laws, particularly under Title 11 of the United States Code, and the standards set by professional organizations such as the American Society of Appraisers (ASA)[12] and the Appraisal Foundation, which issues the Uniform Standards of Professional Appraisal Practice (USPAP)[13]. The USPAP plays a significant role in ensuring consistency and reliability by setting the necessary standards for developing and reporting appraisals. This helps reduce discrepancies and enhances stakeholder confidence in the valuation process.

United Kingdom

The UK insolvency regime[14] focuses on the "going concern value" in administration proceedings. The concept of "pre-pack" administrations in the UK offers interesting perspectives on rapid valuations and sales. The insolvency practitioners play a crucial role in the valuation process.[15]

The UK's insolvency framework emphasizes the need for transparency and consistency in the valuation process. It follows the International Valuation Standards (IVS) issued by the International Valuation Standards Council (IVSC).[16] These standards provide a comprehensive framework for valuation, covering various asset classes and providing guidance on valuation methodologies. The use of the IVS ensures that valuations are conducted in a standardised manner, reducing the risk of discrepancies and enhancing the credibility of the process. Additionally, the UK's insolvency framework requires that valuation reports include detailed explanations of the methodologies and assumptions used, providing stakeholder-s with a clear understanding of the basis for the valuation.

[12] American Society of Appraisers (ASA), https://www.appraisers.org/.

[13] Uniform Standards of Professional Appraisal Practice (USPAP), https://www.appraisalfoundation.org/imis.

[14] Insolvency Act 1986, https://www.legislation.gov.uk/ukpga/1986/45/contents.

[15] R3 — Rescue Recovery Renewal, https://www.r3.org.uk/.

[16] International Valuation Standards Council (IVSC), *New edition of the International Valuation Standards (IVS)* published, IVSC, 2024. RICS, *International Valuation Standards (IVS)*, 2024.

Singapore

Singapore's insolvency laws, recently reformed to provide for a robust valuation framework. The country's emphasis on mediation in insolvency proceedings offers an interesting model for resolving valuation disputes.

Singapore's insolvency framework, governed by the Insolvency, Restructuring and Dissolution Act (IRDA)[17], also emphasizes the importance of accurate and consistent valuations. Valuations in Singapore are typically conducted by professionals who adhere to the standards set by the Singapore Accountancy Commission (SAC)[18] and the Institute of Valuers and Appraisers, Singapore (IVAS).[19]

Singapore's approach to valuation is characterized by a strong emphasis on professionalism and accountability. The use of standardised valuation methodologies and assumptions is encouraged, reducing the potential for discrepancies and enhancing the reliability of the valuation process.

Australia

Australia's insolvency framework is governed by the Corporations Act 2001[20], which emphasizes the importance of accurate and consistent valuations during insolvency proceedings. Valuations are typically conducted by professionals who adhere to standards set by bodies such as the Australian Valuation Standards Board (AVSB)[21] and the Australian Property Institute (API).[22] The framework underscores the need for transparency and accountability, ensuring that valuations follow standardised methodologies to reduce discrepancies and enhance credibility. Additionally, the Corporations Act 2001 and related regulations require valuers to follow strict ethical guidelines.

Comparing valuation practices across jurisdictions reveals several lessons that could strengthen the IBC valuation framework. Key takeaways include the adoption of uniform valuation standards, as seen in the UK, Singapore, the US, and Australia, which reduces discrepancies and enhances reliability through standardised methodologies. Additionally, there is increasing emphasis on utilising technology in valuation, such as automated valuation models (AVMs) and data analytics. These technologies can boost accuracy and efficiency by analysing large datasets, real-time market information and facilitating company-specific valuations through asset tracing, detect hidden liabilities, and valuing complex assets. This technological integration has the potential to simplify the valuation process, reduce human error, and improve overall transparency. Moreover, actively engaging stakeholders, as practiced in the UK and Singapore, is crucial for ensuring transparency and incorporating all relevant information.

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[17] Insolvency, Restructuring and Dissolution Act (IRDA), https://sso.agc.gov.sg/.

[18] The Accounting and Corporate Regulatory Authority (ACRA) [Singapore Accountancy Commission (SAC) merged with it], https://www.acra.gov.sg/who-we-are/overview-of-acra.

[19] Institute of Valuers and Appraisers, Singapore (IVAS), https://www.acra.gov.sg/accountancy/professional-development/chartered-valuer-and-appraiser-programme/ivas.

[20] Australian Corporations Act 2001, https://www.legislation.gov.au/.

[21] Australian Valuation Standards Board (AVSB), https://aasb.gov.au/.

RECENT LEGAL AND REGULATORY DEVELOPMENTS

The valuation framework has evolved significantly over time, with ongoing efforts to better align it with market demands and integrate practical insights gained from experience. Recent legal and regulatory interventions have further strengthened this framework, addressing emerging challenges and refining processes to enhance its effectiveness. These developments are discussed in ensuing paragraphs.

Disclosure of fair value

A recent amendment to the CIRP regulations[23] now allows for the disclosure of FV in the IM. While the CoC retains the discretion to withhold this information if it considers that non-disclosure would benefit the resolution process, such a decision must be carefully justified and documented.

This measure represents a significant shift toward enhancing transparency in the resolution process, providing stakeholders with a clearer understanding of the CD's worth. Earlier, valuation reports were shared exclusively with the CoC, creating a disparity in information between the CoC and prospective resolution applicants. This information asymmetry often discouraged potential bidders who feared that others might have access to more accurate data on the company's value. By making FV part of the IM, all resolution applicants would have equal access to critical information, fostering a more competitive bidding environment and attracting serious bidders. This increased transparency is expected to lead to more accurate and competitive bids, ultimately resulting in better resolution outcomes.

Overall, this change is poised to streamline the due diligence process, enhance trust among stakeholders, and contribute to the formulation of more viable and well-valued resolution plans.

Discussion of valuation methodology with CoC[24]

A recent amendment to the CIRP regulations has mandated the RP to facilitate a meeting between RVs and the CoC wherein the RV shall explain the methodology being adopted to arrive at valuation to the members of the CoC before computation of estimates. This proactive measure allows valuers to explain their methodologies upfront, aiming to enhance transparency, improve the CoC's early understanding of the valuation process, enable more informed decision-making, and reduce potential disputes. Previously, the CoC received valuation reports only after the submission of resolution plans, which often limited their understanding of the FV and LV at early stages of decision-making. This delay also led to disagreements over valuation methodologies and hampered informed decisions regarding the eligibility of prospective resolution applicants. By promoting early communication, this amendment is expected to significantly improve decision-making processes and minimize conflicts related to valuations.

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[22] Australian Property Institute (API), https://www.api.org.au/.

[23] Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations, 2024, notified on 15.02.2024.

[24] *Id.*

Submission of valuation report to the CoC[25]

Under a new requirement, after receiving resolution plans, the RP is mandated to provide not only FV and LV but also valuation report to each member of the CoC in electronic form. The CoC members must provide an undertaking to maintain confidentiality and ensure that information is not misused. This requirement enhances transparency by ensuring uniform access to valuation data, which supports informed decision-making and helps reduce potential disputes. It also safeguards the integrity of the process by preventing misuse of sensitive information.

Introduction of Valuation Report Identification Number[26]

The IBBI has recently introduced the requirement of generating a Valuation Report Identification Number (VRIN) by the RVs, including registered valuer entities (RVEs) for each valuation conducted under the IBC. The introduction of VRIN brings multiple advantages to the valuation process. It significantly enhances the authenticity and traceability of valuation reports, standardizing identification practices across the ecosystem. The mandate on the IPs for not accepting any valuation report without VRIN facilitates twin-fold compliance approach and better monitoring by the IBBI. It aims to boost stakeholder confidence by providing an easy verification method. Collectively, these benefits will create a more transparent, reliable, and streamlined valuation ecosystem.

Progressing towards a simpler standardised approach: A cost-sensitive approach for valuation of smaller companies and MSMEs[27]

A recent consultation paper issued by the IBBI suggests a single valuation estimate for smaller CDs with assets up to a certain threshold, as well as for Micro, Small, and Medium Enterprises (MSMEs).

The requirement of appointing two RVs, along with the option to bring in a third valuer under certain conditions, tends to increase the costs involved in the resolution process, especially for smaller companies and MSMEs. These CDs are typically more sensitive to costs, and any escalation in costs can impact the likelihood of successful resolution. Additionally, any delays in the appointment process of RVs further exacerbate the financial distress of these CDs, undermining the objective of timely resolution under the IBC.

Internationally, there is recognition of the need to tailor insolvency processes to the size and complexity of the distressed entity. For instance, the US bankruptcy framework allows for simplified procedures for smaller businesses under Chapter 11, which include streamlined valuation processes to reduce costs. Similarly, in Australia, insolvency practitioners have the discretion to adjust their approach based on the size and complexity of the case, often relying on a single valuer for smaller entities unless additional scrutiny is deemed necessary. These international practices highlight the importance of flexibility and cost-sensitivity in insolvency frameworks, particularly for smaller entities.

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[25] *Id.*

[26] IBBI Circular No. IBBI/RV/75/2024 dated 12.08.2024.

[27] IBBI Discussion Paper dated 19.06.2024.

Therefore, the proposal to appoint only one RV, while allowing the CoC to decide on additional valuations, if necessary, is a positive step towards making the resolution process more accessible and efficient for these CDs.

WAY FORWARD FOR VALUATION FRAMEWORK IN INDIA: POTENTIAL AREAS FOR REFORMS AND CAPACITY BUILDING

To strengthen the valuation ecosystem under the IBC, several measures can be considered:

Standardisation and best practices for valuation

The diversity of valuation standards and methodologies may lead to inconsistencies and varying assessments of the same asset, potentially impeding decision-making and extending resolution timelines. Standardisation of valuation practices is crucial for ensuring consistency and fairness across the insolvency ecosystem. Adopting uniform valuation methodologies for distressed assets is essential, as it provides a consistent approach to assessing value. The Indian IBC framework would benefit from a more comprehensive set of prescribed standards, methodologies, and assumptions for all valuations conducted under the IBC. This would ensure that valuations are consistent, transparent, and credible, thereby enhancing the reliability of the resolution process.

Developing standardised templates for valuation reports ensures that all necessary information is consistently presented, reducing the likelihood of errors and omissions.

Additionally, industry-specific valuation guidelines may be explored to address unique challenges faced by different sectors, ensuring that valuation approaches are tailored to the specificities of the industry.

Establishing a centralised database of valuation reports of the concluded IBC processes can serve as a valuable resource for benchmarking and promoting transparency, enabling stakeholders to access historical data and trends.

These measures collectively aim to elevate the quality and reliability of valuations conducted under the IBC, ensuring that they meet the highest standards of accuracy and consistency.

Potential legal and regulatory reforms

To strengthen the valuation ecosystem under the IBC, introducing a tiered system of valuation based on the complexity and size of insolvency cases can ensure that valuation efforts are proportionate and appropriate to the nature of the case. This approach allows for a more nuanced and resource-efficient process, where simpler cases undergo basic valuation procedures while more complex cases receive comprehensive and detailed assessments. The recent proposal by the Authority for a cost-sensitive approach for valuation of smaller companies and MSMEs is a positive development.[28]

Institutional capacity building

Institutional capacity building is vital for developing a skilled and competent pool of RVs. Continuous professional development programs for RVs should be promoted to ensure that they remain updated with the latest industry practices, methodologies, and regulatory requirements.

Encouraging research in valuation methodologies, particularly for distressed assets, can lead to the development of more accurate and robust valuation techniques.

The integration of technology and data analytics into the valuation process is also critical, as it can significantly enhance the accuracy, speed, and transparency of valuations. Promoting the use of technology platforms for real-time data sharing and analysis can facilitate better decision-making and ensure that all relevant information is readily available to stakeholders.

Stakeholder engagement and collaboration

Stakeholder engagement and collaboration are key to creating a cohesive and efficient valuation framework under the IBC. Promoting collaboration between valuation professionals, IPs, industry experts, regulators, government can lead to the development of more effective valuation methodologies and practices, benefiting all stakeholders involved. This collaborative approach ensures that diverse perspectives and expertise are integrated into the valuation process, leading to more accurate and reliable outcomes.

Encouraging international collaborations and knowledge exchange programs can further enhance the valuation framework in India by exposing professionals to global best practices and innovative approaches. This cross-border interaction can also help in harmonizing valuation practices with international standards, making the Indian valuation ecosystem more competitive and credible on a global scale.

These collaborative efforts aim to foster a culture of continuous improvement and innovation within the valuation landscape, ensuring that the framework remains responsive to evolving industry needs and challenges.

CONCLUSION

Valuation under the IBC remains a critical and evolving aspect of India's insolvency resolution framework. Since its inception, significant strides have been made in developing a robust valuation ecosystem, including the establishment of regulatory frameworks, the emergence of professional RVs, guidelines by the authorities and the clarification of key concepts through judicial pronouncements.

However, challenges persist, ranging from methodological inconsistencies to the case-specific complexities. The path forward requires a concerted effort from all stakeholders – regulators, practitioners, judiciary, and academia – to continually refine and improve the valuation framework.

As India's insolvency regime matures,the focus must be on enhancing transparency, standardisation, and professionalism in the valuation process. By learning from international best practices and adapting to emerging challenges, India can develop an advanced yet simplified valuation framework that supports efficient, fair, and effective insolvency resolution.

[28] *supra* note 27.

The success of the IBC in achieving its objectives of maximizing asset value and balancing stakeholder interests hinges significantly on the robustness of its valuation framework. As such, continued attention to this critical aspect will be essential in shaping the future of insolvency resolution in India.

08

LEVERAGING THE DIGITAL TRANSFORMATION WITH AI, DIGITAL TOOLS, AND BLOCKCHAIN TOWARDS INSOLVENCY PROCESSES

Pihu M. Shukla and Sushanta Kumar Das

INTRODUCTION

Artificial intelligence (AI) as well as blockchain are widely recognized as prominent technologies (Haru Hong Khanh and Alex Khang, 20). Blockchain is a decentralized and tamper-proof database that is accessible to all participants in a distributed network. It allows for the recording of transaction data and enables straightforward auditing. Whereas AI is a current revolution in thinking that fosters both scientific advancement and industry growth (Dina Darwish, 212). The integration of these two technologies holds significant promise, particularly in the context of businesses and the economy. There is a tremendous need for a thorough examination of these two developing sectors and the significance of their combination.

The application of technology is very vital in redesigning and enhancing insolvency processes, altering the initial traditional methods, and enhancing the efficiency of law firms regarding matters that relate to financial troubles (Abhiman Das, et. al., 118). Practical applications of data analytics, AI, and other forms of digital tools have made the handling of elaborate insolvency processes highly efficient. This way, using algorithms based on AI and machine learning, the specialists in the field of bankruptcy are now capable to analyse substantial amounts of data and make immediate decisions (Andrey Afanasiev and Olga Kandinskaia, 28). They monitor and report data in real time and this means that in the period of restructuring no one can hide anything or try to trick others. The application of these innovative approaches is not only a significant help in the investigation of financial challenges but has also contributed in enhancing the outcome for creditors and debtors.

The purpose of exploring the evolution of insolvency law in relation to digital transformations is to provide clarity on the objectives of insolvency law. The significance lies in the fact that technology is only a means to be utilized in pursuit of any desired objective (Prof. Sivakumar, 101). An insolvent corporation is commonly referred to as a melting ice cube. The evolution emphasizes the importance of time due to the continuous decrease in the value of assets. Efficient methods that maintain value are crucial in the process of insolvency because they help determine the total amount of money available for distribution (Ryan M Mardini, 8).

The first and arguably the most prominent theory when it comes to insolvency law is the creditors' bargain theory which gives consideration to efficiency, particularly concerning the need for the appropriate minimization of transaction costs. Therefore, if technology presents the possibility of improving the operations of insolvency, then it is fully justified for the corporative insolvency laws to incorporate technology in any facet (Catarina Frade and Maria JoaÞo, et. al., 348). Any innovations introduced by corporations pose certain risks, and proper measures must be taken and put into the legal system to curb the use of such risks.

INFORMATION TECHNOLOGY ACT, 2000

As per the Ministry of Law, Justice, and Company Affairs, the Information Technology Act, 2000 (IT Act, 2000) has been defined as –

> An Act to provide legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication, commonly referred to as "electronic commerce", which involve the use of alternatives to paper-based methods of communication and storage of information, to facilitate electronic filing of documents with the Government agencies and further to amend the Indian Penal Code, the Indian Evidence Act, 1872, the Bankers' Books Evidence Act, 1891 and the Reserve Bank of India Act, 1934 and for matters connected therewith or incidental thereto.

Artificial Intelligence

Just like any other country, India has faced high risks in cybercrime as well as exposure to privacy risks because of the advancement of the use of AI and digital governance even without a robust data protection regulation (Christoph Henkel, 378). The lack of data protection laws as factors that facilitated AI, cyberspace, and digital governance has provided grounds for cyber fraud and violation of people's privacy.

Currently, the Information Technology Act of 2000, coupled with the Digital Media Ethics Code, is being enforced in India to address significant privacy concerns related to electronic digital and AI-based activities (Shyam Varan Nath, et. al., 17). The widespread adoption of advanced computing, cloud computing-based applications, and the proliferation of AI-based automated devices worldwide have facilitated the universal integration of AI. However, this has also led to an increased risk of privacy threats and made personal confidential data in cyberspace more susceptible to vulnerabilities.

AI has the capacity to significantly influence all aspects of the legal profession as we currently understand it. Indeed, the practice of insolvency law may experience a more immediate impact compared to other fields (Joong-Hyun Park, et. al., 2095). The intimate relationship between insolvency law and accounting and finance is due to the heavy reliance of both fields on AI technologies. Furthermore, the examination and implementation of AI technology in insolvency legislation have been the subject of research for over twenty years (Anupriya Poddar, et. al., 246). Several law firms have already implemented AI technologies to expedite bankruptcy litigation and enhance the accuracy or predictive ability of results.

The implementation of the EU Reorganization Directive is likely to provide further motivation and speed up the adoption of AI-powered systems in the field of insolvency law. Undoubtedly, AI has the capacity to significantly upset the insolvency threshold. Some specific forms of insolvency examinations or petitions may no longer necessitate the engagement of legal counsel (Alessia Fidelangeli and Federico Galli, 25). Simultaneously, the utilization of AI can generate substantial prospects and offer several benefits for Insolvency Professionals (IPs) and their customers. AI systems have the ability to improve outcome prediction and reduce future insolvency.

Digital Tools

Online digital tools refer to software, programs, technologies, plug-ins, add-ons, or websites that may be accessed through the Internet. Thus, digital tools are the building blocks that are utilized and disseminated through the process of changing IT systems and architecture.

Thus, it can be noted that the framework of insolvency is rapidly changing in the context of digitalization, and high-tech systems of new generations, which offers excellent opportunities to recreate the approach that professionals have to the issue of liquidation. Insolvency practitioners have available a broad spectrum of digital tools: starting with the blockchain's transparent ledger, and continuing with AI's, predictive insights (Daniel Dancsa, et. al., 290). Regarding the interaction of people with the process of digitalization, the foreseeable future of bankruptcy entails a greater level of work effectiveness, an enhanced understanding of the problem and its outcomes, and better results for all the parties who are involved in the processes of corporate distress and revival.

Blockchain

As per the IT Act, 2000–

> A blockchain is a decentralized, distributed, and often public, digital ledger consisting of records called blocks that are used to record transactions across many computers so that any involved block cannot be altered retroactively, without the alteration of all subsequent blocks.

To ensure the achievement of IBC's goal of information symmetry, it is important to consider the utilization of blockchain as a functional tool for information utilities (Marc Pilkington, 226).

LEVERAGING THE DIGITAL TRANSFORMATION TOWARDS INSOLVENCY PROCESSES

a) **National Company Law Tribunal (NCLT)** - The NCLT has implemented an electronic courts (e-courts) platform that allows plaintiffs and respondents to electronically submit their documents online (Prachi Manekar Wazalwar, 20). The Registry conducts a thorough examination and verifies these submissions. The system displays the current status of each appeal to the relevant individuals or groups in the public sphere.

b) **Insolvency and Bankruptcy Board of India (IBBI)** -The IBBI portal serves as a platform for the reporting and monitoring of compliance cases and IPs (Susan Thomas, 1). The IBBI website serves as a centralized storage of orders, tools for insolvency practitioners, publications for market participants and researchers, case data, and information about insolvency practitioners. It is accessible to the public as well as other stakeholders. In addition, it distributes public notices and expressions of interest, auction announcements, and other related information.

c) **Insolvency Professional Agencies (IPAs)** - IPAs provide websites as well as online portals specifically designed for their IP members to complete registration and fulfil various compliance obligations, such as disclosing costs and relationships.

d) **Ministry of Corporate Affairs (MCA)-** All the firms that owe money and were established under the Companies Act, 2013 or previous Acts are included on the MCA portal. This platform facilitates adherence to the regulations outlined in the Companies Act of 2013, including compliance by the IPs during insolvency procedures (S. Sasirekha and S. Anunyaa, 78). It includes details pertaining to directors, charges, insolvency resolution status, and other relevant information.

e) **Information Utility (IU) i.e. National e-Governance Services Ltd. (NeSL)-** The sole IU constituted under the Code serves as the central repository for all debt and default information submitted by the creditors. It provides identity and verification services for debt and default. Additionally, it serves as a platform for distressed assets (PDA) and provides services to support the work of the IPs.

The study on "Leveraging the digital transformation toward insolvency processes" is important as it addresses the increasing requirements of speed, efficiency, and, especially, transparency as relates to insolvency cases. Further, analysing the insolvency process, it is also noted that it may lead to shorter durations and lesser costs for companies thus helping create a better environment for economic and business rehabilitation. As businesses continue to incorporate technology in their operations, it is crucial for legal professionals, policymakers, and other stakeholders to consider the impacts of technology in the processes of insolvency in order to enhance legal compliance and adaptation to new trends and benchmarks in line with global practices.

REVIEW OF LITERATURE

Amidst the swift technological development, numerous conventional legal frameworks must be abolished and restructured. This principle is equally applicable to the law of insolvency. The insolvency legislation is lagging behind the digital revolution (Rafa³ Adamus, 2021). Predicting all potential changes is challenging, but there are several areas that require significant modifications. The insolvency law lags behind the digital revolution. Anticipating all potential changes is challenging, but there are certain domains that require significant revisions.

Enterprise digitization facilitates the implementation of AI, particularly machine learning. Isabel Ramos, et. al., (2022) offered an integrated concept to assist SMEs in evaluating their level of digital transformation, developing necessary digital skills, promoting collaborations between organizations, and formulating digital transformation strategies. The study outcomes made a valuable contribution to the research conducted in the field of lifelong learning. Specifically, the study suggested combining pedagogical methodologies to facilitate independent learning in the workplace. In light of this, Atie Babaie, (2024) assessed the role of mediation in resolving international insolvency conflicts, and then discussed alternative strategies that position mediation as an effective instrument for addressing insolvency disputes involving cryptocurrency.

Blockchain is an emerging technology that utilizes an algorithm to enable participants in an IT network to manage, safeguard, and exchange data across numerous locations without the requirement of an intermediary. Its primary purpose is to guarantee the integrity of the data being handled (Renato Mangano, 2018). Similarly, James S. Welch (2024) contended in his study that there should be substantial restrictions on the utilization of blockchain as a means of preserving value. The study further asserted that the storage of financial assets in a Bitcoin-like blockchain network should not be allowed in its current form and implementation. The conclusion was derived from the following arguments: *firstly*, the storage of financial information in a blockchain network resembling. Bitcoin entails substantial security hazards; *secondly*, current regulatory frameworks and approaches are largely inadequate when applied to crypto-currencies; and *thirdly*, depending on crypto-currency connections can lead to a lack of human legal and moral accountability (Corina Georgiana Costea, 2019).

Insolvency is a state whereby one cannot pay his or her debts or a state of bankruptcy or being solvent to discharge the debt that one has incurred. Well known with bankruptcy, which is a subsequent process that organizations embark on, in the event that they have exhausted all other available options. Thus, Tibor Kezelj and Rudolf Gruenbichler (2021) paid attention to the analysis of business insolvency prediction and prevention with the help of particular AI systems. AI is utilized in the development of insolvency forecasts for firms. On the contrary, Rudolf Grünbichler and Raphael Krebs (2021) presented a literature study on the current utilization of AI in insolvency forecasting. The study found that artificial neural networks, decision trees, support vector machines, and hybrid models are the most crucial algorithms for predicting possible corporate insolvency.

Beata Gavurova (2022) aimed at the prediction of the engineering and automotive enterprise insolvency in the Slovak Republic, and to achieve that the author used the multilayer neural network and logistic regression. The financial ratios which are "Return on Sales (ROS), Quick Ratio (QR), Net Working Capital to Assets (NWC/A) and Price Circle/Sales (PC/S)" reduced the likelihood of bankruptcy. On the contrary, Valdis Savickis (2024) argued that in order to achieve sustainable governance objectives, it is necessary to develop innovative digital and technology solutions. These solutions aim to enhance the economic conditions of society and provide stability in the national economy.

RESEARCH OBJECTIVES

a) To assess the readiness of existing legal frameworks to accommodate AI, digital tools, and blockchain in insolvency processes.

b) To explore how AI chatbots, predictive AI, and blockchain technology can streamline insolvency processes by reducing costs, expediting procedures, and offering timely financial advice.

RESEARCH METHODOLOGY

The research methodology adopted for the study span, test, and examine the subject in the length and breadth of India. The sources of data would emanate mostly from secondary sources; this entails wide and in-depth coverage of analysis of existing literature, case studies, and documented experiences. It is recourse to legal professionals and regulators, who are in a better position to give insight into how digital transformation would be utilized and what implications this has in their insolvency processes. Being descriptive in nature, with elements of an exploratory design in research work, it allows engaging in an in-depth study on how AI, digital tools, and blockchain technologies can be used to advance efficiency, transparency, and effectiveness in insolvency proceedings. It is in this combination of descriptive and exploratory research that able to gain a comprehensive view of the range of possible advantages and challenges that the digital transformation of insolvency processes in India holds for all stakeholders.

RESULTS

Technology is a key driver of change in the insolvency processes, such as AI, blockchain, and data analysis. These technologies increase effectiveness, accountability, and legal requirements in multifaceted restructuring plans (Satish Kumar, et. al., 880). The algorithms support the fast processing of financial data; blockchain provides clear records of the transactions. They also enable cross-border solutions, thus minimizing on the time it takes to execute restructuring in other countries. Advantages of implementing technology in insolvency processes include better possibilities in the analysis of financial statements, asset management, and the use of data (Terence C Halliday, 1081). Nonetheless, some tasks like data security risks, national regulations, and tendencies connected with the usage of such innovative solutions as cloud computing and cryptocurrencies act as threats to IPs.

Thus, the role of technology is massive in increasing the efficiency of insolvency due to its opportunities to over-automatize and optimize the results during the analysis of the data, communication, and document flow (Shivam Gupta, et. al. 108868). Some areas utilize the software to enhance the efficiency of bankruptcy procedures, while others employ digital solutions to enhance clarity, as well as the interaction between creditors together with the methods of the assets' collection. The use of natural language processing as well as other digital technologies is actively transforming insolvency processes through the leverage of big data analysis, risk modelling, and AI (Stefan Cristian Gherghina, 5). It's crucial in facilitating the processes of insolvency, restructuring, and overall proper handling of assets and responsibilities in relation to these matters in extreme financial situations. The use of technological solutions in turn enables the exchange of information and improved communication throughout the cycle of insolvency processes. AI integration in insolvency procedures enables predictive analysis and thus, risks and opportunities can be considered in advance, changing decision-maker processes.

Among the recent insolvency cases, it is possible to identify some significant examples where digital tools, AI, and blockchain are applied to enhance the processes. Here are some examples, with a focus on how these technologies have been incorporated:

a) Jaypee Infratech insolvency case

Due to the large number of claims received from home buyers and creditors, the IBBI and the NCLT have implemented some digital tools (Gausia Shaikh and Anjali Sharma, 40). In this respect, the submission and tracking of the claim were done online to increase efficiency.

b) Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta & Ors.

Claims and financial statements of the company were accounted for with the help of analytical tools that are based on AI (Aakash Thiagarjamurthy and Sheetal Kumar, 89). Multiple and big creditors' committees are allowed to use digital platforms for communication and coordination.

c) Innoventive Industries Ltd. v. ICICI Bank

In this case, although blockchain was not directly employed, it revealed the possible demand for such a solution, such as a more transparent and secure record-keeping system in insolvency procedures (Aditya Vikram Singh and Anmol Gupta, 33).

d) Swiss Ribbons Pvt. Ltd. & Anr. v. Union of India & Ors.

This landmark case established the constitutional viability of the IBC which has further encouraged the use of technology-aided tools for improving the management of cases and overall efficiency of insolvency (Anna Biju, 1). AI tools could be used for analytical means and decision-making.

e) ArcelorMittal India Private Limited v. Satish Kumar Gupta & Ors.

Digital platforms were employed for the efficient handling of the bidding process and ensuring that stakeholders' communication was open (Prachi Trivedi and Amaan Sheikh, 133). It helped minimize the possible disputes that may arise during and at the end of a case hence improving the flow and coordination of the activities in the resolution process.

f) Bhushan Steel Limited insolvency case

The Digital applications were used in the resolution process through managing claims and creditor coordination (Amit Kumar Arora, 60). The financial position of the company was assessed using data analysis with the application of AI.

These examples show how digital tools, AI, and blockchain have been either directly used or can improve insolvency procedures. The use of such technologies makes work efficient, increases the extent of openness, and assists in making the right decisions concerning complex cases of insolvency.

From a global and national standpoint, the implementation of technological tools in insolvency procedures by various jurisdictions offers a consequential yet noteworthy benefit: the accessibility of data. This data can be considered when suggesting changes to insolvency legislation and assessing the economic well-being of a country (Michael Guihot, 508). This data can be utilized by local law reform initiatives to customize solutions for specific circumstances. One further advantage of utilizing technology is that it will enhance transparency, thereby instilling trust in stakeholders and, in notable instances, the general public.

To address the technological needs of small firms facing insolvency, the government should take responsibility for investing in technology. Although simplifying insolvency solutions is indeed applicable, it may be feasible for large corporations to provide affordable services to small business owners through the use of chatbots. Small businesses have the option to seek guidance from a chatbot when they first encounter financial difficulties. This chatbot is a customized version of ChatGPT that is developed by certain IP firms. States and authorities may also contemplate offering a chatbot to provide guidance to small and medium-sized enterprises experiencing financial difficulties. The pandemic has highlighted the significance of small firms in all regions, as demonstrated by the concentration of reform initiatives on reforming small businesses in various areas of the globe.

The capacity of technology to assist in cost reduction and process acceleration should not be disregarded, particularly in the context of restructuring small businesses. While the concept of utilizing technology to forecast corporate insolvency is being debated, it is not presently implemented in the industry. The application of predictive AI in the realm of court decisions has garnered significant interest, however, it remains a subject of controversy. As technology advances, it may become feasible to forecast the insolvency of corporations. This could result in authorities paying particular attention to such companies. Furthermore, it is possible to caution such organizations about the necessity of seeking guidance and taking proactive measures to address any problems.

If predictive AI becomes sufficiently reliable, it might be utilized by liquidators and creditors to determine which legal conflicts are worth pursuing in court and which are not. Predictive AI is currently utilized to a certain degree in various industries, however, its application in the insolvency sector is very limited. Regardless, advancements in technology have the potential to bring about changes in bankruptcy practice, regulation, and ultimately insolvency legislation.

DISCUSSION

Developing economies are seen as having significant potential for transformation through the adoption of digital economies. This is apparent from the proliferation of national digital economy policies in numerous countries, showcasing success stories and future prospects in Bangladesh, China, India, and other nations, along with the diverse range of improvements they have already delivered or are anticipated to deliver. Rebecca Parry (2022) examined the necessary supporting infrastructure for digital economic plans, which includes the importance of legal frameworks and the requirement for technical enhancements. The discussion mostly centres around corporate law and insolvency law, which have hitherto received limited attention.

Emerging technologies, such as AI, are touted as having the potential to address enduring challenges and revolutionize the field of law. Christoph Henkel (2021) conducted a study specifically examining the influence of AI on the bankruptcy legal profession. Indeed, the practice of insolvency law may experience a more immediate impact compared to other fields. The intimate relationship between insolvency law and accounting and finance is due to the heavy reliance of both fields on AI technologies.

India and other countries seeking to enhance their bankruptcy systems through technology can learn valuable lessons from the experiences of other nations, both in the field of insolvency and more broadly. By carefully considering the associated risks, these countries might extract best practices to inform their own efforts. It is crucial to guarantee that such a system is protected from data breaches (Akshaya Kamalnath, 2024). Regarding accessibility, it would be highly beneficial for small and medium-sized enterprises (SMEs) if the system could be easily used by individuals without any technical expertise, and potentially even on their mobile phones.

Recently, the Indian government solicited feedback on proposed amendments to the insolvency legislation in the country. These modifications involve consolidating multiple stages of the insolvency procedure into a single electronic platform.Communication between parties involved in insolvency proceedings has advanced to a higher level of exchanging electronic documents. This can be done through private email providers, the official electronic address managed by the state, or the e-Case platform (Valdis Savickis, 2024).

The preceding discourse implies that AI and technology, in a broad sense, have the potential to supplant human endeavors in certain aspects, but not in all. This holds true, at least for the current moment. However, as previously mentioned, the insolvency profession must enhance its skills, and companies offering these services will allocate resources to technology and recruit individuals with expertise in technology.

CONCLUSION

The study examines the impact of technology advancements on corporate insolvency law and practice, both in the present and potential future changes. It specifically looks at how these advancements affect formal and informal processes, as well as the functioning of the profession. The discussion has focused on the advancements in different legal systems, aiming to provide a concise overview of the technology-driven changes in insolvency law and practice. In addition to discussing the potential concerns, this article also addresses strategies for managing the risks associated with this technological revolution. Ultimately, the article has anticipated and offered insights into the future implications of technology on insolvency legislation and the insolvency profession, drawing from the experiences of pioneering nations. It has also delved into further avenues through which technology could potentially revolutionize these domains.

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09

WALKING A LEGAL TIGHTROPE: AN INTERNATIONAL PERSPECTIVE ON "CREDITOR DUTY" DURING "TWILIGHT ZONE"

Mayank Mehta and Nitika

INTRODUCTION

A company is an artificial legal person which typically acts through its board of directors. Since, the ownership and management of the company's assets is in the hands of directors, the law imposes a fiduciary duty upon them to act in the best interest of the company. Traditionally, courts have interpreted "interest of the company" as "interest of shareholders", but this interpretation has opened a loophole to the detriment of creditors whose economic interest is at stake when the company becomes insolvent. Thereafter, in order to rectify this, there was a shift in the "shareholders centric approach" to the "creditors centric approach" over time.

In ordinary parlance, duties and obligations of the directors differ when the company is "financially healthy" and when it is "approaching insolvency". The latter period is roughly known as the "twilight zone". This period is crucial since it can either lead to revival of the company or its insolvency. Under insolvency regime of most jurisdiction, when the company becomes clearly insolvent and the resolution process is initiated, then usually the charge of the company is taken away from its directors. Therefore, it is this twilight zone, in which most of the transactions to dispose of assets, or to benefit shareholders at the expense of creditors are entered into. During this stage, often there is a conflict between the interest of shareholders and that of creditors. Directors owe a duty towards creditors called as "creditor duty", which becomes paramount once the company is approaching insolvency. If the said duty is not recognized then eventually, the directors can easily get away with fraudulent transactions by stating that they acted in accordance with their fiduciary duty, for the benefit of the shareholders. Thus, the creditor duty has a major role to play.

The nature and extent of this duty during a period when the company is financially distressed but not yet insolvent is not well established. It is a nuanced concept which is increasingly the subject of extensive debate globally. The authors through this article aims to discuss about the conundrum of this twilight zone and the emerging jurisprudence of creditor duty in detail, with reference to recently pronounced judgements.

DEMYSTIFYING THE BORDERLINE INSOLVENCY A.K.A THE TWILIGHT ZONE

The term "twilight zone" refers to a period of trading when a company is on the "verge of insolvency"[1] but not yet "insolvent". It is a potentially imprecise concept which is merely intended to describe a situation when a company's financial stability is continuously deteriorating to the extent that insolvency is imminent.[2] In the UK, the twilight period is considered to be "the period between the point of knowledge or awareness of no real prospect of avoiding an insolvency proceeding against the company, and its actual commencement".[3] Whereas, the Indian Insolvency and Bankruptcy Code, 2016 (IBC) gives it a statutory recognition under section 66(2) and defines the "twilight zone" as a period "before the insolvency commencement date when there is no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process in respect of such corporate debtor".[4] Thus, it is a period when there exists an inevitable possibility of commencement of resolution process due to insolvency in the near future. This period is of prime importance since it give rise to numerous liabilities and duties on the part of directors, one such duty is the creditor duty.

The Legislative Guide on Insolvency Law on Directors' obligations in the period approaching insolvency, recommends that the directors' have a duty to give due regard to the interest of creditors along with other stakeholders and to take reasonable steps to avoid insolvency, and where it is unavoidable, to minimize its extent. To attain this, directors should take reasonable steps such as:

(i) Evaluation of prevailing financial state while ensuring that balance sheets and accounts are well maintained.

(ii) Monitoring situations, holding regular board meetings, taking expert advise and assistance, especially during twilight zone to prevent insolvency by taking early actions.

(iii) Protecting the assets to maximize its value, to abstain from entering into any avoidance transactions, early assistance from auditors and commencement of liquidation proceeding, etc.[5]

FRAMEWORK OF CREDITOR DUTY IN UK

"*The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company*".[6]

Section 172 of the Companies Act, 2006 imposes a duty upon directors to act in good faith, so as to promote the success of the company for benefit of its members as a whole.[7] Sub-clause 3 of this section further adds that it is required to consider the interest of creditors in

[1] Utsav Mitra, *Emerging Jurisprudence of the corporate insolvency Directors duties in twilight zone*, IBBI, (Aug. 19, 2024, 1:29 PM), https://ibbi.gov.in/uploads/engagement/WinnerUtsavMitraNLIUBhopal.pdf.

[2] *Legislative Guide on Insolvency Law Part four: Directors' obligations in the period approaching insolvency (including in enterprise groups)*, United Nations, e-ISBN 978-92-1-004806-4, (2020), https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/19-11273_part_4_ebook.pdf.

[3] D. Milman, *Strategies For Regulating Managerial Performance In The 'Twilight Zone'- Familiar Dilemmas & New Considerations*, 4 J. Bus. Law, 493, 493 (2004).

[4] The Insolvency and Bankruptcy Code, 2016, § 66(2), No. 31, Acts of Parliament, 2016 (India).

[5] *supra note* 2.

[6] Hutton v. West Cork Railway Company, (1883) 23 Ch D 654.

[7] Companies Act, 2006, c. 46, § 173(1), (U.K).

certain circumstances subject to any enactment or rule of law.[8] This lays the foundation for the so called creditor duty, by giving it a statutory recognition.

Ordinarily, a companies' interest lies with its shareholders,[9] however, when the company is "insolvent" or "bordering on insolvency", the interest is transferred to its creditors.[10] The rationale behind it is that in case of insolvency, the creditors become prospectively entitled to deal with the company's assets,[11] since the economic interest in the company as well as the distribution of the risk of loss shifts from shareholders to creditors predominantly.[12] Therefore, the directors' duty to a company as a whole extends to not prejudicing the interests of creditors.[13] When "insolvent liquidation" or "administration" is inevitable, the general rule is that "the more parlous the state of the company, the more the interests of the creditors will predominate, and the greater the weight which should therefore be given to their interests as against those of the shareholders".[14]

The UK Supreme Court in the recent case of *BTI 2014 LLC v. Sequana SA and Ors., 2022*,[15] further clarified this position by providing what is the triggering point of the creditor duty. The situations described by the Hon'ble Court are:

(i) When the company is actually insolvent, either on cash flow/commercial insolvency (when the court is satisfied that the company is unable to pay its debt as they fall due)[16] or balance sheet insolvency (when the value of company's assets is less than its liabilities, including its prospective and contingent liabilities);[17]

(ii) When the company is on verge of insolvency or nearing insolvency i.e., insolvency is imminent;[18]

(iii) When the company is likely to be insolvent, i.e., real and not remote risk of insolvency.[19]

At this stage, when the company is nearing insolvency, it is highly probable that the transactions to dispose of the company's assets are entered into.[20] Therefore, creditor duty becomes relevant.

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[8] Companies Act, 2006, c. 46, § 173(3), (U.K).

[9] Parke v. Daily News Ltd., [1962] Ch 927.

[10] West Mercia Safetywear Ltd. (in liq) v. Dodd, [1988] BCLC 250; MacDonald v. Carnbroe Estates Ltd., [2019] UKSC 57.

[11] Kinsela v. Russell Kinsela Pty Ltd., (1986) 4 NSWLR 722.

[12] Kalls Enterprises Pty Ltd. v. Baloglow [2007] NSWCA 191.

[13] Ciban Management Corporation v. Citro (BVI) Ltd., [2021] AC 122.

[14] Bilta (UK) Ltd. v. Nazir (No. 2), [2015] UKSC 23.

[15] BTI 2014 LLC v. Sequana SA and others, [2022] UKSC 25.

[16] Insolvency Act, 1986, c. 45, §123(1)(e), (U.K).

[17] Insolvency Act, 1986, c. 45, §123(2), (U.K).

[18] Professor Peter Walton, *Directors' duty to act in the interests of creditors under section 172 of the Companies Act 2006- Aussie Rules Gone Walkabout*,University of Wolverhampton, (Aug. 19, 2024, 1:36 PM), https://www.wlv.ac.uk/media/departments/faculty-of-social-sciences/documents/wolverhampton-law-journal/edition-2/6.-Peter-Walton.pdf.

[19] Grove v. Flavel, (1986) 11 ACLR 161.

[20] *Orderly & Effective Insolvency Procedures*, International Monetary Fund, (Aug. 19, 2024, 1:36 PM), https://www.imf.org/external/pubs/ft/orderly.

Section 213 of the Insolvency Act, 1986,[21] imposes personal liability upon the directors for any fraudulent conduct or transaction entered into against the interest of creditors.

JURISPRUDENCE OF CREDITOR DUTY IN SINGAPORE

The discussion around the concept of creditor duty begun with the Singapore High Court's decision in *Voltas Limited v. Ng Theng Swee and another, 2023*,[22] in which it was observed that "Liquidation is a condition precedent to the relevance of the creditor duty in an action that is premised on its breach". Later, the Singapore Court of Appeal clarified the nature, position, and scope of creditor duty, in the case of *Foo Kian Beng v. OP3 International Pte Ltd. (in Liq.), 2024,*[23] as a fiduciary duty that the directors owe to the company.

At the first instance, creditor duty arises when a company is in a "financially parlous" state or "on the verge of insolvency". This signifies that under certain circumstances the interest of creditors acquires discrete significance and separate consideration.[24] Further, it was emphasized that it is not the case that the creditors' interest is otherwise immaterial and only becomes relevant when the creditor duty is engaged.[25] As a general rule, directors are imposed with the duty to act in the best interest of the company, which enjoins them to have regard to the interest of shareholders as well as creditors. However, the said duty can be breached when the company is in a financially healthy state, as during solvency shareholders are the main economic stakeholder of the company.[26]

Besides this, in an action for breach of the creditor duty, it is relevant that the director exercised his discretion in good faith and with due diligence for the benefit of the company, taking into consideration its financial state prevailing at that time.[27]

In order to decide whether the directors acted in breach of creditor duty or not, it is important to determine the financial state of the company prevailing at the time when the said transaction was entered into. The court was of the opinion that the "going concern" test or the "balance sheet" test, although indicative of financial condition of the company, should not be used strictly, rather a broad assessment of facts and circumstances should be done.[28]

Subsequently, the court divided the financial state of the company in three major categories and discussed the directors' duty for each category, as:

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[21] Insolvency Act, 1986, c. 45, §213, (U.K).

[22] Voltas Limited v. Ng Theng Swee and another, [2023] SGHC 245.

[23] Foo Kian Beng v. OP3 International Pte Ltd., [2024] SGCA 10.

[24] Aurelio Gurrea-Martinez, *Towards an optimal model of directors' duties in the zone of insolvency: an economic and comparative approach*, 21(2) J. Corp. Law. Stud. 365, 367–369 (2021).

[25] Foo, *supra note* 23.

[26] Progen, Parakou Investment Holdings Pte Ltd. and another v. Parakou Shipping Pte Ltd (in liquidation) and other appeals, [2018] 1 SLR 271.

[27] Goh Chan Peng and others v. Beyonics Technology Ltd and another and another appeal, [2017] 2 SLR 592.

[28] Dynasty Line Ltd (in liquidation) v. Sukamto Sia, [2014] 3 SLR 277.

Category	Financial State of the company	Directors' Duty
1	When the company is solvent (including the contemplated transaction) and able to discharge its debts.[29]	Creditor duty doesn't arise. Directors are only expected to act in the best interest of company while fulfilling their fiduciary duty.
2	When the company is imminently unable to discharge its debt. This is the "intermediate zone", where a director is expected to reasonably apprehend whether the contemplated transaction is going to render the company imminently unable to discharge its debt, i.e., insolvent.	This is the scenario where the court will scrutinize whether the director acted in good faith[30] while entering into the said transaction. Here, the creditor duty kicks in.
3	When the insolvency proceedings are inevitable.	In this stage, there is a clear shift of economic interests in the company from the shareholders to the creditors. Here, the creditor duty operates to prevent directors to act in a way detriment to the interest of creditors.[31]

In addition to this, the court also provided a non-exhaustive list of factors that should be taken into consideration during the "intermediate zone" while determining whether the transaction will result in imminent insolvency. Factors includes:

(i) The recent financial performance of the company, in particular whether the company's financial performance has been improving or deteriorating as well as the duration and extent of any such improvement or deterioration;

(ii) The industry that the company operates in, including its recent and future prospects;

(iii) Any other external developments, such as geopolitical ones, which may have an impact on the company's business.

The concept of creditor duty further dovetails into section 238 of the Insolvency, Restructuring and Dissolution Act, 2018, which provides for "fraudulent trading". It states that, when business of a company is carried with the intent to defraud creditors or for any fraudulent purpose,

[29] *Directors' duties owed to creditors: Clarity from the Singapore Court of Appeal in Foo Kian Beng v. OP3 International Pte Ltd. (in Liqidation)*, Norton Rose Fulbright, (Aug. 19, 2024, 1:39 PM), https://www.nortonrosefulbright.com/en/knowledge/publications/a36ab2dc/directors-duties-owed-to-creditors-clarity-from-the-singapore-court-of-appeal.

[30] Charles McConnell, *The Director's Duty to Consider Creditor Interests*, White&Case LLP, (Aug. 19, 2024, 1:39 PM), https://www.whitecase.com/insight-alert/directors-duty-consider-creditor-interests.

[31] Foo,*supra note* 23, at 4.

[32] The Insolvency, Restructuring and Dissolution Act, 2018, § 238, (Singapore).

then the court, upon an application, may declare personal liability upon such persons who knowingly entered into such transaction[32], i.e., directors in the most cases.

CREDITOR DUTY IN THE INDIAN CONTEXT

The directors play a major role in financial transactions of a company, they can't be absolved from certain obligations including exercise of due care, skill and diligence considering the interest of all the stakeholders.[2] Section 166 of the Companies Act, 2013, imposes certain duties upon the directors. Clause 2 states that they should *"act in good faith for the benefit of the company as a whole, i.e., its employees, the shareholders, the community, and for the protection of the environment"*.[33] Whereas, under clause 4 it prohibits a director from involving himself in a situation in which he may have a direct or indirect interest that conflicts, or may possibly conflict with the interest of the company.[34] The Hon'ble Supreme Court in the case *Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd. and Ors.*, while interpreting section 166 held that a director acts in a fiduciary capacity to promote the objects of the company for the benefit of all the stakeholders.[35] Therefore, section 166 indirectly provides for the "trust fund doctrine", which refers to the liability imposed upon the directors to refrain from utilizing or misappropriating corporate assets prejudicial to the interest of creditors. The rationale behind this is that the assets are held by directors in trust, creating a fiduciary duty upon them and therefore, they cannot dispose of those assets jeopardizing the rights of creditors.[36] Further, while exercising their duties, they are expected to act with reasonable care[37] so as to avoid the conflict of interests.[38] Section 45 of the IBC carves out an implied duty upon them to undertake prior transactions carefully,[39] and provides for a "look-back period", where the directors can be held liable for prior wrongful transactions.[40]

In addition to this, section 66 of the Code, provides protection to creditors in cases of "fraudulent trading". It states that the directors can be held personally liable for transactions entered into during the "twilight period", with the purpose to defraud creditors.[41] The liability under this section can be imposed "when the directors knew or ought to have known that the there was no reasonable prospect of avoiding the insolvency proceedings"[42] and they "didn't exercise due diligence in minimizing the potential loss to the creditors".[43] Also, "preferential transactions" which puts a creditor in a beneficial position over the others are forbidden.[44]

In India, unlike other jurisdictions, there has not been judicial interpretation and deliberations

[33] Amian Jyoti Roychowdhury v. State of West Bengal, 2024 SCC Online Cal 3268.

[34] The Companies Act, 2013, § 166(2), No. 18, Acts of Parliament, 2013 (India).

[35] M.K Rajagopalan v. Periasamy Palani Gounder, (2024) 1 SCC 42.

[36] Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd. and Ors., (2021) 9 SCC 449

[37] *Director's liabilities in respect of avoidance transactions*, IBBI, (Aug. 19, 2024, 1:39 PM) https://ibbi.gov.in/uploads/meetings/e8e306852963ae62b5fe59c298edb97d.pdf.

[38] The Companies Act, 2013, § 166(3), No. 18, Acts of Parliament, 2013 (India).

[39] The Companies Act, 2013, § 166(4), No. 18, Acts of Parliament, 2013 (India).

[40] The Insolvency and Bankruptcy Code, 2016, § 45, No. 31, Acts of Parliament, 2016 (India).

[41] Utsav, *supra note* 1, at 2.

[42] The Insolvency and Bankruptcy Code, 2016, § 66, No. 31, Acts of Parliament, 2016 (India).

[43] Mr. Shibu Job Cheeran & Ors. v. Mr. Ashok Velamur Seshadri, 2023 SCC OnLine NCLAT 804.

[44] Gaurav Joshi, *Paper on Position of Directors in Twilight Zone*, IBC Laws,(Aug. 19, 2024, 1:40 PM),https://ibclaw.in/paper-on-position-of-directors-in-twilight-zone-by-gaurav-joshi.

on the scope of creditor duty and remedies for its breach. However, a mere glance at the provisions highlights that the obligations imposed upon directors are wide enough to accommodate creditor duty within it.

CONCLUSION

Interestingly, directors' duty of care towards creditors often conflicts with their fiduciary duty in certain circumstances. On one hand, creditor duty imposes a legal obligation upon the directors to be diligent and reasonable while managing company's affairs and transactions, on the other hand fiduciary duty is concerned with directors' loyalty and honesty towards the company and its shareholders. In many jurisdictions, creditor duty is not considered as a fiduciary duty, however, they co-exist harmoniously and parallelly, and one prevails over the another according to the financial state of the company.

Financial stability of the company is directly proportional to directors' liabilities. With the shift in financial situation, duties of directors also primarily shift towards the creditors. This is because the creditors are at a higher risk of loss during the twilight period, therefore, creditor duty provides them with a safe refuge through early action and avoidance of further risks. Consequently, for its effective implementation, often civil, criminal, or personal liability is imposed upon the directors for its breach, subject to due diligence and good faith.

The jurisprudence around the concept of creditor duty is still emerging and is at a nascent stage. This issue of directors' obligation towards creditors during the period of approaching insolvency is neither clearly interpreted by the courts nor widely addressed by the legislations worldwide. Thus, appropriate incentives by identifying obligations of directors and the steps that might be taken to discharge those obligations during this period needs to be developed in order to remove the prevailing uncertainty.

[45] The Insolvency and Bankruptcy Code, 2016, § 43, No. 31, Acts of Parliament, 2016 (India).

10

BALANCING TRANSPARENCY AND PRIVACY: NAVIGATING DATA PROTECTION IN INDIAN INSOLVENCY PROCEEDINGS

Asit Behera and Namisha Singh

"The right to be let alone is indeed the beginning of all freedom."

– Justice William O. Douglas

INTRODUCTION

The intersection of data protection laws and insolvency proceedings represents an evolving challenge in the Indian legal landscape. As India moves towards implementing comprehensive data protection legislation, the insolvency sector is expected to have unique opportunities in adapting its practices to comply with new legal standards while maintaining operational efficacy. This article examines the potential impacts of the proposed Digital Personal Data Protection Act, 2023 (DPDPA) on information sharing practices within insolvency proceedings, seeking to reconcile the fundamental need for transparency in these processes with the growing imperative of safeguarding individual privacy rights.

Achieving harmony between transparency and privacy in insolvency proceedings presents a valuable chance to enhance both legal and financial practices, with significant implications for the efficiency of insolvency resolution, the protection of individual rights, and the overall integrity of the financial system. As India advances to refine its insolvency regime and data protection framework, it is crucial to understand the nuances of their interaction and develop robust strategies to embrace the opportunities of the digital age.

THE EVOLUTION OF INDIA'S INSOLVENCY LANDSCAPE

The introduction of the Insolvency and Bankruptcy Code (IBC/Code) in 2016 marked a watershed moment in India's approach to insolvency resolution.[1] Prior to the IBC, India's insolvency regime was fragmented, with multiple laws governing different aspects of insolvency and bankruptcy. This fragmentation led to delays, inconsistencies, and inefficiencies in the resolution process.

The IBC introduced a unified framework for insolvency resolution, aiming to:

a) Facilitate the reorganization and insolvency resolution of corporate persons, partnership firms, and individuals in a time-bound manner;

[1] Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016 (India).

b) Maximize the value of assets of such persons;

c) Promote entrepreneurship and availability of credit; and

d) Balance the interests of all stakeholders.

Impact and achievements of the IBC

Since its inception, the IBC has had a significant impact on India's insolvency landscape:

a) Rescuing distressed companies: Over the past eight years, the IBC has been instrumental in rescuing 3,293 distressed companies, demonstrating its effectiveness in corporate revival.[2]

b) Facilitating business closure: The IBC has provided a structured mechanism for the closure of unviable businesses, allowing for more efficient resource allocation in the economy.

c) Improving resolution timelines: The fiscal year 2023-24 witnessed a substantial 42% increase in approved resolution plans compared to the previous year, indicating improvements in the speed and efficiency of the resolution process.[3]

d) Enhancing creditor rights: The IBC has significantly strengthened the position of creditors, particularly financial creditors, in the insolvency resolution process.

Transparency as a cornerstone of the IBC

A fundamental principle underlying the IBC is the emphasis on transparency throughout the insolvency resolution process. This commitment to transparency is manifested in several key provisions:

a) Information memorandum: The IBC mandates the preparation of an information memorandum containing comprehensive details about the debtor's financial position, allowing potential resolution applicants to make informed decisions.[4]

b) Public announcements: The Code requires public announcements of insolvency commencement, inviting claims from creditors and ensuring wide dissemination of information.[5]

c) Committee of Creditors (CoC) meetings: The proceedings and decisions of the CoC are required to be transparent, with detailed minutes and voting records maintained.[6]

d) Resolution plan disclosure: The contents of resolution plans, including financial proposals and operational strategies, are made available to relevant stakeholders.[7]

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[2] Insolvency and Bankruptcy Board of India, Quarterly Newsletter (Apr-Jun, 2024), https://ibbi.gov.in/uploads/publication/Newsletter_Jan-Mar2024.pdf.

[3] *Id.*

[4] Insolvency and Bankruptcy Code, 2016, §29, No. 31, Acts of Parliament, 2016 (India).

[5] *Id.*, § 13.

[6] *Id.*,§ 24.

[7] *Id.*,§30.

This emphasis on transparency serves multiple crucial purposes in the insolvency resolution process:

1. **Informed decision-making by creditors:**

    a) Comprehensive information access: Transparency allows creditors to access detailed financial information about the debtor's business, including assets, liabilities, cash flow, and operational data.

    b) Viability assessment: With this information, creditors can conduct thorough assessments of the business's viability, evaluating its potential for turnaround or the necessity for liquidation.

    c) Negotiation leverage: Armed with accurate information, creditors are better positioned to negotiate fair and realistic repayment terms or restructuring plans.

    d) Risk evaluation: Transparency enables creditors to accurately evaluate the risks associated with different resolution strategies, leading to more informed voting decisions in the CoC.

2. **Fraud prevention and detection:**

    a) Public scrutiny: By exposing the insolvency process to public scrutiny, transparency creates a deterrent effect against fraudulent activities.

    b) Early detection: Open access to financial records increases the likelihood of early detection of suspicious transactions or asset transfers that may have occurred prior to insolvency.

    c) Collaborative oversight: Transparency allows multiple stakeholders, including creditors, regulators, and the public, to collectively scrutinize the process, making it more difficult to conceal fraudulent activities.

    d) Accountability: The knowledge that their actions will be subject to scrutiny encourages Insolvency Professionals (IPs) and other participants to adhere strictly to legal and ethical standards.

3. **Enhanced market confidence:**

    a) Fairness perception: Transparency in the insolvency process assures investors and other stakeholders of the fairness of the proceedings, crucial for maintaining trust in the financial system.

    b) Efficiency demonstration: Open processes allow stakeholders to observe the efficiency of the insolvency resolution, potentially attracting more investors to participate in the distressed asset market.

    c) Predictability: A transparent system leads to more predictable outcomes, which is essential for investor confidence and market stability.

d) Benchmark setting: Publicly available information on insolvency proceedings helps set benchmarks and best practices, contributing to the overall improvement of the insolvency regime.

4. **Improved valuation accuracy:**

a) Comprehensive asset disclosure: Transparency ensures that all assets of the debtor are properly disclosed and valued, leading to more accurate estimations of the company's worth.

b) Market-based valuation: Open information allows for market-based valuation of assets, potentially leading to better outcomes in terms of asset realization.

5. **Creditor participation and engagement:**

a) Informed participation: Transparency encourages more active participation from creditors by providing them with the necessary information to engage meaningfully in the process.

b) Collaborative problem-solving: Open sharing of information can lead to more collaborative approaches to problem-solving among creditors and other stakeholders.

6. **Systemic risk management:**

a) Early warning system: Transparent insolvency processes can serve as an early warning system for systemic issues in specific sectors or the broader economy.

b) Policy formulation: Regulators and policymakers can use the information from transparent insolvency proceedings to formulate more effective policies and regulations.

7. **Educational value:**

a) Learning opportunities: Transparency in insolvency proceedings provides valuable learning opportunities for businesses, helping them understand potential pitfalls and best practices in financial management.

b) Academic and professional development: Open access to insolvency data and processes contributes to academic research and professional development in the field of insolvency law and practice.

8. **International credibility:**

a) Global standards alignment: A transparent insolvency regime aligns with international best practices, enhancing the country's credibility in global financial markets.

b) Cross-border insolvency facilitation: Transparency is crucial for effective handling of cross-border insolvency cases, facilitating cooperation between jurisdictions.

By serving these multiple purposes, transparency in insolvency proceedings not only benefits the immediate stakeholders but also contributes to the overall health and efficiency of the financial ecosystem. It plays a vital role in balancing the interests of various parties, ensuring fairness, and maintaining the integrity of the insolvency resolution process.

THE DIGITAL PERSONAL DATA PROTECTION ACT, 2023: A NEW PARADIGM FOR DATA PROTECTION

Overview of the DPDPA

The DPDPA, passed on August 11, 2023, represents a significant milestone in India's journey towards a comprehensive data protection framework.[8] It aims to protect the digital personal data of individuals (Data Principals) by regulating the collection, storage, processing, and sharing of such data by entities (Data Fiduciaries).

Key features of the DPDPA include:

a) Consent-based framework: It emphasizes obtaining explicit, informed consent from Data Principals for the collection and processing of their personal data.[9]

b) Purpose limitation: Personal data can only be collected and processed for specific, lawful purposes that have been disclosed to the Data Principal.[10]

c) Data minimization: It requires that only necessary personal data be collected and processed, aligning with global data protection principles.[11]

d) Rights of Data Principals: The DPDPA grants various rights to individuals, including the right to access their personal data, correct inaccuracies, and request erasure of data.[12]

e) Obligations of data fiduciaries: DPDPA imposes significant responsibilities on entities handling personal data, including implementing security safeguards and conducting data protection impact assessments[13].

f) Cross-border data transfers: It provides for restrictions on the transfer of personal data outside India, subject to certain conditions.[14]

Implications for insolvency proceedings

The introduction of the DPDPA opens new avenues for insolvency practitioners to strengthen data protection measures such as:

a) Data fiduciary obligations: IPs, acting as data fiduciaries, are required to be open in welcoming the new law concerning personal data handled during

[8] Digital Personal Data Protection Act, 2023, No. 22, Acts of Parliament, 2023 (India).

[9] *Id.*,§6.

[10] *Id.*, §4.

[11] *Id.*, § 8(3).

[12] *Id.*, § 11-13.

[13] *Id.*, § 8.

[14] *Id.*, §16.

insolvency proceedings. This includes ensuring the accuracy of data, implementing security measures, and respecting the rights of data principals.[15]

b) Consent requirements: DPDPA's emphasis on obtaining verifiable consent may result in strengthening the information collected and used in insolvency cases.[16]

c) Data protection impact assessments: Significant data fiduciaries may need to conduct periodic assessments to evaluate compliance with the Act. This could be an additional safeguard for the data of the insolvency resolution process.[17]

d) Cross-border insolvencies: The provisions of DPDPA on cross-border data transfers provide a framework to enhance secure and compliant information sharing with foreign creditors or insolvency practitioners, fostering international cooperation.[18]

BALANCING TRANSPARENCY AND PRIVACY IN INSOLVENCY PROCEEDINGS

The imperative of information disclosure in insolvency

The effective functioning of insolvency proceedings heavily relies on the availability and accessibility of comprehensive information about the debtor's financial affairs. This transparency serves several crucial purposes:

a) Informed decision-making by creditors: Access to detailed financial information is essential for the CoCs to make informed decisions about a business's viability and potential restructuring options.

b) Maximizing asset value: Transparency in asset disclosure helps ensure that all assets are properly identified and valued, maximizing potential recovery for creditors.

c) Detecting fraudulent transactions: Open access to financial records aids in the identification of potential fraudulent or preferential transactions that may have occurred prior to insolvency.

d) Facilitating market confidence: Transparency in insolvency proceedings helps preserve market confidence by assuring investors and other stakeholders of the fairness and efficiency of the process.

e) Encouraging responsible corporate behaviour: The prospect of financial disclosure in the event of insolvency can serve as a deterrent to irresponsible corporate behaviour and encourage better financial management practices.

Personal data rights preservation in the insolvency context

The Code read with various regulations require an IP to maintain several records in relation to the assignments conducted by him under the Code. Keeping in view the importance of such records, clause (g) of sub-regulation (2) of regulation 7 of the IBBI (Insolvency Professionals) Regulations, 2016 (IP Regulations) provides that the registration granted to an IP shall be subject to the condition that he maintains records of all assignments undertaken by him

[15] *Id.*, §8.

[16] *Id.*,§6.

[17] *Id.*,§10(2)(c)(i).

[18] *Id.*,§16.

under the Code for at least three years from the completion of such assignment. Clause 19 of the Code of Conduct appended to the First Schedule to the IP Regulations mandates an IP must provide all records as may be required by the Insolvency and Bankruptcy Board of India (IBBI) or the Insolvency Professional Agency (IPA) with which he is enrolled.

Regulation 39A of the IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 mandates the Interim Resolution Professional and the Resolution Professional to preserve a physical as well as an electronic copy of the records relating to the corporate insolvency resolution process of the corporate debtor, as per the record retention schedule.

An IP shall preserve copies of records relating to or forming the basis of:- (a) his appointment as interim resolution professional or resolution professional, including the terms of appointment; (b) handing over / taking over of the assignment; (c) admission of corporate debtor into corporate insolvency resolution process; (d) public announcement; (e) the constitution of committee and meetings of the committee; (f) claims, verification of claims, and list of creditors; (g) engagement of professionals, registered valuers, and insolvency professional entity, including work done, reports etc., submitted by them; (h) information memorandum; (i) all filings with the Adjudicating Authority, Appellate Authority and their orders; (j) invitation, consideration and approval of the resolution plan; (k) statutory filings with the IBBI and IPAs; (l) correspondence during the corporate insolvency resolution process; (m)insolvency resolution process cost; and (n) preferential, undervalued, extortionate credit transactions or fraudulent or wrongful trading.

Thus, while transparency is crucial, insolvency proceedings also involve handling of sensitive personal and financial information as mentioned above, raising significant privacy concerns:

1. **Sensitive personal data**: Insolvency proceedings often require the disclosure of sensitive personal data of individuals associated with the insolvent entity, including financial records, employment details etc.
2. **Third-party information**: The financial records of an insolvent entity may contain personal data of employees, customers, and other third parties who are not directly involved in the insolvency proceedings.
3. **Digital footprints**: With the increasing digitization of financial records, there's a growing risk of unauthorized access, data breaches, or misuse of personal information collected during insolvency proceedings.
4. **Post-insolvency privacy**: There are concerns about the retention and potential future use of personal data collected during insolvency proceedings after the process has concluded.

CHALLENGES AND POTENTIAL SOLUTIONS

Harmonizing Legal Frameworks

The introduction of the DPDPA presents an opportunity to align data protection principles with the transparency requirements of the IBC. Key areas of alignment include:

a) **Balancing data minimization and comprehensive disclosure:** The DPDPA's principle of data minimization can be strategically integrated with the IBC's requirement for comprehensive financial disclosure. This integration can lead to more focused and relevant information sharing, enhancing both privacy and transparency.

b) **Adapting purpose limitation to dynamic information needs:** The purpose limitation principle under the DPDPA can be flexibly applied to accommodate the evolving information needs in insolvency proceedings. This adaptation can ensure that data use remains purposeful while meeting the dynamic requirements of insolvency processes.

c) **Aligning consent mechanisms with mandatory disclosures:** The DPDPA's emphasis on consent-based data processing provides an opportunity to develop innovative consent models that complement the mandatory disclosure requirements under the IBC. This alignment can enhance transparency while respecting individual privacy rights.

d) **Integrating data subject rights with insolvency priorities:** The exercise of data subject rights under the DPDPA can be thoughtfully integrated with the information needs of insolvency proceedings. This integration can lead to a more balanced approach that respects individual rights while maintaining the integrity of the insolvency process.

Implementing data protection safeguards

To address privacy concerns while maintaining necessary transparency, IPs and relevant authorities should consider implementing robust data protection safeguards. Data security methods encompass various strategies to protect sensitive information from unauthorized access and misuse. These include encryption, which involves applying cryptographic algorithms to ensure data cannot be easily read or altered by unauthorized parties. Data Erasure ensures that data no longer in use is reliably deleted from repositories, preventing unauthorized access. Masking substitutes all or part of a high-value data item with a low-value token, reducing its exposure. Additionally, resilience involves creating backup copies of data, allowing organizations to recover information in case it is accidentally erased, corrupted, or stolen during a breach. Data protection measures are crucial for balancing the need for open information in insolvency proceedings with the imperative of protecting personal data. The following comprehensive strategies should be considered:

I. **Data anonymization and pseudonymization:**

a. Technique application: Where possible, personal data in insolvency reports and disclosures should be anonymized or pseudonymized. This involves removing or replacing identifying information while retaining the data's utility for insolvency purposes.

b. Differential privacy: Implement advanced statistical techniques like differential privacy to add controlled noise to datasets, preserving privacy while maintaining data utility.

c. Re-identification risk assessment: Regularly assess the risk of re-identification in anonymized data sets, especially when combining multiple data sources.

d. Contextual anonymization: Adapt anonymization techniques based on the specific context and sensitivity of the data involved in each insolvency case.

II. **Access controls and encryption:**

a. Multi-factor authentication: Implement robust multi-factor authentication for accessing sensitive insolvency data.

b. Role-Based Access Control (RBAC): Develop a granular RBAC system to ensure that individuals only have access to the data necessary for their specific role in the insolvency process.

c. End-to-end encryption: Utilize strong end-to-end encryption for data storage and transmission, particularly for highly sensitive financial and personal information.

d. Regular access audits: Conduct frequent audits of access logs to detect and investigate any unusual patterns or potential breaches.

e. Secure data sharing protocols: Establish secure protocols for sharing data with authorized parties, such as creditors or regulatory bodies.

III. **Data minimization strategies:**

a. Need-to-know basis: Develop protocols to ensure that only necessary personal data is collected and processed during insolvency proceedings.

b. Data inventory and mapping: Create and maintain a comprehensive inventory of personal data collected, processed, and stored during insolvency proceedings.

c. Regular data reviews: Implement a system for regular reviews of collected data to identify and remove unnecessary information.

d. Privacy by design: Incorporate data minimization principles into the design of insolvency processes and supporting technologies.

e. Automated data filtration: Develop automated systems to filter out non-essential personal data from insolvency reports and disclosures.

IV. **Secure data destruction:**

a. Comprehensive destruction policies: Implement detailed policies for the secure destruction of personal data once it is no longer needed for insolvency proceedings.

b. Multiple destruction methods: Utilize various methods of data destruction, including physical destruction of hardware and secure digital erasure techniques.

c. Third-party verification: Engage third-party specialists to verify the complete and secure destruction of sensitive data.

d. Destruction logs: Maintain detailed logs of all data destruction activities for audit and compliance purposes.

e. Scheduled destruction protocols: Establish automated schedules for regular review and destruction of outdated or unnecessary data.

V. **Training and awareness:**

a. Comprehensive training programs: Provide thorough and regular training to IPs on data protection principles, legal requirements, and best practices.

b. Role-specific training: Tailor training programs to specific roles within the insolvency process, addressing unique data handling challenges for each position.

c. Simulated breach exercises: Conduct simulated data breach exercises to prepare staff for potential security incidents.

d. Continuous education: Implement a system of continuous education to keep professionals updated on evolving data protection laws and technologies.

e. Cultural awareness: Foster a culture of privacy awareness within insolvency practices, emphasizing the importance of data protection at all levels.

VI. **Data protection impact assessments (DPIAs):**

a. Regular assessments: Conduct DPIAs for all significant data processing activities in insolvency proceedings.

b. Risk mitigation strategies: Develop and implement risk mitigation strategies based on DPIA findings.

c. Stakeholder involvement: Involve key stakeholders, including data protection officers and legal experts, in the DPIA process.

VII. **Incident response planning:**

a. Comprehensive response plans: Develop and maintain detailed incident response plans for potential data breaches or unauthorized disclosures.

b. Regular drills: Conduct regular drills to test and refine incident response procedures.

c. Clear communication Protocols: Establish clear protocols for communicating data incidents to affected parties and regulatory authorities.

VIII. **Technology integration:**

a. Blockchain for data integrity: Explore the use of blockchain technology to ensure the integrity and immutability of insolvency records while enhancing privacy.

b. AI for data protection: Implement AI-driven systems for anomaly detection and automated compliance monitoring in data handling processes.

c. Privacy-enhancing technologies (PETs): Integrate advanced PETs, such as homomorphic encryption, to allow data analysis without exposing raw personal data.

IX. **Third-party risk management:**

a. Vendor assessment: Thoroughly assess and monitor the data protection practices of third-party vendors involved in the insolvency process.

b. Contractual safeguards: Implement strong contractual safeguards with all third parties handling personal data related to insolvency proceedings.

c. Regular audits: Conduct regular audits of third-party data handling practices to ensure ongoing compliance.

X. **Cross-border data protection:**

a. International standards compliance: Ensure compliance with international data protection standards when handling cross-border insolvencies.

b. Data localization considerations: Address data localization requirements in different jurisdictions while maintaining the integrity of the insolvency process.

c. International cooperation: Develop frameworks for international cooperation in data protection related to cross-border insolvency cases.

By implementing these comprehensive data protection safeguards, IPs and authorities can significantly enhance the privacy and security of personal data involved in insolvency proceedings. This robust approach not only helps in complying with data protection regulations but also builds trust in the insolvency process, balancing the critical needs of transparency and privacy.

Enhancing data subject rights in insolvency contexts

The DPDPA grants various rights to data principals, including the right to access, correct, and erase personal data. Insolvency professionals have the opportunity to develop innovative mechanisms that respect data subject rights while fulfilling their statutory obligations under the IBC :

1. **Transparent information policies**: Clearly informing data subjects about how their personal data will be used in insolvency proceedings and what rights they can exercise.

2. **Efficient request handling**: Establishing streamlined processes for handling data subject requests in the context of ongoing insolvency proceedings.

3. **Balancing mechanisms**: Developing frameworks for balancing data subject rights against the legitimate interests of the insolvency process, potentially involving judicial or regulatory oversight.

4. **Post-proceeding data management**: Establishing clear policies for the retention, access, and eventual deletion of personal data after the conclusion of insolvency proceedings.

USAGE OF INFORMATION UTILITY IN INSOLVENCY DATA PROTECTION

Information Utilities (IUs) play a critical role in the insolvency framework, particularly in ensuring responsible data handling practices. As regulated entities under the IBC, IUs are tasked with the collection, storage, and dissemination of financial information pertinent to the insolvency proceedings. Their primary function is to provide accurate and timely information to creditors, IPs, and other stakeholders, thereby facilitating informed decision-making during the resolution process.

Given the sensitive nature of the data they handle, including financial records and personal information of debtors, IUs are obligated to adhere to stringent data protection standards as per the Guidelines for Technical Standards for the Performance of Core Services and other Services under the IBBI (Information Utilities) Regulations, 2017 (Guidelines). This includes implementing robust security measures to prevent unauthorized access, ensuring the integrity and confidentiality of data, and complying with applicable data protection laws. Additionally, IUs must manage data transparently, providing access to authorized parties while safeguarding against data misuse. These responsibilities are crucial for maintaining trust in the insolvency process and ensuring that the information provided by IUs is both reliable and secure, thereby upholding the integrity of the insolvency resolution ecosystem. It can be said that information stored with an IU is designed to be secure and safe through a combination of legal, technological, and procedural safeguards. An IU ensure the security and safety of the information following these factors:

1. **Regulatory Framework:**

   - **Regulation by IBBI**: IUs in India are regulated by the IBBI and Guidelines for Technical Standards for the Performance of Core Services and other Services under the IBBI (Information Utilities) Regulations, 2017. IUs have to adhere to the regulations and guidelines to ensure the integrity, security, and confidentiality of the information.

   - **Compliance requirements**: IUs must comply with various regulatory requirements, including data privacy laws, cyber security norms, and operational guidelines. IUs are also subject to periodical security audits. Regular security and software audits by 'Cert-in certified auditors' are to be conducted.

2. **Data encryption:**

   - **Encryption standards**: Information stored with IUs is encrypted both at rest and in transit using industry-standard encryption protocols. This ensures that unauthorized access to the data is prevented, even if the data is intercepted or compromised. The data should be transferred using secure, authenticated and industry-accepted encryption mechanisms to avoid malicious users intercepting the data and gaining unauthorized access.

   - **Access controls**: Only authorized personnel can access the information, and this access is often logged and monitored to prevent unauthorized usage. Access to data is provided only to authorised persons after verifying their identity through log-in credentials.

3. **Data integrity:**

- **Immutable records**: IUs maintain immutable records of the information stored, meaning once data is recorded, it cannot be altered or deleted. This ensures the integrity and reliability of the data. The financial information collected by the IU shall be stored securely, duly ensuring adequate safeguards and security as prescribed in the Information Technology Act, 2000.
- **Audit trails**: IUs maintain detailed audit trails that log every action taken on the stored information. This allows for tracking any changes or access to the data, providing transparency and accountability.

4. **Data redundancy and backup:**

- **Multiple data centres**: The data centre and disaster recovery design and operations should conform to performance standards and operational standards. The data centre and DR design includes multi-tier security features like access control to only authorised personnel with proper approval mechanism, audit log for support / service engineers and video monitoring.
- **Regular backups**: Regular data backups are performed to prevent data loss due to hardware failures, cyber attacks, or natural disasters. Suitable Business Continuity Plan and Disaster Recovery Mechanisms are to be put in place by the IU.

5. **Cybersecurity measures:**

- **Firewall and intrusion detection systems**: IUs employ robust firewall and intrusion detection systems to protect against cyber threats. These systems are designed to detect and respond to any unauthorized access attempts in real time.
- **Continuous monitoring**: Continuous monitoring of the IT infrastructure is conducted to identify and mitigate potential security threats before they can cause any damage.
- **Security policy**: IT security policy and Cyber security policy, detailing all preventive measures to mitigate data security risks are to be put in place.
- **Security standards:** For security standards, IUs must consider relevant security frameworks (including cyber security) used by regulatory bodies like RBI and SEBI. IUs are required to consider Information Security standards such as ISO 27000 for adoption and establish efficient information security through Security Information and Event Management (SIEM) capabilities.

6. **Confidentiality agreements:**

- **User agreements**: Users of IUs are required to enter into confidentiality agreements, ensuring that the information they access is not shared or used inappropriately.
- **Legal protections**: The law provides strong protections for the confidentiality of the data stored with IUs, and any breach of these protections can result in severe penalties.

7. **Incident response and recovery:**

- **Incident response plans**: IUs have robust incident response plans in place to quickly address and recover from any security incidents, such as data breaches or cyber attacks.
- **Disaster recovery**: Disaster recovery protocols are established to ensure the continuity of operations and data availability in the event of a major incident. IUs data centre and disaster recovery design and operations should conform to performance standards, such as Uptime Institute's Tier Standards with a data centre rating of Tier 3 or above. IU service shall be hosted in a data centre and DR facilities shall be within India and be governed by its applicable laws.

CONCLUSION: CHARTING A PATH FORWARD

The intersection of data protection and insolvency law in India represents a complex and evolving landscape that demands careful navigation. As India's insolvency regime continues to mature and its data protection framework takes shape, it is crucial to strike a delicate balance between the imperatives of transparency in insolvency proceedings and the protection of individual privacy rights.

The introduction of the DPDPA, as a significant step forward in safeguarding personal data, presents new avenues for strengthening privacy of data in the insolvency sector. These avenues offer opportunities for innovation and improvement in insolvency practices. By addressing the tensions between transparency and privacy, India has the potential to develop a more robust, fair, and efficient insolvency resolution system that respects individual rights while maintaining the integrity of the process.

The path forward requires a nuanced approach that recognizes the value of both transparency in insolvency and the protection of personal data. It calls for innovative thinking, collaborative effort, and a commitment to upholding the principles of fairness, efficiency, and individual rights.

As India navigates this complex terrain, it has the opportunity to set a global benchmark for how modern insolvency regimes can operate in an increasingly data-driven world. By successfully balancing the needs of the insolvency process with robust data protection measures, India can enhance the integrity and effectiveness of its insolvency regime while safeguarding the privacy rights of individuals.

Ultimately, the goal should be to create a system where transparency and privacy are seen as complementary elements of a fair, efficient, and trustworthy insolvency resolution process. This balanced approach will not only strengthen India's insolvency framework but also contribute to building a more resilient and ethically grounded financial ecosystem.

The journey ahead is demanding, with careful consideration, collaborative effort, and innovative solutions, India can forge a path that respects both the need for openness in financial dealings and the fundamental right to privacy. In doing so, it will not only address a critical legal and practical opportunity but also set a precedent for how emerging economies can adapt to the demands of the digital age while maintaining the integrity of their financial systems.

11

THE STATUS QUO OF HOMEBUYERS: A COMPLEX WEB OF UNCERTAINTY AND CONCERNS

Nainshree Goyal and Shalini Shah

INTRODUCTION

The onset of insolvency proceedings brought renewed hope for distressed companies, offering a chance for survival and a boost to the economy, thereby safeguarding the job of employees. However, it is also part of the system that certain sections of society remain under haze. One such sector is 'homebuyers' whose rights and interests remain uncertain. The advent of the Insolvency and Bankruptcy Code, 2016 (IBC/Code) has brought this unheard sector of society into a lot of turbulence.

PRIOR TO 2018 AMENDMENT

Since the inception of the Code in 2016, the rights of homebuyers have been left in dark with uncertainty. There have been several judgments during the initial phase of the Code, where various benches of Adjudicating Authority i.e. NCLT have ruled that the homebuyers do not fit into the categories of either financial creditors (FCs) or operational creditors (OCs), leaving their status and rights completely ambiguous.

In the matter of *Nikhil Mehta v. AMR Infrastructure,*[1] the homebuyers have been understood as FCs because of the feature of 'assured return' scheme in the contracts that they are party to. The contracts usually have an arrangement wherein it is agreed that the seller of the apartments would pay 'assured returns' to the home buyers till possession of property is given. This clause is used in certain cases, though not all cases. In such cases, it was held in this case that such a transaction was like a loan and constituted a 'financial debt' within the Code.

Another case of *Anil Mahindroo & anr v. Earth Organics Infrastructure*[2] the Hon'ble NCLAT had a similar view. It is important to note that the judgments were based on the specific contractual terms between homebuyer and sellers, making them case-specific and dependent on individual circumstances. This prevented any generalized status for the homebuyers and did not help them with their rights.

[1] (Company Appeal (AT) (Insolvency) No. 74 of 2017).

[2] (Company Appeal (AT) (Insolvency) No. 74 of 2017) (NCLAT New Delhi, Company Appeal (AT) (Insolvency) No. 74/2017, Date of decision – 02 September, 2017).

In 2017, the Insolvency and Bankruptcy Board of India (IBBI) brought about a form to file claim for "creditors other than FCs or OCs" i.e. form F as per the IBBI (Insolvency Resolution Process for Corporate Persons), Regulations, 2016. This form could be interpreted as an indication that homebuyers are neither FCs nor OCs due to a new category being formed. As a result,the homebuyers do not have right to initiate insolvency process but were allowed to file claim under the category of 'other creditors'. The Insolvency Law Committee (ILC)[3] in 2018 observed that prospective homebuyers usually make payments in exchange for a future asset, specifically their future home. In case of failure of the project, the refunds are made considering the time value of money, taking into account the interest that would have accrued over time.

JOURNEY THROUGH PRECEDENTS: POST 2018 AMENDMENT

- The ILC after several questions and deliberation provided clarity that fund raised from homebuyers under a real estate project should be classified under section 5(8)(f). Understanding the recommendations of the ILC, the IBBI vide amendment dated June 6, 2018, added explanation clarifying that in the case of homebuyers, the amount raised from a home buyer, in a real estate project, shall be considered 'deemed commercial borrowing'. This effect is considered as the amount given by the homebuyer for a real estate project is treated and used for the real estate project itself.

- In *Flat Buyers Association v. Umang Realtech Pvt. Ltd.,*[4]the NCLAT in its order dated February 4, 2020 affirmed that unsecured creditors, including homebuyers, have rights over the assets of a corporate debtor (CD), such as flats or apartments. This means that once a builder-buyer agreement is signed, the homeowner immediately acquires an interest in the property, even if the property is not yet specified or constructed. The payment made under this agreement effectively creates a lien, encumbrance, or charge on the CD's assets. Therefore, the homeowner's main entitlement is to receive the property they have paid for, which establishes a floating charge in their favour of the homeowner.

- In the case of *Pioneer Urban Land and Infrastructure Limited and Anr. v. Union of India and Ors.*,[5] the Supreme Court upheld the validity of the 2018 amendment, ruling that money raised by developers from homebuyers is intended for profit and thus functions similarly to borrowing. Consequently, the Court classified any funds collected from an allottee of a real estate project as 'financial debt' under section 5(8)(f) of the Code. The Court further stated that homebuyers or allottees can be regarded as individual FCs,*akin* to debenture holders and fixed deposit holders. This classification means that homebuyers are part of a broader category of FCs, and thus, designating them as FCs does not breach Article 14 of the Constitution of India.

- After the Insolvency and Bankruptcy Code (Amendment) Act, 2018, homebuyers were granted rights similar to those of secured FCs and the amounts owed to them were

[3] Insolvency Law Committee, Report of the Insolvency Law Committee,http://www.mca.gov.in/Ministry/pdf/ILRReport2603_03042018.pdf.

[4] (Company Appeal (AT) (Insolvency) No. 926 of 2019, https://nclat.nic.in/Useradmin/upload/18011332575e3d0b157e29a.pdf).

[5] (2019) 8 SCC 416).

classified as financial debt. However, they are still not recognized as secured FCs. The Supreme Court, in the *Pioneer case*, clarified that homebuyers are unsecured creditors. It noted that although they are classified as unsecured creditors, they have a significant stake in the funds advanced for the project's completion, potentially covering the entire cost of the project if fully funded by them.

- Post the Insolvency and Bankruptcy Code (Amendment) Act, 2018, even though the homebuyers were granted similar rights as secured FCs and the amount owed to them being recognized as financial debt, are still not completely treated as secured FCs. The Supreme Court in the *Pioneer case* clarified homebuyers to be unsecured creditors: "*54… True, allottees are unsecured creditors, but they have a vital interest in amounts that are advanced for completion of the project, maybe to the extent of 100% of the project being funded by them alone.*"
- The 'time value of money' is an essential feature of any financial debt as per the Supreme Court decision in *Anuj Jain IRP for Jaypee Infratech Ltd. v. Axis Bank Ltd.*[6] Additionally, the Apex Court clarified in *Pioneer case* that, in the case of allottees/ homebuyers, only those amounts disbursed with the primary objective of earning a 'profit' can be deemed as financial debt and fall under the purview of the explanation to section 5(8)(f).

The Supreme Court for the first time through its judgment in *Chitra Sharma v. Union of India*[7] granted homebuyers rights *akin* to those of secured FCs, and the amounts owed to them were categorized as financial debt. Nevertheless, they are not considered secured FCs. The Supreme Court, in the *Pioneer case*, clarified that while homebuyers are categorized as unsecured creditors, they hold a crucial interest in the funds they advance for the project's completion, which could amount to funding the entire project if they have provided all the financial resources.

INSOLVENCY AND BANKRUPTCY CODE (AMENDMENT) ACT, 2020

The 2020 Amendment Act introduced new requirements for initiating corporate insolvency resolution process (CIRP) against real estate companies. To file a CIRP, at least 100 allottees or 10% of the total allottees under the same project, whichever is less, must jointly file a petition. In other words, after the 2020 Amendment in the Code, a single homebuyer could not approach Hon'ble NCLT under section 7 of the Code to initiate insolvency proceedings. Additionally, individual homebuyers' cases filed before the amendment were decided to be dismissed if they didn't meet this threshold within 30 days of the amendment's commencement unless modified to comply with the new requirements. The object of the said amendment was to prevent any abrupt hold on the real estate projects on disagreements or disappointment of a few homebuyers. In the case of *Manish Kumar v. Union of India*,[8] the Supreme Court upheld the constitutional validity of the 2020 Amendment Act.

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[6] 2018) 18 SCC 575.

[7] (2018) 18 SCC 575.

[8] (2021 SCC Online SC 30).

IMPLEMENTATION OF AMITABH KANT'S COMMITTEE REPORT[9] ON REAL-ESTATE PROJECTS

Next landmark breakthrough in the field of 'homebuyers under IBC' was under the Amitabh Kant Committee report. The Committee chaired by Sh. Amitabh Kant, which was established to address issues concerning Legacy Stalled Real Estate Projects, recommended that *"the IBC should be reformed to more effectively address the complexities of the real estate sector."* Among the suggested reforms to the IBC are:

a) Project wise CIRP: It becomes mandatory for all projects to be pre-registered with Real Estate Regulatory Authority (RERA). Since RERA registration maintains the record and registrations to be project-wise, this approach can be adopted under the Code for its implementation and the rights pertaining to homebuyers.

b) Transfer of ownership/possession to allotees:[10] The Committee proposes that the IBC may enable Resolution Professionals (RPs) to transfer the ownership and possession of a plot, apartment, or building to the allottees during the resolution process. An option may also be given to allottees to acquire such units on 'as is where is' basis or on payment of balance required to complete the unit during the process. Houses which are under possession of allotees should not be included in the IBC process.

c) Registration/ transfer of ownership where possession transferred: Where possession of a plot, apartment, or building to the allottees have already been transferred, these transactions must be formalised through registration during a CIRP or a project- specific resolution process under the IBC.[11]

d) The Committee strongly recommends immediate registration/execution of subleases in favour of these rightful home buyers. This should not be contingent on the recovery of dues from the builders.

STATUS OF HOMEBUYER: IBC, RERA, AND TRANSFER OF PROPERTY ACT

The legal definitions that govern the rights of homebuyers and must be looked into are hereunder. The following definitions provided in the IBC deal with the issue of secured or unsecured creditor:

a) Section 3(30): **"secured creditor"** means a creditor in favour of whom security interest is created;

b) Section 3(31): **"security interest"** means right, title or interest or a claim to property, created in favour of, or provided for a secured creditor by a transaction which secures payment or performance of an obligation and includes mortgage, charge, hypothecation, assignment and encumbrance or any other agreement

[9] Report of Committee to examine the Issues related to Legacy Stalled Real Estate Projects, July 2023, https://mohua.gov.in/upload/whatsnew/64e31f9e36e0creport.pdf.

[10] Discussion Paper Real-Estate Related Proposals- CIRP & Liquidation (Nov. 6, 2023), https://ibbi.gov.in/uploads/public_comments/Discussion_Paper_Real_Estate_November2023_Final.pdf.

[11] *Id.*

or arrangement securing payment or performance of any obligation of any person:Provided that security interest shall not include a performance guarantee;

c) Section 3(4): **"charge"** means an interest or lien created on the property or assets of any person or any of its undertakings or both, as the case may be, as security and includes a mortgage;

d) Section 3(33): **"transaction"**includes an agreement or arrangement in writing for the transfer of assets, or funds, goods or services, from or to the corporate debtor;

e) Section 3(34): **"transfer"** includes sale, purchase, exchange, mortgage, pledge, gift, loan or any other form of transfer of right, title, possession or lien;

f) Section 3(35): **"transfer of property"** means the transfer of any property and includes a transfer of any interest in the property and the creation of any charge upon such property;

g) Section 5(8) of the Code defines financial debt as follows:

"Financial debt" means a debt along with interest, if any, which is disbursed against the consideration for the time value of money and includes–

…

(f) any amount raised under any other transaction, including any forward sale or purchase agreement, having the commercial effect of a borrowing;

[12] [Explanation. -For the purposes of this sub-clause, -

(i) any amount raised from an allottee under a real estate project shall be deemed to be an amount having the commercial effect of a borrowing; and

(ii) the expressions, "allottee" and "real estate project" shall have the meanings respectively assigned to them in clauses (d) and (zn) of section 2 of the Real Estate (Regulation and Development) Act, 2016 (16 of 2016);]

In addition to above provisions, the reference can be made to the ILC Report of 2018 where it is observed that delay in the completion of flats/apartments has become a common phenomenon and that amounts raised from home buyers contribute significantly to the financing of the construction of such flats/apartments. Finally, the ILC concluded that the current definition of 'financial debt' is sufficient to include the amounts raised from home buyers/allottees under a real estate project, and hence, they are to be treated as FCs under the Code. Accordingly, in CIRP, it is considered that homebuyers will be a part of the committee of creditors (CoC) and will be represented in the manner specified in paragraph 10 (Manner of representation of large number of creditors in the CoC) of this report, and in the event of liquidation, they will fall within the relevant entry in the liquidation waterfall under section 53 of the Code.

[12] (Ins. by the Insolvency and Bankruptcy Code (Second Amendment) Act, 2018, w.e.f. 06.06.2018).

Salient features of the transaction between a homebuyer and builder as per the Transfer of Property Act, 1882

Section 55(6)(b) of the Transfer of Property Act, 1882 deals with the rights of buyers of property under an Agreement to Sell. Some of the relevant part of the provisions are reproduced hereunder for ready reference:

Section 55(6)- The buyer is entitled—

> (a) where the ownership of the property has passed to him, to the benefit of any improvement in, or increase in value of, the property, and to the rents and profits thereof;
>
> (b) unless he has improperly declined to accept delivery of the property, to a charge on the property, as against the seller and all persons claiming under him, to the extent of the seller's interest in the property, for the amount of any purchase-money properly paid by the buyer in anticipation of the delivery and for interest on such amount; and, when he properly declines to accept the delivery, also for the earnest (if any) and for the costs (if any) awarded to him of a suit to compel specific performance of the contract or to obtain a decree for its rescission.

Section 55(6)(b) provides that an agreement to sell creates the following rights of buyer on the property: -

- It creates a charge on the property, to the extent of the seller's interest in the property
- To compel specific performance of the contract; or
- To obtain a decree for its rescission

From the provision mentioned above, it can be stated that homebuyers, do come in the category of creditor as interest is created in their favour the moment an agreement creating charge is entered with builder for sale of property.

Deeper jurisprudence

Post the Insolvency and Bankruptcy Code (Amendment) Act, 2018, homebuyers, despite being granted similar rights as secured FCs and with the amount owed to them being recognized as financial debt, are as of yet not considered secured FCs.[13]

However, the given case is limited to the facts and has also used the term in passing references. It will not be appropriate to rely on the same completely.

In another case, *Naresh Sundarlal Jain v. Udaipur Entertainment World*, Hon'ble Bombay High Court vide order dated September 27, 2023 in para 14 had observed that –

> ……..It is an admitted fact that role of the Petitioner was no more than that of a lender of some money to Respondent no.1 and that there was neither any allotment/agreement

[13] Report of the Insolvency Law Committee, March 2018, https://ibbi.gov.in/uploads/resources/ILRReport2603_03042018.pdf.

> whatsoever made in favour of the Petitioner unlike the home buyers in whose favour there were agreements/allotments made for sale of flats in their favour creating in them a security interest as defined under Section 2(31) of the IBC. We may say it here that mere lending of money without there being any security created for repayment of loan, would not create any security interest as contemplated under section 2(31) of the IBC and therefore, a person like the Petitioner can only be treated as an unsecured creditor as defined under the IBC, and we do treat him to be so. This is, however, not so in case of home buyers in whose favour there have been issued allotment letters and/or agreements made, thereby creating security interest for sale of flats to them as per Section 2(31) of the IBC, putting them unmistakably in the category of secured creditors under Section 2(30) of the IBC.

The given matter is also limited to the facts and does not deal with the issue of secured or unsecured creditor in detail. The issue is lightly touched, but not analysed from the perspective of jurisprudence. Thus, the judicial pronouncements in areas of real estate insolvency have been mixed up to bring about clear understanding.

Further, the concept of 'Reverse CIRP' has also been recognised NCLAT Delhi in *Flat Buyers Association Winter Hills v. Umang Realtech.*[14] This case established the concept that the CD can act as financial lender, before the CIRP starts, to infuse funds and resolve the debt burden. This scenario is very much in favour of the homebuyers, because along with the resolution, it also aims at giving the homebuyers their rights on the houses/ real estate properties. Therefore, this scenario seems appropriate for homebuyers. However, the proposal from CD may not be always welcomed. The rights of various other creditors may also be at stake. Therefore, it is important to consider the rights of homebuyers from other perspectives as well.

In the matter of *Logix Developers Ltd.*, NCLT New Delhi vide order dated July 13, 2023 directed the RP to hand over the possession of the flats and take all necessary steps in furtherance of the same as required under law to ensure the lawful and peaceful possession of the residential flat in favour of the applicant. In the matter of *AU Small Finance Bank Ltd. v. Coral Infragold Pvt. Ltd.*, NCLT Jaipur Bench vide order dated February 15, 2023 permitted RP to hand over the flats after compliance of the statutory provisions and allowed sale/registration of the flats allotted to the home buyers. However, in another matter, a conflicting view was taken up.

In the matter of *M/s. Samruddhi Realty Ltd.*, NCLT (Bengaluru Bench) considered the facts that several allottees (homebuyers) had entered into a sale agreement in 2011, making full payments, and had taken possession of the nearly completed villas in 2016. These allottees filed an application to exclude the property in their possession from the liquidation estate and for its registration in their favour. Despite the fact that full payments were made by these allottees for these properties which were in their possession, NCLT ruled on May 25, 2023 that since no sale deed was executed, the property cannot be excluded from the liquidation estate. This was also affirmed by the NCLAT Chennai in the same matter, highlighting that no security interest was created in favour of the applicants, and without a registered sale deed, they had no ownership rights, thereby denying them any relief. This case clearly emphasised on the importance of registered conveyance deed, and it is thereby creates right in favour of the homebuyer.

[14] Company Appeal (AT) (Insolvency) No. 926 of 2019

Intwine of IBC and RERA

The Insolvency and Bankruptcy Code (Amendment) Act, 2020 introduced new provisions to section 7(1) of the IBC and imposed additional conditions for real estate allottees to approach the NCLT. In *Manish Kumar v. Union of India*[15] wherein it was challenged the bank's right to initiate proceedings on the ground that the entire debt had not been repaid. The Supreme Court while upholding the Amendment Act also held that as determination of a real estate project would depend on the terms and conditions, in which the allottees are a part of. This means that specific details and characteristics of each real estate project will be taken into consideration when assessing a real estate project.

RERA aims to protect the interests of homebuyers and ensure project completion, but the IBC's focus on resolution might involve changes in project management or even liquidation, potentially conflicting with RERA's objectives.

Under the Transfer of Property Act, 1882, a buyer is entitled to a charge on the property to the extent of the purchase money paid by her along with interest. This statutory right provided to a buyer is subject to a contract to the contrary.

Under the Indian Registration Act, 1908, any agreement involving the transfer of an interest in immovable property valued at over one hundred rupees must be registered. Therefore, if a property is purchased based solely on an agreement for sale without a subsequent registered sale deed, the buyer does not acquire any rights or interests in the property.

However, there is an exception to this rule outlined in section 53A of the Transfer of Property Act, 1882. Section 53A protects the buyer who has taken possession of the property and fulfilled their obligations under the agreement, preventing the seller from disrupting the buyer's possession. It's important to note that while section 53A shields the buyer from the seller, it does not transfer ownership of the property to the buyer; the seller retains ownership until a registered sale deed is executed. Section 53A operates only when the agreement is registered.

In essence, the transfer of title in immovable property can only be accomplished through a registered sale deed. Without a properly stamped and registered sale deed, the buyer does not gain any rights, title, or interests in the property.

When possession of a plot, apartment, or building has already been transferred to the allottees, these transactions must be formalized through registration during CIRP or a project-specific resolution process under the IBC. In the matter of *Pradip Kumar Chaudhuri v. Dagcon (India) (P) Ltd.*,[16] it has been held that there was no bar on the execution of sale deeds in favour of allottees even during the moratorium under section 14 of the Code.

Therefore, reading the above laws together, it can be interpreted that homebuyers can be considered secured only when the right is created upon the buyers. Such rights is created by virtue of the sale deed/ agreement and such documents is duly registered as per the above

[15] (2021 SCC Online SC 30).

[16] 2020 SCC NCLAT 860.

given laws read in harmony together. No such right of charge can be created in favour of a homebuyer unless the registration of such transfer is duly done. It is imperative to understand, that once the registration is done, on payment, the homebuyer can no longer be called a creditor. There is a difference between the registered agreement to sell and the registered sale deed.

CONCLUSION

The journey for homebuyers and their rights has been a long one. From 2018, the amendments were taken as an active step to consider the rights of homebuyers. Various other laws, which have been focusing on rights of the homebuyers were also considered. Even though, after a rigorous study from all aspects in legal industry, the rights of homebuyers in insolvency proceedings remain a contentious and uncertain issue. Although the IBC amendment aimed to address homebuyers' concerns by including allottees as FCs, however, there have been judgements which have not brought in clarity to the status of homebuyers. The homebuyers at large, are being considered as 'unsecured'.

There are situations where cases of delay must be considered and the impact on homebuyers. The aim of this study is not to tamper with the Code, but to strengthen the rights of homebuyers by strengthening the Real Estate (Regulation and Development) Act, 2016.

Considering section 55(6)(b) of the Transfer of Property Act, 1882, a purchaser has the right to claim a charge on the property up to the amount of the purchase price paid, along with any accrued interest. However, this statutory entitlement is subject to any contractual agreements to the contrary.

The Transfer of Property Act, 1882 specifies that an agreement for sale, whether with or without possession, does not constitute a conveyance. Section 54 of the Act stipulates that the sale of immovable property must be executed through a registered instrument, and an agreement for sale does not establish any interest or charge on the property.

Under the Indian Registration Act, 1908, any agreement involving the transfer of an interest in immovable property valued at over one hundred rupees must be registered. Therefore, if a property is purchased based solely on an agreement for sale without a subsequent registered sale deed, the buyer does not acquire any rights or interests in the property.

However, there is an exception to this rule outlined in section 53A of the Transfer of Property Act,1882. Section 53A protects the buyer who has taken possession of the property and fulfilled their obligations under the agreement, preventing the seller from disrupting the buyer's possession. It's important to note that while section 53A shields the buyer from the seller, it does not transfer ownership of the property to the buyer; the seller retains ownership until a registered sale deed is executed.

In essence, the transfer of title in immovable property can only be accomplished through a registered sale deed. Without a properly stamped and registered sale deed, the buyer does not gain any rights, title, or interests in the property.

When possession of a plot, apartment, or building has already been transferred to the allottees, these transactions must be formalized through registration during CIRP or a project-specific resolution process under IBC.

Therefore, in cases where the allottees have paid the amount and have already occupied the units, or possession of a plot, apartment, or building has been handed over to them, it is essential to formalize these transactions through the transfer of such units during the resolution process with the approval of the CoC and get the said sale deed registered, in order to create a charge in favour of the home buyer. Therefore, reading the above laws together, it can be interpreted that homebuyers can be considered secured only when the right is created upon the buyers. Such rights is created by virtue of the sale deed/ agreement and such documents is duly registered as per the above given laws read in harmony together. No such right of charge can be created in favour of a homebuyer unless the registration of such transfer is duly done. In this, regard, it may also be taken into consideration the legal maxim *'nemo dat quod non habet'*, meaning no one can give what they do not have, and it is true for ownership titles and benefits. The stand of homebuyer in view of IBC and Transfer of property Act, 1882 cannot be solely consolidated and other sector also have to take into consideration the plight of homebuyers.

This recommendation is aimed at strengthening the rights of the homebuyers, without further amendments to the Code. This very small act by the RPs will have a major impact on this stakeholder of society and better resolution results for economy at large.

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THE CASE FOR ALLOWING DIRECT DISSOLUTION DURING CIRP: A NEEDED EVOLUTION IN IBC

Surbhi Gupta

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) is a landmark legislation in India aimed at creating a unified framework for addressing insolvency and bankruptcy issues in a time-bound and efficient manner. The Code consolidates and amends the existing laws relating to the reorganization and insolvency resolution of corporate entities, partnership firms, and individuals, with the primary objective of maximizing asset value, promoting entrepreneurship, enhancing the availability of credit, and balancing the interests of all stakeholders. The Code is designed to focus on resolution rather than recovery proceedings.

The Bankruptcy Law Reforms Committee, in framing the Code, aimed to establish a system that enables the quick resolution of the sick companies. The Code is structured to assess the viability of an enterprise at an early stage, emphasizing that the viability of a business should be determined through negotiations between creditors and the debtor. Ultimately, the final decision on the viability of the enterprise rests with the creditors, who are the ones bearing the financial risk.The Code also enforces a time-bound process to preserve the economic value of the enterprise, ensuring that any delaying tactics do not extend the corporate insolvency resolution process (CIRP) period beyond the set timeline.

However, in cases where no resolution of the corporate debtor (CD) is achieved or approved by the committee of creditors (CoC) or resolution plan is not implemented, the liquidation of the CD is ordered. Once the CD's assets are completely liquidated and the outstanding debts are repaid as per the waterfall mechanism provided under section 53 of the Code, the National Company Law Tribunal (NCLT) orders dissolution of the CD, meaning the legal death of the CD.

As the implementation of the Code has progressed, certain practical challenges have emerged, revealing the need for more flexibility in its procedures. One such area that merits reconsideration is the possibility of allowing direct dissolution during the CIRP, especially in cases where the CD has no assets to realize. This would not only conserve the efforts and resources of creditors and various stakeholders but also expedite the process, thereby achieving the objectives of the Code in its true letter and spirit.

THE ABSENCE OF DIRECT DISSOLUTION DURING CIRP

The IBBI (Liquidation Process) Regulations, 2016, particularly Regulation 14, allow for an "early dissolution" during liquidation. This provision enables the liquidator to file for dissolution of the CD before the one-year liquidation period is completed, provided the CD's assets have been fully sold, and the realization and distribution process is finished.

However, despite the allowance for early completion of the liquidation process, the Code currently does not provide any provision for direct dissolution during the CIRP itself. This means that even if a CD has no assets, the liquidation process must still proceed, potentially leading to unnecessary delays and costs. The sequence of IBC process i.e., CIRP followed by liquidation and then dissolution, remains to be strictly adhered to under the current legal framework of the Code, regardless of the specific circumstances of the CD.

THE RATIONALE FOR DIRECT DISSOLUTION DURING CIRP

In addition to the basic objective of the Code of improving the effectiveness and efficiency of insolvency resolution process, there is also an additional objective which seeks value maximization for all the stakeholders and to promote sound business decision making. However, in the peculiar cases, when a CD has no assets, and the CIRP of the CD had failed, the liquidation process serves no purpose other than to incur additional costs which have to be ultimately bear by the stakeholders. In such scenarios, the rigid requirement of undergoing liquidation before dissolution contradicts the very basic principle of the Code.

The Hon'ble National Company Law Appellate Tribunal (NCLAT), in the matter of *Binani Industries Limited v. Bank of Baroda & Anr.,*[1] clarified the objectives of the Code as: *'The first order objective is "resolution". The second order objective is "maximisation of value of assets of the Corporate Debtor" and the third order objective is "promoting entrepreneurship, availability of credit and balancing the interests". This order of objective is sacrosanct.'*

Allowing direct dissolution during CIRP in cases of CDs with nil assets would align more closely with the objective of the Code for the following reasons:

a) **Cost efficiency**: Liquidation process incurs additional costs which includes liquidator's fees, expenses for public announcement, appointing other professionals and other administrative and legal expenses which can be significant. When there are no assets to realize, these costs are effectively wasted, diminishing whatever minimal returns creditors might expect from the process. The process allowing direct dissolution after failure of the CIRP eliminate these unnecessary expenses.

b) **Time efficiency**: The liquidation process, even in cases of nil estate of assets, can be time-consuming. Allowing direct dissolution after failure of the CIRP would speed up the closure of the insolvency process, allowing creditors and other stakeholders to move on and allocate resources elsewhere.

c) **Reduction of judicial burden**: Liquidation cases with no liquidation estate adds to the caseload of NCLT. Allowing direct dissolution during CIRP would reduce

[1] Binani Industries Limited v. Bank of Baroda & Anr., Company Appeal (AT) (Insolvency) No. 82 of 2018.

the burden on Tribunals, enabling them to focus on cases where there is a genuine possibility of asset recovery.

d) **Alignment with IBC's objectives**: The Code is designed to ensure the efficient resolution of insolvency, with liquidation as a last resort. However, when liquidation is guaranteed to be ineffective, mandating it becomes an unnecessary formality. Allowing direct dissolution after the failure of the CIRP would be a more practical application of the Code's objectives and principles.

SAFEGUARDS AND CONSIDERATIONS

While the advantages of allowing direct dissolution after the failure of CIRP are discussed above, the approach of allowing direct dissolution after failure of the CIRP requires careful and cautious implementation to prevent the abuse of the law. The key safeguards may include the following in order to ensure that the objective of the Code are protected:

- **Verification of nil assets**: Before permitting direct dissolution, the Resolution Professional (RP) should thoroughly verify that the CD genuinely has no assets and the certificate from a Registered Valuer in this respect may be obtained.
- **Mandatory CoC approval**: CoC's approval is required for liquidation under the section 33(2) of the Code, similarly, any resolution towards direct dissolution should also require the consent of the CoC. The CoC would also be required to record the reasons for going for direct dissolution which may consider factors including but not limited to non-operational status of the CD, goods produced, or service offered or technology employed being obsolete, absence of any assets, lack of any intangible assets or other factors which substantiate the decision for direct dissolution of the CD. This would ensure that no stakeholder is disadvantaged by the dissolution.
- **Judicial oversight**: The NCLT should retain oversight over the process to ensure that the decision to dissolve directly during CIRP is based on sound reasoning and that all stakeholders' interests are considered.

UNDERSTANDING THE CASES OF DIRECT DISSOLUTION CONSIDERED BY NCLT

The NCLT has adjudicated on the issue of direct dissolution of CDs without proceeding to liquidation in several cases. A few of these cases are briefly discussed as follows:-

a) **In the matter of M/s. Synew Steel Private Limited**[2]– In a first of its kind, the NCLT, Bengaluru Bench, *vide* order dated November 16,2020, ordered for direct dissolution of M/s. Synew Steel Private Limited from CIRP, thereby waiving the mandatory requirement to undergo the liquidation process. NCLT had allowed direct dissolution of the CD on the ground that no useful purpose will be served by placing the CD under liquidation, as all the assets available with the CD were already realized, the liquidation process under the provisions of the Code is deemed to have been completed and therefore, it would be just and proper to dissolve the company.

[2] IA(IBC)/435/2020 in CP(IB)/96/BB/2020; order dated: 16/11/2020.

b) **In the matter of M/s. Aesys Technologies India Private Limited**[3]–The NCLT Division Bench- II Chennai ordered direct dissolution of M/s. Aesys Technologies India Private Limited. The decision was based on the findings that the CD had no fixed assets, no public deposits, and had already paid all statutory dues, with no material statutory dues pending. Further, the CD's audited balance sheet showed only a minimal cash balance of ₹335 and ₹59740.78 in its bank account, which was used to cover the CIRP costs. Additionally, no claims were received from the employees, and the CoC resolved in its first meeting on July 15, 2021 to pursue an early/direct dissolution of the CD, citing the absence of assets for realization.

c) **In the matter of M/s. Ogene Systems India Limited**[4] **-** The NCLT Hyderabad Bench- II ordered direct dissolution of M/s. Ogene Systems India Limited. The decision was based on the findings that the CD had no chances of reviving as there are no immovable assets or even no plant and machinery and the average liquidation value of the CD as per the valuation reports is only ₹87000 which can be used towards the CIRP cost. Further, CoC is of the opinion that as there are no assets to liquidate and distribute to the stakeholders and therefore, inviting expression of interest will not serve the purpose of resolving the insolvency of the CD. The CoC in order to avoid liquidation costs had resolved to dissolve the CD.

d) **In the matter of M/s. Nouvelle Advisory Services Private Limited**[5] **-** The NCLT, Kolkata Bench ordered the direct dissolution of the CDon the ground that the CD had no realizable assets and insufficient funds to cover the costs of both the CIRP and potential liquidation. The CoC comprising the sole financial creditor (FC), agreed that pursuing liquidation would be futile, as it would incur additional costs without any recovery.

e) **In the matter of M/s. Shoes on Loose Private Limited**[6] **-** The NCLT, New Delhi Bench - IV, approved the direct dissolution of M/s. Shoes on Loose Private Limited. This decision was made without proceeding through the liquidation process, primarily because the company had no substantial assets left to liquidate. NCLT observed that CD's business had ceased following the COVID-19 pandemic, and its only remaining tangible assets, which included outdated mobile phones and laptops, were sold for a minimal amount. The CoC after realizing that any further proceedings would only escalate costs without yielding significant returns, unanimously resolved to dissolve the company directly. The NCLT emphasized that the continuation of the insolvency resolution process or initiation of liquidation would serve no practical purpose, as all realizable assets had already been dealt with.

[3] IA(IBC)/978(CHE)/2021 IBA/20/2020; order dated: 11/03/2022.

[4] I.A.No.520/2023 in C.P.(IB)No.114/7/HDB/2022.order dated 13.04.2023.

[5] IA(IBC)/1026(KB)2023 in CP(IB)/191(KB)2022 order dated 21.08.2023.

[6] IA/2598/ND/2022 in CP(IB)/862/ND/2020 order dated 31.10.2023.

f) **In the matter of M/s. Value Solar Energy Private Limited[7] -** The NCLT, New Delhi Bench -III ordered the direct dissolution of M/s. Value Solar Energy Private Limited on the ground that the CD had no tangible assets, with only a small amount of cash on hand, which had already been used to cover the CIRP costs. Despite efforts to evaluate the company's financial and transactional records, no preferential, undervalued, extortionate, or fraudulent transactions were found. The CoC consisting of a single member who held 100% voting rights, resolved to pursue dissolution instead of liquidation, as there were no assets to liquidate, and no further expenses were justified. The NCLT also emphasized that the objective of the IBC is to resolve insolvency or dissolve the entity expeditiously to maximize asset value. Thus, the NCLT concluded that the affairs of the CD were fully wound up, and ordered its dissolution without proceeding through the liquidation process.

g) **In the matter of M/s. United Fortune International Private Limited[8] -** The NCLT, Mumbai Bench ordered the direct dissolution of M/s. United Fortune International Private Limited on the ground that no useful purpose would be served by placing the CD under liquidation process which will increase the cost without any fruitful result. The NCLT noted that the secured FC has already proceeded against the CD by taking possession and selling all the premises and offices owned by the CD. The liquidation process under the provisions of the Code can be considered to have been carried forward and thus it would be just and proper to dissolve the CD, as proposed by the RP, when the members of the CoC in its commercial wisdom has passed resolution seeking dissolution of the CD.

Further, the issue of early dissolution of the CD without proceeding to liquidation also arose before the Hon'ble NCLAT, Chennai Bench, where the validity of this approach was discussed in detail. A brief summary of the same is encapsulated as follows:

In the matter of M/s. Air Pegasus Private Limited - The NCLT, Bengaluru Bench[9] approved direct dissolution of M/s. Air Pegasus Private Limited without going through the liquidation process on the reasoning that CD had no realisable assets. However, the said order of NCLT, Bengaluru Bench was appealed before the Hon'ble NCLAT Chennai Bench[10] by the Managing Director of the CD. The Hon'ble NCLAT, Chennai after considering the submissions, upheld the NCLT's order dated June 24, 2020 wherein the dissolution of CD was ordered. Whileupholding the order of direct dissolution the Hon'ble NCLAT, Chennai had observed as follows-

> 43. It cannot be lost sight off that the 'Corporate Debtor', had 'No Realisable Financial Assets', and the only 'Valuable Asset', was of 'Intangible' in nature of the 'Air Operator Permit', a 'License', issued by the 'DGCA' and the 'Validity' of the said 'License', had lapsed on 23.03.2020.

[7] IA-4855/2023 in C.P.(IB) – 280(ND)/2022 order dated: 29.11.2023.

[8] IA(IB)-3490(MB)2023 in C.P.(IB)-4313(MB)2018 order dated : 22.12.2023.

[9] I.A. No. 198/2020 in C.P.(IB) No. 180/BB/2018 order dated 24.06.2020.

[10] Shyson Thomas v. Mr. MadhugiriVenkatarayappa Sudarshan [T.A(AT)No.8 of 2021 in C.A(AT)(CH)(INS)/925/2020; order dated 01.06.2023].

44. It cannot be brushed aside that the 'Dissolution' of the'Corporate Debtor', was approved by the 'Financial Creditor' with'100% Voting Rights', and in IA No. 198 of 2020, filed by the 1st Respondent / Resolution Professional (under Section 54 of the I & B Code, 2016), an 'Order', dissolving the 'Corporate Debtor' / 'M/s. Air Pegasus Private Limited' (Applicant Company), was passed with an immediate effect, etc.

45. At this juncture, this 'Tribunal', pertinently points out that thereis no fetter that the 'Corporate Debtor', cannot be 'Dissolved', without undergoing the 'Process of Liquidation'

….

53. Suffice it for this 'Tribunal', to make a pertinent mention that inthe absence of any 'Asset(s)' / the 'Resolution Plan(s)', theResolution Professional, had no other go, but to pray for an 'Order of Dissolution', to be passed by the 'Adjudicating Authority'. Afterall, the end of 'Liquidation', requires complete 'Dissolution' of an'Entity'."

Grounds considered by the NCLT & NCLAT allowing direct dissolution

In conclusion, the common ground in the judgments referred above by the NCLT across various cases and the Hon'ble NCLAT is the absence of realizable assets within the CD. In each instance, the available assets were either insufficient to cover more than the CIRP or were non-existent. Additionally, the CDs in question had ceased operations, leaving no ongoing business activities to warrant the possibility of receiving expression of interest. The CoC, exercising their commercial wisdom, unanimously decided to avoid the additional costs and efforts associated with the liquidation process, opt instead for direct dissolution.

WAY FORWARD

The IBC has significantly strengthened India's insolvency framework, promoting efficiency and expediency. However, as the system matures, it is crucial to address practical challenges and refine processes to ensure that the Code continues to meet its objectives effectively. One such refinement could be the broader adoption of direct dissolution during the CIRP in cases where the CD has ceased operations and lacks assets for liquidation. This approach would be a logical evolution of the law, saving time, reducing costs, and aligning with the Code overarching goal of value maximization. The Adjudicating Authority's (AA's) decision in the Synew Steel case followed with other similar rulings, few of which as mentioned above and the Hon'ble NCLAT's observations in the M/s. Air Pegasus Private Limited case, provide a strong foundation for this approach.

To support this evolution, the regulations needs to be aligned with the objectives of the Code. Instead of mandating liquidation for defunct CDs having no assets or obsolete assets having negligible realizable value, the Code and its regulations may allow for direct dissolution following the failure of the CIRP. A standardized procedure, complete with mandatory conditions and a compliance checklist similar to those available for CIRP and liquidation in Form-H, may be incorporated. This would provide clear guidance to RPs, the CoCs, other stakeholders as well as to the AA on the prerequisites for exercising the power of direct dissolution. Such standardization would also help prevent any potential misuse of the process while ensuring consistency and transparency in such cases.

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TWEAKING IBC TO RESOLVE AIRLINE INSOLVENCIES

Kumar Saurabh Singh, Ashwij Ramaiah and Rohitesh Tak

ABSTRACT

The Convention on International Interests in Mobile Equipment (Cape Town Convention or CTC) read with the Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft Equipment (Aircraft Protocol) lay down the global legislative framework for financing and leasing of aviation assets. The Convention and the Aircraft Protocol stipulate that the municipal laws of member States shall contain provisions which allow lessors to repossess their aircraft objects during insolvency resolution of a distressed airline. India, being one of the signatories to the CTC and Aircraft Protocol, issued the notification no. S.O. 4321(E) dated October 3, 2023 through the Ministry of Corporate Affairs (MCA Notification) clarifying that moratorium under Section 14 of the Insolvency and Bankruptcy Code, 2016 (IBC/Code) is not applicable to transactions/arrangement/agreements related to aircraft, aircraft engines, airframes and helicopters to which the CTC and Aircraft Protocol, apply.

While the object of the CTC and Aircraft Protocol is laudable, it bears consideration that conferring the lessors with the unrestricted right to repossess the aircraft objects during insolvency of an airline could be counter productive for the overall revival of the airline. In the absence of operating aircraft, the airline has negligible prospects of revival/ turnaround which can be detrimental to the various other stakeholders such as banks, financial institutions, employees, workmen, passengers whose interests are also inter-linked to successful resolution of the airline.

The aim of this research paper is to suggest an alternative approach which strikes a more equitable balance between the right of lessors to repossess aircraft viz creating space for distressed airline to revive its business as a going concern. The research paper shall examine: (a) stakes involved in an airline insolvency and measures required for a successful turnaround, (b) impact of the MCA Notification and its effects on the airline sector, (c) the manner in which other jurisdictions have incorporated provisions of the CTC and Aircraft Protocol in their municipal law; and (d) suggesting options which could be considered to balance the interest of lessors while giving the airline a realistic chance of revival.

Keywords: Airline Insolvency, Moratorium, Aircraft Lessors, Repossession, Balanced Approach

INTRODUCTION

The airline sector is strategically important for the Indian economy. The passenger traffic in India (domestic and international) has increased from 10.53 crore (in FY 2021-22) to 19.06 crore (in FY 2022-23),[1] and is slated to increase manifold in the near future. As per the latest market forecast by Airbus, India will require 2,210 new aircraft over the next 20 years.[2] The combined value of these aircraft will be over ₹ 20,40,000 crore, and financing of about ₹ 35,000 crore would be required for taking deliveries of 100 of the seaircraft each year.[3] With global aircraft leasing market expected to grow from $172.9 billion in 2023 to $317.5 billion by 2030,[4] it is anticipated that the majority of the financing for the import of new aircraft in India would be through lease arrangements backed by global financiers. However, the cost of availing financing through such lease-backed arrangements would be dependent on the level of legal protection available to the aircraft lessors/financiers, especially in repossession of the aircraft if the airline faces insolvency.

Needless to say, aircraft lessors want the unrestricted right to repossess aircraft during the insolvency resolution of the distressed airline. However, vesting such a right with them raises concerns regarding the ability ofthe distressed airline to renegotiate and have the leeway to operate the aircraft for running its business as a going concern. In the absence of operating aircraft, the airline has negligible prospects of revival/turnaround, which can have a detrimental impact on various stakeholders. These include passengers, vendors, banks and financial institutions, employees, and workmen. This can impact the economy as a whole. Therefore, from a legislative perspective, it is ideal to adopt an approach that strikes a delicate balance between protecting the legal rights and interests of the aircraft lessors during the insolvency resolution process of the airline on one hand, and the successful revival/turnaround of the airline company on the other.

Under the scheme of the IBC, with effect from the date of commencement of the corporate insolvency resolution process (CIRP) under the provisions of Chapter II of Part II of the IBC, a moratorium comes into place. It *inter-alia* restricts owners/lessors from repossessing the assets which are in the occupation/possession of the corporate debtor (CD) undergoing the CIRP.[5] This was an omnibus restriction which applied in the case of every CIRP, notwithstanding the sector in which the concerned CD was engaged in.

However, an exception to this restriction has recently been carved out in the context of the insolvency resolution of CDs in the airline sector. The MCA Notification issued on October 3, 2023 has clarified that the moratorium under section 14 of the IBC is not applicable to

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[1] Directorate General of Civil Aviation, *Handbook on Civil Aviation Statistics 2022-23*, 6 (2023), https://www.dgca.gov.in/digigovportal/?page=jsp/dgca/InventoryList/dataReports/aviationDataStatistics/handbookCivilAviation/HANDBOOK%202022-23.pdf&main4252/4205/sericename[hereinafter DGCA Report].

[2] *India aircraft demand seen at 2,210 over next 20 years,* Airbus, (Mar. 24, 2022), https://www.airbus.com/en/newsroom/press-releases/2022-03-india-aircraft-demand-seen-at-2210-over-next-20-years.

[3] Ministry of Civil Aviation, Government of India, *Report of the Working Group on 'Project Rupee Raftar'- Development of Aircraft Financing and Leasing in India*, 4 (2019).

[4] *Aircraft Leasing Market Size, Share & Covid-19 Impact Analysis, By Aircraft Type (Narrow Body, Wide Body, and Regional Body and Regional Aircraft), By Lease Type (Wet Lease, Dry Lease, and Damp Lease) and Regional Forecast, 2023-2030,* Fortune Business Insights (May, 2023),https://www.fortunebusinessinsights.com/aircraft-leasing-market-107476.

[5] The Insolvency and Bankruptcy Code, 2016, §14(1)(d), No. 31, Acts of Parliament, 2016 (India).

transactions/arrangements/agreements related to aircraft, aircraft engines, airframes and helicopters. It must be noted, however, that this exception applies to only those aircraft, aircraft engines, airframes and helicopters to which the Cape Town Convention and Aircraft Protocol (signed and acceded by India), apply.[6]

In the opinion of the researchers, this notification has the potential to create uncertainty in the resolution of airline companies facing distress. This is because it prioritises the interests of aircraft lessors over all other stakeholders of the distressed airline. These include banks and financial institutions, employees and workmen, passengers, and other vendors, all of who mare within the ambit of moratorium and whose interests are also interlinked to a successful resolution of the airline. Therefore, the present research paper seeks to suggest certain changes/modifications which may be incorporated into the IBC. These could further the prospect of resolution of airlines while giving more say to the lessors in the insolvency resolution process of troubled airline companies. The aim of this research paper is to propose a more balanced approach between the right of an aircraft lessor to take repossession of a leased aircraft vis-à-vis creating an opportunity for a distressed airline to revive and run its business as a going concern. Towards this end, the research paper delves into: (a) the airline sector in India and the growing prominence of lease as a measure of financing aircraft; (b) analysis of the provisions of the CTC and the Aircraft Protocol in relation to repossession of aircraft by the lessors during insolvency resolution of the distressed airline; (c) insolvency law for the resolution of airline companies in India, the stakes involved in an airline insolvency, and the measures required for a successful turnaround; the impact of the notification and its effects on the airline sector from an entrepreneurship perspective; (d) the manner in which other jurisdictions have incorporated provisions of the Cape Town Convention and the Aircraft Protocol in their municipal law; and (e) suggesting options which could be considered to balance the interest of lessors while giving the troubled airline a realistic chance of revival.

THE INDIAN AVIATION SECTOR AND AIRCRAFT LEASING

Brief historical background

India's history in the civil aviation sector dates back to February 18, 1911, when M. Picquet (a French pilot) flew from Allahabad to Naini, covering a distance of eight miles to deliver letters and postcards.[7] However, it was only in 1932 when Tata Sons Limited became the first airline (i.e. Tata Airlines) to begin commercial operations between Karachi – Ahmedabad – Bombay – Bellary – Madras.[8] Later, between 1933-34, a number of airlines such as Indian Trans Continental Airways, Indian National Airways, Madras Air Taxi Services etc. came up and the aviation activities expanded with new routes introduced in Karachi, Jodhpur, Delhi, Allahabad, Gaya, Calcutta, Akyab, Rangoon.[9] Subsequently, in 1946, Tata Airlines was renamed as Air India and converted to a public company.[10]

[6] Ministry of Corporate Affairs, *Notification S.O. 4321 (E) under Section 14(3)(a) of the IBC* (Oct. 3, 2023), https://ibbi.gov.in/uploads/legalframwork/8273e42bb4de11d39f37ab81f96f93ec.pdf. [hereinafter MCA Notification].

[7] Sujan Kumar Saraswati, *Civil Aviation Environment in India*, 36 Econ. & Pol. Wkly. 1639, 1639 (2001)[hereinafter Sujan Kumar].

[8] J.R.D Tata, *The Story of the India Aircraft*, 65 Journal of the Royal Aeronautical Society 455, 459 (1961).

[9] Sujan Kumar, *supra note* 7, at 1639.

[10] Vippan Raj Dutt, *Dimensions Of Customer Service Quality – An Empirical Study Of Domestic Airline Industry In India*, Aligarh Muslim UnivInflibnet Service, 17 (2002) [hereinafter Vippan Raj Dutt].

At the time of independence in 1947, India had around 44 operational airports and 11 functional airlines.[11] However, owing to stiff competition and limited number of passengers, airlines began to undercut each other which led to losses.[12] Further, the increase in price of aviation fuel, operational expenditures and large fleets with less passengers took a heavy toll on the airlines operating at the time.[13] In 1948, Jupiter Airways went into liquidation, followed by Ambica Airlines in 1949, and later, many other airlines also went bankrupt.[14] Concerned by the stress in the aviation sector, in February 1950, the then Government of India (Government), set up the Air Traffic Enquiry Committee to recommend measures for improvement in the overall functioning of the industry.[15] The said committee, in its report, recommended voluntary mergers, deregistration of some airlines, and reallocation of assistance (including loans) to re-equip airlines with newer aircraft.[16] However, at that time, the Government was not keen to provide any financial assistance through restructuring of airlines and decided to nationalise the industry.[17]

As a result, the Air Corporations Act, 1953 (Air Corporations Act) was passed by the Parliament of India.[18] The salient features of the Air Corporations Act were that: (i) two corporations, Indian Airlines and Air India International, were established which had the power to operate any air transport, both domestic and international;[19] (ii) the finances and planning of the two corporations were to be controlled by the Government;[20] (iii) all licenses provided to private commercial operators for domestic scheduled services were nullified;[21](iv) the Government was given the power to regulate the functioning of the civil aviation industry in the country.[22]

Till the 1980s, India's civil aviation sector remained monopolised by the Government owned airlines.[23] However, in 1986, the Government again permitted the private sector companies to undertake air taxi services. The private sector companies included Air Sahara, Jet Airways, Damania Airways, East West Airlines, Modi Luft, and NEPC Airways.[24] Subsequently, in 1994, the Air Corporation Act was repealed which allowed the entry of private players (both resident and non-residents) in the airline industry.[25] However, not many operators were able to continue their business, and by 1997, only two private operators – Jet Airways and Air Sahara remained in business.[26]

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[11] Sujan Kumar, *supra note* 7, at 1639.

[12] Arijit Mazumdar, *Regulation of the Airline Industry in India: Issues, Causes and Rationale*, 70 Indian J. of Pol. Sci. 451, 452 (2009) [hereinafter Arijit Mazumdar].

[13] Vippan Raj Dutt, *supra note* 10, at 17.

[14] Sujan Kumar, *supra note* 7, at 1640.

[15] Ministry of Communication, Government of India, *Report of Air Transport Enquiry Committee* 2 (1950), https://space.gipe.ac.in/xmlui/handle/10973/26777.

[16] *Id.* at 105-116.

[17] Arijit Mazumdar, *supra note* 12, at 453.

[18] *Id.*

[19] The Air Corporations Act,1953, § 3, 7(1),No. 27, Acts of Parliament, 1953 (India).

[20] *Id.*, § 10.

[21] *Id.,* § 19.

[22] *Id.*, § 34.

[23] Pavithra Kumari and P. S. Aithal, *An Overview of the Aviation Industry in India with Special Emphasis on Privatization,* 4(2) IJCSBE 220, 221 (2020).

[24] Vippan Raj Dutt, *supra note* 10, at 19.

[25] The Air Corporations (Transfer of Under Takings and Repeal) Act, 1994, § 8(11), No. 13, Acts of Parliament, 1994 (India).

[26] Vippan Raj Dutt, *supra note* 10, at 19.

In 2003, the introduction of low-cost carriers (LCC) by Air Deccan brought a new competitive spirit to India's civil aviation industry and challenged the duopoly of Jet Airways and Air Sahara.[27] Furthermore, the introduction of low-cost airlines also changed the perception that air travel was reserved only for the elites.[28] The initial success of LCC in India led to the entry of more players into the market. These included Spice Jet, Kingfisher, Indigo, Paramount, and Go Air.[29]

At present, around 14 airlines are operating in India. Out of them, Indigo commands 54.7% of the domestic market share, followed by Vistara (10.4%), Air India (9.3%), Spice Jet (8.4%), Go Air (8.4%), Air Asia (7.0%), Akasa Air (1.1%) and other airlines (0.7%).[30] Practically, 98% of the airline business in India is with three players, i.e. Indigo, Air India (which is amalgamating Vistara and Air Asia), and Spice Jet.

Growth prospects of civil aviation in India

With time, there has been an exponential growth in the aviation sector due to high investments, structural reforms, improvement in quality of services, entry of LCC, etc. At present, with a population of more than 1.3 billion, India has great potential for further growth and development in the aviation industry. Air transportation in India is already estimated to support 6.2 million jobs and contribute US $35 billion towards the country's GDP. Moreover, air transport and foreign tourists arriving by air are expected to support 1.5 % of the Indian GDP.[31] Further, the revenue contribution of the aviation sector is estimated to be over ₹ 87.5 billion through tax receipts from employees and corporates, and additional revenue of ₹ 9.8 billion through the supply chain.[32]

According to the International Air Transport Association (IATA), in the next ten years, India is expected to overtake China and the United States as the world's third-largest air passenger market.[33] The recent trends show that the air passenger traffic in India, both domestic and international, witnessed a positive growth and increased to 190.60 million (FY 2022-23) as compared to 105.35 million in the previous year.[34]

To cater to the rising air traffic, the Government has been working towards increasing the number of airports. As of 2023, India has 148 operational airports, which are slated to increase to 220 by 2025.[35] Further, in the Union Budget of 2023-24, ₹ 3,224.67 crore (US$ 440.36 million) was allocated to the Ministry of Civil Aviation.[36] The UDAN Scheme, which aims to

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[27] *Id.*

[28] K. Deeppa, R. Ganapathi and Prasoom Dwivedi, *Services of Low-Cost Carriers in India: The Customer's Perspective,* 10(9) Indian J. of Sci. and Tech. 1, 1 (2017).

[29] Vippan Raj Dutt, *supra note* 10, at 20.

[30] DGCA Report, *supra note* 1, at 9.

[31] IATA, *The Importance of Air Transport in India,* 1, iata.org/en/iata-repository/publications/economic-reports/india—value-of-aviation/.

[32] Uttiya Bhattacharyya and Dr. Dhalla Rizwan Salim, *Modeling the Dynamic Air Transport Industry Aviation Fuel Demand in India,* 4 Int. J Sup. Chain. Mgt 35, 36 (2015).

[33] IATA, *The Future is Bright: But Not Without Its Challenges*, 1 (2018), https://www.iata.org/en/iata-repository/publications/economic-reports/the-potential-and-challenges-of-indian-aviation/.

[34] DGCA Report, *supra note* 1, at 6.

[35] *Indian Aviation Industry,* Indian Brand Equity Foundation(Aug. 2023), https://www.ibef.org/industry/indian-aviation.

[36] *Id.*

stimulate regional air connectivity, was allocated ₹ 601 crore (US$ 77.52 million).[37] Moreover, in 2023, the Government has accorded 'in-principle' approval for setting up of 21 greenfield airports across the country. Out of these, 11 greenfield airports have already been operationalised.[38]

The Government has further announced that it will spend US$ 11.88 billion by 2025 to boost regional connectivity by constructing new airports and modernising existing ones.[39] Further, as per the recent report of the Ministry of Civil Aviation, earlier, about 40% of the airspace in India was unavailable for civilian use.[40] This airspace has now been agreed to be released by the Indian Air Force.[41] This is estimated to provide overall benefit to the aviation ecosystem including significant savings in flight time, fuel usage, and reduction in carbon emission.[42]

Furthermore, globally, the maintenance, repairs, and operations (MRO) industry is expected to grow from US$ 68.5 billion in 2021 to US$ 117 billion by 2031. In light of this, the Government has envisaged developing an MRO industry in India that can, at the very least, fulfil the demands of the Indian airlines.[43] To achieve this, the Government has proposed various key steps, including setting up of a high-power task force for the promotion of MRO, the declaration of MRO and component warehouses as free trade zones with 0% GST, and import restrictions.[44]

Based on the above, it is evident that with the increase in passenger traffic and measures taken by the Government, the development in the aviation sector looks very promising. Having said this, airlines would be required to increase their fleet of aircraft substantially over the next few years to meet the increase in demand of passenger base. This would ultimately require a huge amount of finance, and for which,asset backed financing in the form of aircraft lease will have a key role to play. This aspect is analysed below.

Aircraft leasing and Indian aviation sector

As per the Air Leasing Manual issued by the Directorate General of Civil Aviation (DGCA), the term aircraft lease is defined to mean "*an agreement by a person (the lessor) to furnish an aircraft to another person (the lessee) to be used for compensation or hire purposes for a specified period or a defined number of flights*".[45] Aircraft leasing can be in the form of a wet lease, a dry lease or a damp lease. In a wet lease, the essential aircraft, crew, maintenance and insurance i.e.,

[37] *Id.*

[38] Ministry Of Civil Aviation, *In-Principle approval to set up 21 new Greenfield Airports in country* (July 23, 2023), https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1942034.

[39] Jamie Freed and Gerry Doyle, *India To Boost Aviation Infrastructure As Demand Booms,* Reuters (Mar. 20, 2023), https://www.reuters.com/business/aerospace-defense/india-eases-leasing-rules-address-aircraft-shortages-minister-2023-03-20/.

[40] Ministry of Civil Aviation - Government of India, *Annual Report 2020-21* 3-4, https://www.civilaviation.gov.in/sites/default/files/migration/AR-Eng-2020-21.pdf.

[41] *Id.*

[42] *Id.*

[43] NITI Aayog, *MRO In India – Trends, Challenges and Way Forward,* Brief 18 (July 2022), https://www.niti.gov.in/sites/default/files/202303/Development%20of%20MRO%20%28Maintenance%20repair%20and%20overhaul%29%20industries%20for%20the%20aviation%20sector%20in%20India.pdf.

[44] *Id.* at 52.

[45] *Aircraft Leasing Manual*, DGCA 6 (2013), http://164.100.60.133/manuals/cap3200.pdf.

ACMI are also leased along with the aircraft.[46] In a dry lease,only the aircraft is leased without the crew.[47] Finally, in a damp lease, the aircraft is leased along with partial crew to the lessee.[48]

Leasing an aircraft has its own advantages. The cost of purchasing an aircraft is high and can substantially increase the capital expenditure of an airline.[49] To mitigate this risk, airlines, especially those operating at low cost, tend to lease aircraft as the cost gets spread across the lease period, making it possible for them to fly at competitive rates.[50] Typically, sale and lease-back model is resorted to for leasing the aircraft.[51] Under this model, the airline first purchases the aircraft from manufacturer. Then, close to the delivery, the airline sells it to the lessor, and later leases it back from the lessor.[52] With this model, the operator gets to operate younger flights with low maintenance cost, and also benefits from leasing back the aircrafts.[53] Additionally, the leasing of aircraft provides various other advantages to the operator, including that: (a) it conserves their working capital and credit capacity; (b) provides up to 100% of finance, with no deposits or prepayments; and (c) provides volume discounts for aircraft purchase that can be passed on to airline.[54]

As per Boeing's commercial market outlook for 2019–2038, LCCs in India have dominated the Indian market, accounting for 65% of all domestic seats and 52% of total capacity (including international travel).[55] Due to the large market share of LCCs in the airline sector, the total numbers of leased aircraft in India stood around 86% (in 2021).[56] In fact, Indigo, which has more than 300 aircraft in its fleet, has recently disclosed in its annual report that out of its total debt of ₹ 448,542 million, operating lease liability amounted to ₹ 415,477 million.[57]

At present, Indian airlines are highly dependent on foreign leasing companies to finance their acquisition of aircraft. As of 2021, Avolon (Ireland) is the largest lessor to Indian airlines, with GE Capital Aviation Services (Ireland) and DAE Capital (UAE) at the second and third position respectively.[58] The other lessors to Indian airlines include, BBAM (USA, Australia),

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[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] Dipesh Shah and Pawan Kumar Chugan, *Aircraft Financing and Leasing in India Challenges & Opportunities: An Exploratory Study of Developing Aircraft Financing and Leasing in India,* in Business, Economy and Environment: Corporate Perspectives 282-290 (2019).

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] Peter S. Morrell, Airline Finance, 196(3rded. 2007).

[55] *Commercial Market Outlook 2019-2038*, Boeing 50 (2019), https://www.google.co.in/url?sa=t&rct=j&q=&esrc=s&source=web&cd=&cad=rja&uact=8&ved=2ahUK Ewjo1ISjluSDAxXba2wGHSkOBk0QFnoECAkQAw&url=https%3A%2F%2Fs4cd98e6181776fd7.jimcontent.com%2Fdownload%2 Fversion%2F1597359309%2Fmodule%2F8027287461%2Fname%2Fcmo-sept-2019-report-final.pdf&usg=AOvVaw1FgkaqW4zjwb5WmJd7UUYl&opi=89978449.

[56] Shanglio Sun, *Fleet Composition of Major Airlines in India as of January 31, 2021, by Aircraft Ownership,* Statista (Sep. 29, 2022), https://www.statista.com/statistics/1249054/india-fleet-composition-of-major-airlines-by-aircraft-ownership/.

[57] *Indigo Annual Report 2022-23- Towards New Heights & Across New Frontiers*, Indigo 38 (2023), https://www.goindigo.in/content/dam/goindigo/investor-relations/annual-report/2022-23/Annual-Report-2023-24.pdf.

[58] *Knowledge Report on Leasing & Financing Aircraft in India,* Acumen Aviation Group, 6 (2021), https://aidat.in/wp-content/uploads/2016/08/Knowledge-report-on-Aircraft-leasing-financing-IFSC-India.pdf.

BOC Aviation (Singapore), Dubai Aerospace (UAE), CDB Leasing (China), Aircastle (USA), ALAFCO (Kuwait), DVB Bank (Germany), and Goshawk Aviation.[59] Almost 100% of the aircraft that have been leased by Indian airlines are from these foreign leasing companies.

Heavy reliance of the Indian airlines on foreign leasing companies has prompted the Government to develop an aircraft leasing market in India. In this regard, the Government has taken key steps including: (a) developing International Financial Services Centres at GIFT City; (b) permitting insurance companies to undertake aircraft insurance and invest in leasing and financing business; (c) enabling pension funds and alternative investment funds to participate in aircraft financing; (d) exempting corporate tax for a block period of 10 years within 15 years for leasing units; (e) notifying aircraft lease as a financial product.[60] However, while these steps are in the right direction, it will take some time for them to fructify.

Currently, the aircraft leasing industry in India is still at the nascent stage. It is only in the latter half of this year that Indian companies, such as Adani Ports and Special Economic Zone (APSEZ),[61] Air India, and Indigo announced about setting up leasing units in IFSC to carry out the business activity of owning and leasing aircraft.[62] Considering this aspect, the Indian airlines will invariably continue to have reliance on foreign leasing companies for financing the acquisition of aircraft. In fact, recently, the Directorate General of Civil Aviation (DGCA) had granted its in-principle approval to Air India and Indigo for import of 470 and 500 aircraft respectively, which are proposed to be inducted during the period of 2023-2035.[63] It is likely that most of these aircraft would be financed by foreign aircraft lessors. Having said this, the critical factor that would drive the confidence of foreign lessors in the Indian aviation market would be the legal protection available to them for repossessing the aircraft in case any Indian airline faces insolvency.

India is already a signatory to CTC which is an international instrument providing for a uniform legal regime for the creation, perfection, priority, and enforcement of the security interests in objects such as aircraft, railway, and space objects. The demand of the foreign aircraft lessors across the globe has been for aneffective implementation of the CTC in the State in which the leased aircraft and lessors are located. This is because, aircraft lease being a mode of asset-based financing, the lessor, upon default by the debtor, wants prompt realisation of the value of the leased asset for generating proceeds/revenues.[64]

It is incumbent for the aircraft lessors to factor the pricing of the lease rentals for the aircraft based on the remedies available to them for repossessing the aircraft through the

[59] *Id.*

[60] *Government taking steps to make India a hub for aircraft leasing and financing*, PIB (July 28, 2021), https://pib.gov.in/Press Release Page.aspx?PRID=1740009.

[61] Libin Chacko Kuiran, *Adani Ports incorporates aircraft leasing unit in GIFT City*, ITLN (Oct. 25, 2023), https://www.itln.in/latest-news/adani-ports-incorporates-aircraft-leasing-unit-in-gift-city-1350211.

[62] Arindam Majumder, *Indigo, Air India to Set up Leasing Units at the Gift City*, The Economic Times (Sep. 4, 2023), https://economictimes.indiatimes.com/industry/transportation/airlines-/-aviation/indigo-air-india-to-set-up-leasing-units-at-gift-city/articleshow/103352060.cms?from=mdr.

[63] *Aviation Body Gives Nod to Air India, IndiGo to Import 970 Planes: Centre*, Press Trust of India (July 31, 2023), https://www.ndtv.com/india-news/aviation-body-dgca-gives-nod-to-air-india-indigo-to-import-970-planes-centre-4256746#:~:text=Aviation%20regulator%20DGCA%20has%20given%20an%20in-principle%20nod,IndiGo%20is%20to%20buy%20500%20planes%20from%20Airbus.

[64] Ronald Scheinberg, The Commercial Aircraft Finance Handbook 28 (2017).

effective implementation of the CTC. In the past, the Export Import Bank of the United States had reduced its exposure fee on financing of U.S. commercial aircraft by one-third for foreign buyers from countries that have ratified and implemented the CTC.[65] Further, authors in their studies have also estimated that upon adopting the CTC and Aircraft Protocol, a country could save between $7.6 billion and $11.1 billion over a twenty-year period,[66] and between thirteen and twenty percent per dollar of principal borrowed on interest.[67] Conversely, non-implementation of the CTC in its letter and spirit can increase the cost of lease rentals for airlines, which can have a detrimental impact on the end use customers/passengers and other stakeholders.[68]

It is estimated that in India, airlines have had to pay $1.2-1.3 billion extra in lease rentals because of the challenges faced by the foreign lessors in repossessing their aircraft within the country.[69] In this context, it is clear that the MCA has recently issued the Notification to further the right of lessors to repossess the aircraft swiftly during the insolvency resolution of the airline with a view to boost the confidence of the foreign lessors.[70] However, the Aviation Working Group Global (AWG) has still downgraded India to 'negative' from 'positive' owing to foreign lessors being unable to repossess their aircraft from Go Air which have been grounded since 2 May 2023.[71]

In view of the above, to appreciate the intent behind aircraft lessors seeking effective implementation of the CTC, a detailed analysis of the provisions of the CTC and the Aircraft Protocol is necessary.

CTC AND THE AIRCRAFT PROTOCOL

Background of the CTC

The history of CTC dates back to 1988, when T.B. Smith QC first proposed the idea of drafting an international convention to cover secured transaction for high value mobile equipment. This proposal was made during the diplomatic conference held in Ottawa for the signing of the Convention on International Financial Leasing and the Convention on International Factoring.[72] After assessing this proposal, the International Institute for the Unification of

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[65] Linda Formella, *EX-IM Bank Offers One-Third Reduction of its Exposure Fee on Export Financing for U.S. Large Commercial Aircraft,* EXIM(Jan. 20, 2003),https://www.exim.gov/news/ex-im-bank-offers-one-third-reduction-its-exposure-fee-export-financing-for-large-commercial.

[66] Anthony Saunders, Anand Srinivasan and Ingo Walter, *Innovation in International Law and Global Finance: Estimating the Financial Impact of the Cape Town Convention,* NYU Working Paper No. FIN-06-037 31–32 (2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=894027.

[67] Vadim Linetsky, *Economic Benefits of the Cape Town Treaty,* Aviation Working Group 2 (Oct. 18, 2009), http://www.awg.aero/assets/docs/ economicbenefitsofCapeTown.pdf.

[68] Nettie Downs, *Taking Flight From Cape Town: Increasing Access To Aircraft Financing,* 35 U. Pa. J. Int'l L. 863, 881-883 (2014).

[69] *Airlines could save around $1.3 billion as leasing costs decrease: Civil Aviation Ministry,* Business Line (Oct. 7, 2023) https://www.thehindubusinessline.com/news/ibc-regime-made-air-carriers-pay-12-13-b-extra-lease-rentals-moca/article67389589.ece.

[70] MCA Notification, *supra note* 6.

[71] Saurabh Sinha, *GoAir fallout: Global leasing watchdog downgrades India,* Times of India (Dec. 8, 2023), http://timesofindia.indiatimes.com/articleshow/105825064.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

[72] R Goode, H Kronke and E Mckendrick, Transnational Commercial Law: Text, Cases and Materials 394 (2015).

Private Law (UNIDROIT) formed a study group to create the draft of the convention for harmonising the law on secured transaction involving high value collateral equipment which were later reduced to aircraft, rolling stock, and space assets.[73] The study group had participation of the IATA and the AWG, comprising of representatives from the aviation, manufacturing, and finance sectors, and was co-chaired by Boeing and Airbus.[74]

In the beginning of the process, AWG and the IATA worked with the representatives of the space, railway and other industries to craft a single convention that would serve the needs of all the industries.[75] This process took around eight years, and later, in 1996, it stalled due to non-consensus being reached on having a common set of rules for different industries.[76]

Subsequently, UNIDROIT reorganised the drafting process, whereby it was decided that it would oversee the draft of the base convention. Further, an aircraft protocol group comprising of the AWG, the IATA and the International Civil Aviation Authority was formed, which would draft the additional aircraft protocol to the base convention.[77] Finally, on November 16, 2001, the CTC and the Aircraft Protocol were complete and opened for signature at the diplomatic conference convened for this purpose in Cape Town.[78] The CTC entered into force with respect to aircraft on March 1, 2006, when the Aircraft Protocol entered into force.[79]

Key provisions of the Convention related to enforcement rights of aircraft lessors

The CTC, along with the Aircraft Protocol, specifically apply to three categories of aircraft objects, namely, airframes, helicopters, and aircraft engines.[80] Moreover, Article 2 of the CTC elucidated three type of international interests in aircraft objects, namely, charger under a security agreement; conditional seller under a title reservation agreement; and lessor under a leasing agreement.[81] For the purposes of the present article, the authors have limited their analysis of the CTC and the Aircraft Protocol in relation to repossession of aircraft by the lessor in case of default by the debtor.

Under the CTC, the term 'creditor' includes an aircraft lessor, [82] and the 'debtor' includes a lessee under a lease agreement. [83] Further, the term 'lease agreement' is defined to mean *an agreement by which one person (the lessor) grants a right to possession or control of an object (with or without an option to purchase) to another person (the lessee) in return for a rental or other payment.*[84]

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[73] Anton N. Didenko, The Cape Town Convention-A Documentary History 8 (2021).
[74] Mark J. Sundahl, The Cape Town Convention- its Application to Space Assets and Relation to the Law of Outer Space 23 (2013).
[75] *Id.*
[76] *Id.*
[77] *Id., see also* Sanam Saidova, *Security Interest Under The Cape Town Convention On International Interest In Mobile Equipment* 6 (2018) [hereinafter Sanam Saidova].
[78] *Id.*
[79] *Id.*
[80] International Institute for the Unification of Private Law, The Convention on International Interests in Mobile Equipment, art. 2, Nov. 16, 2001, 2307 U.N.T.S. 285[hereinafter CTC]; Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment, art. I, Nov. 16, 2001[hereinafter Aircraft Protocol].
[81] CTC, *supra note* 80, art. 2.
[82] *Id.*, art. 1(i).
[83] *Id.*, art. 1(j).
[84] *Id.,* art. 1(q).

In terms of the CTC, in the event of default by the debtor, an aircraft lessor: (a) can terminate the lease agreement and take possession and control of the aircraft; or (b) apply for a court order authorising or directing either of these acts. Once possession is regained, the aircraft lessor is free to utilise the aircraft as desired.[85] Further, the lessee and the lessor can contractually decide on an event of default that would give rise to the rights and remedies specified in Articles 8 to 10 and 13 of the CTC.[86] Additionally, upon default by the lessee, an aircraft lessor can also seek interim relief from a court in a contracting State where the aircraft is located. The relief so granted may include: (a) preservation of the aircraft; (b) gaining possession, control and custody of the aircraft; (c) managing the aircraft and the income there from; (d) immobilisation of the aircraft.[87]

Key provisions of the Aircraft Protocol

The CTC is further supported by three equipment (i.e. aircraft, space object, and railway) specific protocols. The specific protocol that deals with the aircraft is known as Aircraft Protocol. In case of any inconsistencies, the provisions of the Aircraft Protocol take precedence over the Convention.[88]

It is a given that post default, the primary concern for the lessor is the prompt repossession of the aircraft, as allowing the debtor to retain it poses various risks.[89] The lessor is wary of potential relocation to an unfavourable jurisdiction, and aims to initiate revenue generation by leasing the aircraft to new customers.[90] Keeping such hardship of the lessor in mind, Article IX of the Aircraft Protocol provides for the de-registration, and export and physical transfer of the aircraft in the event of a default.[91] De-registration, a prerequisite for re-registration in a different territory as per the Chicago Convention, is facilitated by Article IX.[92] The remedy of de-registration and export can be implemented through two approaches: (a) a self-help method, and (b) court assistance. These are set out below:

a) Self Help Remedy

In terms of Article XIII of the Protocol, an airline company, as part of its leasing arrangement with its lessors, may issue an "irrevocable de-registration and export request authorisation" (IDERA) substantially in the form and manner annexed to the Protocol, in favour of its lessors.[93] The lessor in whose favour the IDERA has been issued or its certified designee (IDERA Holder) shall be entitled to exercise the following remedies: (a) procure the de-registration of aircraft;[94] and (b) procure the export and physical transfer of the Aircraft Object[95] from the territory in which it is situated.

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[85] *Id.*, arts. 10, 54(2).
[86] CTC, *supra note* 80, art. 11.
[87] *Id.,* art. 13.
[88] CTC, *supra note* 80, art. VI.
[89] *Aircraft repossession upon default – A review of the issues of the United Kingdom, USA, India and Nigeria,* INSOL International, https://brownrudnick.com/wp-content/uploads/2019/12/INSOL-International-Restructuring.pdf.
[90] *Id.*
[91] Aircraft Protocol, *supra note* 80, art. IX.
[92] Aircraft Protocol, *supra note* 80.
[93] *Id.,* art. XIII(1).
[94] *Id.,* art. I(2)(i) [The phrase "de-registration of aircraft" means deletion/removal of registration of the aircraft from the designated aircraft register maintained by a national authority in charge of registration/deregistration of aircraft].
[95] *Id.,* art. I(2)(c) ["Aircraft Objects" shall mean airframes, aircraft engines and helicopters].

The IDERA Holder may make an application to the Registry Authority[96] where the Aircraft Object is situated seeking deregistration and export of the concerned Aircraft Object (Deregistration Request). Such Deregistration Request is required to be honoured by the Registry Authority subject to applicable safety laws and regulations so long as : (a) the request is properly submitted by the authorised party under a recorded IDERA; and (b) the IDERA Holder certifies to the Registry Authority, if required by that authority, that all Registered Interests,[97] ranking in priority to that of the creditor in whose favour the authorisation has been issued, have been discharged, or, that the holders of such interests have consented to the de-registration and export of the Aircraft Object.

Lastly, the IDERA Holder is required to provide reasonable prior notice in writing of the proposed Deregistration Request to: (a) the debtor; (b) any person who, for the purpose of assuring performance of any of the obligations in favour of the lessor, gives or issues a suretyship, or a demand guarantee, or a standby letter of credit, or any other form of credit insurance. Additionally, the IDERA Holder must notify any other person having rights in or over the Aircraft Object, who have given notice of their rights to the chargee within a reasonable time prior to the de-registration and export.

b) Court Assistance

Court assistance can be requested by the lessors pursuant to Article13(1) of the Convention and Article X (6) of the Protocol.[98] Article 13(1) of the Convention allows for interim remedies in cases of debtor default, including the preservation of aircraft and aircraft objects, gaining possession, control, or custody of the aircraft, etc.[99] An order obtained under Article 13(1) of the Convention can be executed within five working days under Article X (6) of the Aircraft Protocol in the Contracting State where the aircraft is located.[100]

c) Obligations of the Contracting State under the Convention and the Aircraft Protocol related to insolvency of an airline

Under the CTC, "insolvency proceedings" have been defined to mean bankruptcy, liquidation, or other collective judicial or administrative proceedings, including interim proceedings, in which the assets and affairs of the debtor are subject to control or supervision by a court for the purposes of reorganisation or liquidation.[101]

The Aircraft Protocol consists of specific approaches that Contracting States can adopt in their domestic law for addressing the rights of lessors to take repossession of the aircraft in case insolvency proceedings are initiated against the debtor. These approaches are set out below:

[96] *Id.,* art. I(2)(o) ["Registry Authority" means the national authority or the common mark registering authority, maintaining an aircraft register in a Contracting State and responsible for the registration and de-registration of an aircraft in accordance with the Convention on International Civil Aviation dated 7 December 29144 ("Chicago Convention").]

[97] CTC, *supra note* 80, art. 1(cc) [The term "Registered Interest" shall collectively refer to: (i) International Interest; (ii) a registrable non-consensual right or interest (Registrable NCRI); and (iii) a National Interest specified in a notice of a national interest registered pursuant to Chapter V of the CTC.]

[98] Aircraft Protocol, *supra note* 80, art. X(6); CTC, *supra note* 80, art. 13.

[99] *Id.*

[100] *Id.*

[101] CTC, *supra note* 80, art. 1(l).

Alternative A: Under this approach, upon occurrence of an insolvency related event, the Resolution Professional (RP)/debtor would be required to give possession of the aircraft to the lessor at the end of the 'waiting period', or the date on which the creditor would be entitled to the possession of the aircraft object, if this Article IX of the Aircraft Protocol does not apply, whichever is earlier.[102]

Under this approach, the 'waiting period' would be the period specified in the declaration of the Contracting State. Contracting States that have adopted Alternative A in their domestic law have prescribed different waiting periods.[103] For instance, China, Jordan and New Zealand, among other countries, have declared the waiting period to be 60 days. On the other hand, Nigeria and Malaysia have declared it to be 30 days and 40 days, respectively.[104]

Further, until the lessor is given the possession of the aircraft, the RP/debtor would be required to maintain it and its value in accordance with the lease agreement.[105] The possession of the aircraft can be retained, if, within the waiting period, events of defaults have been cured by the lessee (except the one on account of filing for insolvency) and that it further agrees to perform the future obligations.[106] However, a second waiting period is not applicable in case the lessee defaults in the performance of its future obligations to the lessor.[107]

Alternative B: Under this approach, the RP/debtor is required to give notice to the lessor within the timeline specified in the declaration made by the Contracting State, pursuant to Article XXX(3) of the Aircraft Protocol (Notice).[108] By the said Notice, the RP/debtor is required to inform the lessor whether: (a) it will cure all the defaults (except the one on account of filing for insolvency) and agree to undertake future obligations under the agreement and related transaction documents; or (b) allow the lessors to take repossession of the aircraft.[109] If the RP/debtor fails to give the Notice or fails to allow the lessor to repossess the aircraft, then the lessor can approach the court for seeking necessary direction to repossess the aircraft.[110] In this regard, the court may order and require the lessor to take any additional step or provide any additional guarantee to comply with the terms of its order.[111] Further, pending the decision of the court, the aircraft object shall not be sold.[112]

Till date, only Mexico has adopted the Alternative B approach and declared that the debtor's notice must be given to the creditor within the contractually agreed time period.[113]

It is worth noting that unlike other States, USA has adopted a slightly different approach. In USA, upon filing of the insolvency petition, the automatic stay/moratorium becomes applicable

[102] Aircraft Protocol, *supra note* 80, art. XI(2) (Alternative A).
[103] *Id.*, art. XI(3) *(Alternative A)*.
[104] Sanam Saidova, *supra note* 77, at 246.
[105] Aircraft Protocol, *supra note* 80, art. XI(5) (Alternative A).
[106] *Id.*, art. XI(7) (Alternative A).
[107] *Id.*
[108] Aircraft Protocol, *supra note* 80, art. XI(2) (Alternative B).
[109] *Id.*
[110] *Id.*, art. XI(5) (Alternative B).
[111] Aircraft Protocol, *supra note* 80, art. XI(5) (Alternative B).
[112] *Id.*, art. XI(6) (Alternative B).
[113] Sanam Saidova, *supra note* 77, at 250.

which restricts the creditors from enforcing their recovery rights against the debtor.[114] However, an exception is provided under the Chapter 11 of the US Commercial Code, in relation to the bankruptcy of an airline company. Within 60 days from the date of filing a bankruptcy application, the debtor can elect to cure the events of defaults under the lease agreements, and thereby restrict the aircraft lessor from repossessing the aircraft, till such time.[115] However, the election to cure events of default by the debtor is subject to approval by the bankruptcy court.[116] Further, the timeline of 60 days for automatic stay can be extended further by the mutual consent of the debtor and lessor.[117] But, if the debtor fails to cure the default with 60 days from the date of filing the bankruptcy petition or such other date as decided mutually by the debtor and the lessor, then the lessor would have the right to repossess the aircraft.[118]

INTERPLAY BETWEEN AIRCRAFT LAWS AND THE IBC

The commencement of CIRP of Jet Airways Limited (Jet Airways) and Go Airlines (India) Limited (Go Air) prompted the need to examine the interplay between the provisions of extant laws pertaining to the regulation of airline companies in India, and the scheme of the IBC. One of the primary areas where such examination assumes critical importance is the right of a lessor to repossess its aircraft pursuant to defaults committed by the airline company in discharging its payment obligations towards lease rentals.

Remedies available to lessors under extant aircraft laws

The principal legislation governing the legal framework applicable to airline companies in India, is the Aircraft Act, 1937 (Aircraft Act), and the rules and regulations framed thereunder. Subsequent to the adoption of CTC and the Aircraft Protocol, India deposited Form No.27, making a declaration under Article XXX(1) of the Aircraft Protocol,[119] in terms of which India agreed to enforce the provisions under Article XIII of the Aircraft Protocol.[120] Subsequently, the provisions of Aircraft Rules, 1937(Aircraft Rules) were amended to accommodate the protection granted to lessors in terms of Article XIII of the Protocol.

In this context, the remedies made available to lessors under the provisions of Aircraft Act and Aircraft Rules (together Aircraft Laws) are set out herein below:

a) Firstly, Rule 30(6)(iv) of the Aircraft Rules stipulates that the Central Government shall mandatorily [121] revoke or cancel the certificate of registration if the lease in respect of the aircraft has expired or has been terminated by the lessor.

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[114] 11 U.S.C § 362.

[115] 11 U.S.C § 1110 (a).

[116] *See* Stephen R. Tetro et al., *Bankruptcy and Aircraft Finance,* Champan and Cutler3 (April 2020), https://www.chapman.com/media/publication/1011_Chapman_Bankruptcy_and_Aircraft_Finance_0420.pdf.

[117] 11 U.S.C, § 1110 (b).

[118] 11 U.S.C § 1110 (c).

[119] Aircraft Protocol, *supra note* 80, art. XXX(1) [art. XXX(1) stipulates that a contracting state may, at the time of ratification, acceptance, approval of, or accession tothis Aircraft Protocol, declare that it will apply any one or more of Articles VIII, XII and XIII of this Aircraft Protocol.]

[120] Article XIII of the Aircraft Protocol contains provisions pertaining to deregistration and aircraft of aircraft.

[121] Rule 30(6)(iv) of the Aircraft Rules stipulates the Central Government "may" cancel the registration of an aircraft registered in India *inter-alia* if the lease in respect of the concerned aircraft has expired or has been terminated. However, the Hon'ble Delhi High Court in the matter of *Awas 39423 Ireland Ltd and Ors* v. *Directorate General of Civil Aviation and Anr* 2015 SCC OnLine Del 8177 held that the term "may" is required to be interpreted as "shall" and accordingly, if the lessors have terminated the lease, then DGCA is obliged to cancel the registration of the aircraft.

b) Secondly, sub-Rule 7 was added to Article 30 of the Aircraft Rules,[122] which stipulated that if an IDERA Holder makes a Deregistration Request to the Central Government, the Central Government *"shall"* cancel the registration of the concerned aircraft[123] within a period of 5 working days. This would be done without seeking the consent or any document from the operator of the aircraft or any other person (including the airline company). To seek such cancellation of registration, the IDERA Holder is required to make an application (IDERA Application)[124] along with: (a) the original or notarised copy of the IDERA recorded with the DGCA; (b) priority search report from the International Registry regarding all Registered Interests in the aircraft ranking in priority; (c) a certificate from the IDERA Holder that all Registered Interests ranking in priority to that of the IDERA Holder in the priority search report have been discharged, or that the holders of such interests have consented to the deregistration and export of the aircraft. The cancellation of the registration of the aircraft, however, does not negate the right of the Central Government, or any affiliated entity, or any inter-governmental organisation in which India is a member, or other private provider of public services in India, to take actions such as arresting, detaining, attaching or selling an aircraft object under its applicable laws. These actions can be taken to recover owed amounts to the above mentioned entities, directly related to services provided by the aircraft in question.

c) Thirdly, Rule 32A was introduced into the Aircraft Rules. This stipulates that if the IDERA Holder makes an application for the export of the aircraft, the Central Government, consequent upon cancellation of the registration of an aircraft, under Rule 30(7) of the Aircraft Rules, shall take necessary actions to facilitate the export and physical transfer of the aircraft, along with spare engine, if any. This would be subject to: (i) the payment of outstanding dues in respect of the aircraft; and (ii) the compliance of the rules and regulations relating to safety of the aircraft operation.

d) In addition to the above, the DGCA, on November 16, 2018, issued 'Standard Operating Procedure for Implementation of Rule 32A Relating to Export of Aircraft Covered Under Cape Town Convention' (SOP).[125] The SOP, *inter alia*, states that when an IDERA Holder makes an IDERA Application, the DGCA is required to immediately publish the receipt of IDERA Application on its website, giving the date of receipt of the request, type and registration number of the aircraft, and the name of the operator in whose name the aircraft is registered.[126] In this regard, the airport operators are required to calculate the outstanding dues related to the aircraft in question for a period of 3 months immediately preceding the date of "declared default" (i.e. the date on which the request

[122] MCA Notification, *supra note* 5.

[123] Under the terms of Rule 5 of the Aircraft Rules, no aircraft can be operated unless such aircraft is registered with the Central Government in terms of Rule 30 of the Aircraft Rules.

[124] The format of making an IDERA Application has been prescribed in Appendix "A" of the Standard Operating Procedure being AIC 12/2018 issued by the Directorate General of Civil Aviation.

[125] *Standard Operating Procedure for Implementation of Rule 32A Relating to Export of Aircraft Covered Under Cape Town Convention,* Directorate General of Civil Aviation, AIC 12/2018(Nov. 16, 2018), http://164.100.60.133/aic/AIC12_2018.pdf [hereinafter SOP].

[126] *Id.*, Clause 3.

for deregistration was received by DGCA), and raise bills within 5 working days of the date of receipt of IDERA Request (Priority Dues) which are required to be paid by the IDERA Holder.[127] Once such payment is made by the IDERA Holder, the DGCA can then permit the IDERA holder to fly the aircraft out of India.[128]

A conspectus of the foregoing provisions demonstrates that under the prevailing Aircraft Laws, if an IDERA Holder makes a request for the de-registration and export of aircraft, then, so long as the conditions stipulated in Rule 30(2) read with 37 are satisfied, the Central Government (acting through DGCA) is mandatorily required to honour the request for deregistration and export the aircraft lodged by the IDERA Holder. This legal framework is in line with the declaration made by the Government in accordance with Article 54(2) of the CTC, which stipulates that "*Any and all remedies available to the creditor under the Convention which are not expressed under the relevant provision thereof to require application to the court may be exercised without court action and without leave of the court.*"

In this regard, the Hon'ble Delhi High Court, in the matter of *Awas 39423 Ireland Ltd and Ors. v. Directorate General of Civil Aviation and Anr*[129] (*Spice Jet Case*), observed that if the conditions set out in Rule 30 read with Rule 37 of the Aircraft Rules are satisfied, then the DGCA does not have any discretion and is obliged to deregister the aircraft. While arriving at its decision, it is relevant to note that the Hon'ble Delhi High Court placed reliance on the declaration made by the Government in the instrument of accession in terms of Article 54(2) of the CTC. Similar observations were made by the Hon'ble Delhi High Court in the matter of *Corporate Aircraft Funding Company LLC v. Union of India and Ors.*[130]

Interplay between the Aircraft Laws and IBC – Era of primacy of IBC over Aircraft Laws

In the foregoing paragraphs, the authors discussed that ordinarily, the remedies available to IDERA Holders under the Aircraft Laws are near absolute, and that its request for procuring deregistration and export are required to be mandatorily honoured by the Central Government. However, such rights available to IDERA Holders is put to test in cases involving insolvency resolution of airline companies.

Particularly, under the scheme of the IBC, simultaneous with the commencement of CIRP of a CD, a moratorium comes into force in terms of section 14 of the IBC. Section 14(1)(d) of the IBC stipulates that pursuant to the commencement of the CIRP of a CD, there is a prohibition on an owner/lessor from recovering any property which is in the occupation/possession of aCD. Consequently, in the event that an airline is subjected to CIRP, situations may arise wherein the right of an IDERA Holder to recover its aircraft by seeking deregistration and export under the Aircraft Rules is in direct conflict with the prohibition on such lessors to recover the aircraft which are in occupation/possession of the concerned airline company in light of section 14(1)(d) of the IBC.

This apparent conflict was put to test for the first time in the insolvency resolution process of Jet Airways. The Mumbai Bench of the Hon'ble National Company Law Tribunal (NCLT –

[127] *Id.,* Clause 5.
[128] SOP, *supra note* 125, Clause 8.
[129] Awas 39423 Ireland Ltd v. Directorate General of Civil Aviation, (2015) S.C.C. On Line Del. 8177 (India).
[130] Corporate Aircraft Funding Company LLC v. Union of India, (2013) S.C.C. On Line Del. 1085 (India).

Mumbai) passed an order dated June 20, 2019[131] commencing the CIRP of Jet Airways. Subsequent to the commencement of the CIRP, the lessors of Jet Airways sought to repossess their aircraft by making applications for deregistration and export of their respective aircraft with the DGCA. The RP of Jet Airways approached NCLT – Mumbai praying to restrain the DGCA from deregistering the aircraft until the completion of the CIRP. The NCLT – Mumbai passed an order dated July 5, 2019[132] (Jet Airways Order) observing that section 14(1)(a) of the IBC prohibits the institution of suits or continuation of pending suits or proceedings against the CD, including the execution of any judgment, decree, or order in any court of law, tribunal, arbitration panel, or "*other authority*". The phrase "*other authority*" was held to be wide enough to include the DGCA. Accordingly, the restrictions imposed in terms of section 14 of the IBC are applicable even *qua* the DGCA.

The NCLT – Mumbai further observed that under the scheme of the IBC, while a CD is undergoing CIRP, the custody and control over the assets of the CD are vested with the RP. During such process, if the lessors are allowed to procure deregistration and possession of aircraft, then a situation may arise that most of the aircraft, which are *the most valuable assets of the corporate debtor, would be taken away by the lessors*. Lastly, the NCLT – Mumbai observed that in case of a conflict between the provisions of the IBC and the provisions of Aircraft Laws, the former shall prevail. In view of these grounds, the NCLT – Mumbai passed an interim order dated July 5, 2019[133] restraining the DGCA from deregistering the aircraft in the fleet of Jet Airways.

Similarly, in the matter of Go Air, the lessors of Go Air attempted to procure deregistration and export of the leased aircraft after Go Air filed for the commencement of CIRP under section 10 of the IBC on May 2, 2023. However, prior to the expiry of the statutory period of 5 days as prescribed under the Aircraft Rules for deregistration of aircraft, Go Air was subjected to CIRP, pursuant to the order dated May 10, 2023, passed by the Principal Bench, NCLT.[134] Consequently, the DGCA did not proceed with the deregistration of the aircraft in view of the moratorium which came into force in terms of section 14(1) of the IBC. Aggrieved by the decisions of the DGCA, the lessors approached the Hon'ble High Court of Delhi seeking direction against the DGCA to deregister the aircraft and allow the export of aircraft that were in possession of Go Air. Parallelly, the lessors approached the NCLT, Principal Bench contending that pursuant to the termination of the lease, the aircraft no longer vested with the CD (and consequently, the RP of the CD), and consequently prayed the NCLT, Principal Bench to direct the RP to refrain from operating or flying these aircraft.

While the matter is *sub-judice* before the Hon'ble High Court of Delhi as on the date of this article, the NCLT, Principal Bench dismissed the application filed by the lessors. Crucially, the NCLT, Principal Bench in its order dated July 26, 2023[135] (Go Air Order) made the following observations:

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[131] State Bank of India v. Jet Airways (India) CP 1938, 1968 and 2205 (MB) – MB – 2019 (N.C.L.T. Mumbai Bench).
[132] State Bank of India v. Jet Airways (India),(2019) S.C.C. OnLine N.C.L.T. 24944 (India).
[133] *Id.*
[134] Go Airlines (India) Limited, Company Petition No. (IB)-264(PB)-2023 (N.C.L.T. New Delhi (Special Bench)).
[135] Go Airlines (India) Limited, (IB)-264(PB)/2023, IA/3280/2023, IA/3277/2023, IA-2944/2023, IA/3254/2023, IA-3048/2023, IA-2850/2023 in Company Petition No. (IB) – 264-(PB)-2023 (N.C.L.T. New Delhi (Court V)).

(a) In terms of section 14(1)(d) of the IBC, there is a prohibition by an owner/lessor on the recovery of any "*property*" which has been in the occupation/possession of the CD. The term "*property*" includes "*money, goods, actionable claims, land and every description of property situated in India or outside India and every description of interest including present or future or vested or contingent interest arising out of, or incidental to, property.*"[136] Further, the Hon'ble Supreme Court, in the matter of *Rajendra K Bhuta v. Maharashtra Housing and Area Development Authority,*[137] held that the term "occupied by" appearing in section 14(1)(d) of the IBC would mean actual physical possession.

(b) Aircraft which were provided by the lessors on lease to Go Air squarely fall within the definition of the term "property" under IBC. The physical possession of the aircraft is indisputably with Go Air. Accordingly, the aircraft would be covered within the scope of section 14(1)(d) of the IBC and the lessors would not be within their rights to claim possession of the aircraft.

(c) In the aviation industry, the prevailing practice is that most airline companies lease the aircraft for their operation rather than owning them. The provisions of IBC would have no meaning in respect of airlines as CDs, if the sole essence of the airline company is taken away. It would invariably result in the corporate death of the airline company, leaving no scope for resolution of the airline.

(d) The lessors were aware that Go Air had filed an application under Section 10 of the IBC praying for the commencement of its insolvency resolution, since it was widely reported in the media. This is strongly indicative of the fact that the objective behind the termination of lease agreements by the lessors was to evade the rigours of the moratorium as envisaged under Section 14 of the IBC.

The Jet Airways Order and the Go Air Order demonstrate that in instances where there has been a conflict between the remedies available to lessors to repossess their aircraft under the terms of Rule 30(7) read with 32A of the Aircraft Rules, and the prohibition imposed in terms of section 14(1)(d) of the IBC against an owner/lessor recovering property which is in occupation/possession of the CD, the prohibition imposed under the IBC has been held to prevail over the rights conferred on the lessors under the Aircraft Laws.

IBC Vs. Aircraft Laws – changing tides against IBC

The judgments in the matters of Jet Airways and Go Air espoused the primacy of the IBC over Aircraft Laws in cases of conflict. However, the aforesaid legal position appears to be on the cusp of undergoing substantial modifications to tilt the tide in favour of Aircraft Laws over IBC.

i. Notification issued by the Central Government under section 14(3)(a) of the IBC

The legal position according primacy to the provisions of IBC over Aircraft Laws underwent a *volte face* in view of the Notification issued by the Ministry of Civil Aviation. The

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[136] Insolvency and Bankruptcy Code, 2016, § 3(27).

[137] Rajendra K. Bhuta v.Maharashtra Housing and Area Development Authority, A.I.R. 2020 S.C. 3274 (India).

Central Government (acting through MCA) issued the Notification in exercise of its powers under section 14(3) of the IBC,[138] clarifying that the moratorium under section 14 of the IBC is not applicable to transactions/arrangement/agreements related to aircraft, aircraft engines, airframes and helicopters to which the Cape Town Convention and the Protocol apply.

In other words, the Jet Airways Order and the Go Air Order accorded primacy to the provisions of IBC over Aircraft Laws and curtailed the rights of lessors to repossess their aircraft during the moratorium period. However, the Central Government took the legislative route to hold that a right available to a lessor under the Aircraft Laws to recover possession of its aircraft by exercising their right as an IDERA Holder shall continue to be available to the lessors, *notwithstanding the moratorium imposed in terms of Section 14 of the IBC*.

ii. Notification issued by the Ministry of Civil Aviation being Notification Number G.S.R 296I dated April 13, 2022

As a part of pre-legislative consultation, the Ministry of Civil Aviation issued a notification dated April 13, 2022, inviting public comments in relation to the proposed 'Protection and Enforcement of Interests in Aircraft Objects Bill, 2022' (Aviation Bill),which is proposed to be enacted to solidify India's commitment to its obligations under the CTC and the Aircraft Protocol. It is relevant to note that the Ministry of Civil Aviation espoused the enactment of a separate and dedicated legislation for implementing the CTC and the Aircraft Protocol as a few of their provisions are in conflict *with the provisions of existing laws such as the Civil Procedure Code, 2008, the Specific Relief Act, 1963, the Companies Act, 2013 and the IBC.*[139] In other words, the Ministry of Civil Aviation has proposed the Aviation Bill with the expressly avowed objective of giving primacy to India's obligations under the CTC and the Aircraft Protocol over all other laws for the time being in force, including the IBC.

The Aviation Bill envisages that In International Interest registered in accordance with CTC shall be recognised even in the CIRP of the concerned airline company.[140] However, this is without prejudice to: (a) any rules of law applicable in the insolvency proceeding relating to the avoidance of a transaction as a preference or a transfer in fraud or otherwise; or (b) any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of the insolvency administrator.[141]

Particularly in relation to a moratorium, the Aviation Bill stipulates that notwithstanding anything contained in section 14 of the IBC or in any other provision of IBC dealing with moratorium/interim moratorium, upon the commencement of the CIRP of a CD,

[138] Section 14(3)(a) of the IBC stipulates that the moratorium imposed in terms of Section 14(1) of the IBC shall not be applicable to such transactions, agreements or other arrangements as may be notified by the Central Government in consultation with any financial sector regulator or any other authority.

[139] Paragraph 3 of the Explanatory Note read with Section 31 of the Protection and Enforcement of Interests in Aircraft Objects Bill, 2022.

[140] Protection and Enforcement of Interests in Aircraft Objects Bill, 2022 [hereinafter Aviation Bill], § 18(1).

[141] *Aviation Bill*, *supra note* 140, Proviso to § 18.

the RP/CD who has actual or constructive custody of the Aircraft Object[142] is required to give possession of such Aircraft Object to the creditor/lessor within a period of: (a) 2 calendar months from the date of commencement of insolvency proceedings; or (b) the date on which the creditor would have otherwise been entitled to take possession of the Aircraft Object, whichever is earlier (Waiting Period).

During the Waiting Period: (a) the insolvency administrator or the debtor, as the case may be, is required to preserve the Aircraft Object and maintain it and its value in accordance with the terms of the lease agreement, notwithstanding any powers relating to the sale or disposal of assets conferred upon such administrator under the provisions of IBC; and (b) the lessor is entitled to apply for any other forms of interim relief available under the law for the time being in force.[143] Further, the RP is entitled to be indemnified by the creditors for all the reasonable costs incurred by the RP during the Waiting Period to preserve the aircraft.[144]

However, the RP may retain the possession of the Aircraft Object where, before the expiry of the Waiting Period: (a) all defaults under the agreement, other than a default constituted by the commencement of the insolvency proceedings have been cured; and (b) the insolvency administrator or the debtor, as the case may be, has agreed to perform all future obligations of the debtor under the agreement (Retention Obligations).[145] However, where the insolvency administrator or the debtor fails to perform all future obligations of the debtor by the Waiting Period, the creditor *may immediately exercise his right to take possession of the Aircraft Object* as well as exercise other remedies provided under this Act.[146]

Further, in a marked deviation from the observations in the Jet Airways Order and the NCLT Order, the Aviation Bill abundantly clarifies that even during the course of the CIRP of the CD, the lessors will still be entitled to procure deregistration and export of aircraft when the right of the lessor to repossess its aircraft crystallises.

The Aviation Bill further clarifies that the remedies available in relation to deregistration and export of aircraft shall be made available by the DGCA subject to aviation safety laws and regulations, in a manner as prescribed. These remedies are to be made available within 5 working days after the date on which the creditor notifies DGCA that it is entitled to procure those remedies crystallises, either on the expiry of the Waiting Period or upon the failure of the insolvency administrator to comply with his Retention Obligations.[147]

A critical change proposed to be introduced under the Aviation Bill is regarding the order of priority of claims during insolvency resolution proceedings. The scheme of the IBC provides an order of priority of claims in the context of both the CIRP and liquidation.

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[142] Pari materia to the term "Aircraft Object" defined under the Aircraft Protocol. *See* Section 2(4) of the Aviation Bill.
[143] Aviation Bill, *supra note* 140, § 19(3)(a).
[144] *Id.*, § 19(4).
[145] Aviation Bill, *supra note* 140, § 19(5).
[146] *Id.*, Proviso to § 19(5).
[147] *Id.*, § 19(8).

However, the Aviation Bill proposes to usher in a revised order of hierarchy of claims. Under the Aviation Bill, in the event an airline company is subjected to CIRP, then, *notwithstanding anything contained in any other law (including IBC)*, a creditor/lessor holding Registered Interest[148] shall rank in priority over all other creditors, except for the following non-consensual rights or interests:[149]

(a) liens in favour of airline employees for unpaid wages arising since the time of a declared default by that airline under a contract to finance or lease and aircraft object;

(b) liens or other rights of an authority of India relating to taxes or other unpaid charges arising from or related to the use of that aircraft object and owed by the owner or operator of that aircraft object, arising since the time of a default by that owner or operator under a contract to finance or lease that aircraft object;

(c) liens in favour of repairers of an aircraft object in their possession to the extent of service or services performed on and value added to that aircraft object.

In other words, the Aviation Bill stipulates the following hierarchy of claims in the context of insolvency resolution process: (a) non-consensual rights and interests; (b) creditors holding Registered Interest; and (c) order of priority as prescribed in IBC.

The Aviation Bill also stipulates that the remedies available to the creditors/lessor under this Act shall be in addition to all other remedies available to a creditor under the law for the time being in force or agreed upon by the parties unless such rights are inconsistent with provisions of the Bill.[150]

Motivations for changing tides – perceived *sui generis* nature of the airline industry?

The legal framework envisaged under the Aviation Bill read with the Notification issued by the MCA demonstrates that the legislature seeks to accord primacy to India's obligations under the CTC and the Aircraft Protocol to insolvency resolution under the auspices of IBC. It is noteworthy to explore the various considerations which motivated such a paradigm shift in law.

First and foremost, there are commercial objectives sought to be achieved by providing primacy to India's commitments under the CTC and the Aircraft Protocol. In the explanatory note for the Aviation Bill, the Ministry of Civil Aviation proposed to enact a legislation for the purpose of achieving the following objectives:[151]

(a) It was noticed that international financial institutions have not been giving due weightage to accession to CTC/Aviation Protocol by any country unless it is accompanied by an implementing legislation.

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[148] Pari materia to the term "Aircraft Object" defined under the Aircraft Protocol. *See* Section 2(43) of the Aviation Bill.

[149] Aviation Bill, *supra note* 140, § 19(10).

[150] Aviation Bill, *supra note* 140,§ 20.

[151] Aviation Bill, *supra note* 140, para 3 of the Explanatory Statement.

(b) The Organisation for Economic Cooperation and Development has set a norm that a 10% discount will be given in the processing fee for a loan to acquire aircraft to the airlines of any country which is a party to the CTC/Aircraft Protocol, provided an implementing legislation has been passed by the specified country.

(c) An Act of Parliament would also provide greater confidence to the intending creditors resulting in a reduction of the risk applicable to asset-based financing and leasing transactions. The risk reduction is envisaged to result in a reduction in the cost of aviation credit, and will also bring down the lease rentals. This will be of immense help to the Indian aviation industry and will also benefit the passengers and other end users bypass-through price reductions and increased levels of service.

In addition to the aforementioned commercial reasons, legal commentators have hypothesised that the legal framework under IBC may not be adequately equipped for the insolvency resolution of entities in the aviation sector *inter-alia* on account of certain complexities which are unique to the airline sector. Accordingly, a*sui generis* legislation may be required for rehabilitation of airline companies undergoing stress. Some of these unique characteristic features are as under:

(a) Substantial assets involved in the aviation industry are capital intensive assets, 81% of which are leased commercially operated aircraft. The time typically taken for the completion of the CIRP under the IBC is not only likely to cause value erosion in relation to these assets but also result in massive maintenance expenditure;[152]

(b) Insolvency of airline companies involve substantial passenger interest wherein passengers may suffer both financial losses, on account of having purchased a ticket in relation to an aircraft which has suffered insolvency, and in some cases, welfare losses for being stranded in a location without any recourse to reaching their intended destination.[153] The treatment of the claims of these passengers may pose certain unique challenges:

    (i) First and foremost, the welfare losses of passengers are not quantifiable;

    (ii) Secondly, a passenger may purchase a ticket either from the airline itself through its physical counters or its website / mobile application or through a travel agency. In case of the former, the passenger himself will have a claim against the airline company. However, in case of the latter, the passenger may seek a refund and compensation for loss from the travel agency (subject to the cancellation policy of the travel agency). In such a case, the travel agency will, in turn, file a claim with the airline company for the amount claimed by the

[152] Dr. Neeti Shikha and Urvashi Shahi, *Policy Inputs on Report of Subcommittee on Prepack, Centre for Insolvency & Bankruptcy,* Indian Institute of Corporate Affairs 11 (Feb. 2021), https://iica.nic.in/images/Prepacks-in-India.pdf.

[153] Department of Transport, London, Airline Insolvency Review – Final Report, 8 (March 2019), https://assets.publishing.service.gov.uk/media/5cd1a8c940f0b6332070f283/airline-insolvency-review-report.pdf[hereinafter Airline Insolvency Report].

[154] The resolution professional of Go Air has published Guidelines for Filing of Claims by Operational Creditors (except workmen and employees) wherein: (a) passengers who have directly purchased tickets have been instructed to directly file their claims with the resolution professional; and (b) passengers who have purchased their tickets through travel agents/aggregator websites may not file their claims with the resolution professional. Travel Agents/aggregators may file consolidated claims on their behalf.

consumer.[154] In addition to the above, travel agents in India also have the option of seeking a refund from IATA[155] in which case the IATA may file its claim against the RP. Lastly, some passengers who may have purchased their tickets through credit cards may claim refund/compensation from the credit card company and subsequently, the credit card company may file its claim against the airline company.

In view of the foregoing, making an assessment of which person is entitled to verify their claim, assessing the extent of the amount which is due and payable after taking into account the cancellation policies and ensuring that there is no double counting of claims is an extremely onerous and challenging task.[156]

(c) The aviation industry is a highly technical and consequently a highly regulated sector. Managing the affairs of an airline company as a going concern requires personnel comprising of a niche set of skills, training and knowledge. It also requires the engagement of persons who may liaison with the DGCA and ensure that all licenses, approvals, grants etc are regular and that the operations of the airline are carried out in accordance with applicable legal framework. Typically, insolvency administrators or the firm with which they are associated with may not have in-house expertise to navigate these complexities. Additionally, the existing personnel of the CD who may be equipped to assist the insolvency administrator in this regard may not be persuaded to remain in employment with an airline which is undergoing insolvency resolution process.[157]

(d) IBC is essentially a domestic law which only extends to the jurisdiction of India.[158] However, airline business more often than not involves complex cross border complications. Typically, the lessors are situated outside India. If an airline company operates international routes, it may have assets situated outside India. It may also be catering to Indian passengers who are travelling back to India from abroad who need to be protected and rehabilitated form the adverse effects of the airline company's insolvency.[159]

The commercial reasons for according primacy to Aircraft Laws over IBCis not within the scope of enquiry of this paper. However, from a legal perspective it bears examination whether according primacy to Aircraft Laws over IBC justify a legal framework which retains the near absolute rights available to lessors under Aircraft Laws, notwithstanding the ongoing insolvency resolution process of the airline company.

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[155] IATA settlement service between airlines and travel agents (known as the BSP or Billing and Settlement Plan), may allow IATA10 to reimburse travel agents for monies submitted to the airline, depending on the national bankruptcy legislation and the specifics of the airline's participation with IATA.

[156] Bahram Vakil and Gausia Shaikh, *Insolvency in Aviation Sector, Insolvency and Bankruptcy Code - A Miscellany of Perspectives,* Insolvency and Bankruptcy Board of India,115-117 (2019), https://ibbi.gov.in/en/publication/others.

[157] *Id.*

[158] Insolvency and Bankruptcy Code of India, 2016, § 1(2).

[159] *Airline Insolvency Report, supra note* 153*,* at 118 – 119.

PRIMACY OF AIRCRAFT LAWS OVER IBC – CONSEQUENCES ON AIRLINE SECTOR IN PARTICULAR AND THE SCHEME OF THE IBC AS A WHOLE

Consequences on the scheme of IBC – Risk of dilution of "sector agnostic nature" of IBC

The modification to the scheme of IBC *vide* the Notification and the proposed modifications to Aviation Laws in terms of the Aviation Bill is likely to have far reaching consequences on the insolvency resolution of airline companies in India. These developments harken back to the legal position echoed in the *SpiceJet Case* where the Hon'ble Delhi High reaffirmed the near absolute right of lessors to repossess their aircraft by seeking deregistration and export in their capacity as IDERA Holders.

But before analysing the specific consequences of these developments on the airline industry, on a fundamental level, it may be relevant to examine whether allowing sector specific considerations to prevail over the all-encompassing insolvency framework in India under the IBC is a step in the right direction.

The very genesis of the IBC is rooted in evolving a single robust legal framework pertaining to insolvency resolution of debtors in the backdrop of a myriad of legislations governing the framework of insolvency resolution such as the Sick Industrial Companies Act, 1985 (now repealed), Provincial Insolvency Act, 1926, Presidency Towns Insolvency Act, 1920 etc., which grossly failed to achieve time-bound resolution of stressed assets.[160]

It is noteworthy that in the Problem Statement identified in Volume I of its Report titled *"Rationale and Design"*, the Bankruptcy Law Reforms Committee (BLRC) recognised that the multiplicity of legal arrangements has given rise to contradictory legal outcomes. It echoed the need for a single unified framework for dealing with insolvency and bankruptcy processes *of all legal entities* in India, notwithstanding the nature of business which such entities are engaged in. Particularly, the BLRC recommended that to preserve and ensure legal clarity, *"there should be a single Code to resolve insolvency for all legal entities"* such that *"all questions related to insolvency of any legal entity in India will find answer in a single Code."*

The BLRC recommended a single code taking into account the following advantages: (a) having a single unified code ensures legal clarity and certainty when there arises any question of insolvency or bankruptcy; and (b) a common insolvency and bankruptcy framework for individuals and enterprises will enable more coherent policies when the two interact. In other words, when different entities interact with each other, the factum of all these entities being governed under the terms of a common framework substantially improves business environment. For instance, it is quite common that in an enterprise, a company engaged in the steel sector may borrow monies from a creditor, which is secured by way of: (a) a corporate guarantee by another group company which is engaged in the power sector; and (b) a mortgage over a piece of land owned by another group company engaged in the real estate sector. In this scenario, having a common legal framework for insolvency resolution of one or more entities, irrespective of the sectors in which these companies conduct their business, makes the whole legal system synchronous, inexpensive, and helps increase efficiency of recovery.

[160] Anirud Wadhwa et al., Guide to the Insolvency & Bankruptcy Code xi (1st ed.,2019).

In view of the above, the IBC was specifically enacted as *"a sector agnostic legislation"* aimed at providing a single window for insolvency resolution of all legal entities notwithstanding the sector in which the concerned CD is operating.

Further, the scheme of the IBC has been open to recognise that insolvency resolution of certain category of CDs may require specific treatment considering the special nature of the business and the stakeholders involved. Often the legislature has found a way to accommodate these interests within the broader framework of the IBC. For instance, in the context of insolvency resolution of entities in the real estate sector, the Central Government: (a) included homebuyers within the definition of "financial creditors" (FCs) and consequently has granted them rights of representation, participation and voting in the Committee of Creditor (CoC) of the CD; and (b) is now contemplating to allow insolvency resolution of specific projects as opposed to CIRP of the corporate entity as a whole.[161] Similarly, in the case of insolvency resolution process for non-banking financial companies, the IBC provides a specific framework for their insolvency resolution which is *parimateria* to the insolvency resolution of any other corporate entity, but with certain modifications, taking into account the unique nature of the business of the non-banking financial company (NBFCs) and the stakeholders involved.

It is also crucial to know that while the IBC has accommodated sector specific interests, it has not given ground to the primacy of objectives sought to be accomplished under the IBC to other sectoral interests/legislation. For instance, while suitable amendments have been incorporated into the IBC to accommodate the interests of stakeholders of CD involved in the real estate sector, the primacy given to the IBC in terms of section 238[162] have not been diluted, and that in case of conflict, the provisions of the IBC still prevail over the provisions of Real Estate Regulatory Authority (RERA).[163] Similarly, while the IBC has entertained modifications in the interest of stakeholders of the CD involved in the financial services sector, courts/tribunals have still held that in case of conflict, the provisions of the IBC shall prevail over sectoral laws applicable to these financial services.[164]

Furthermore, a key objective of insolvency law is the efficient allocation of resources.[165] Having a single framework for insolvency resolution ensures a single regulatory/judicial system. For instance, in the present legal framework, the regulatory issues pertaining to insolvency resolution of legal entities, notwithstanding the sector in which these entities conduct their business, is overseen by the Insolvency and Bankruptcy Board of India (IBBI). Further, the judicial forum which addresses disputes on questions pertaining to insolvency

[161] *File No. 30/38/2021 – Insolvency, Government of India,* Ministry of Corporate Affairs (Jan. 18, 2023), https://www.mca.gov.in/content/dam/mca/pdf/IBC-2016-20230118.pdf.; Project-wise resolution of corporate debtors engaged in the real estate sector has already been judicially recognised. *See* Flat Buyers Association Winter Hills – 77, Gurgaon v. Umang Realtech Private Limited [Company Appeal (AT)(Ins) No. 926 of 2019]; Whispering Tower Flat Owner Welfare Association v. Abhay Narayan Manudhane [Company Appeal (AT)(Ins) No. 896 of 2021].

[162] § 238 of the IBC stipulates that the provisions of IBC 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.

[163] Pioneer Urban Land and Infrastructure Limitedv. Union of India, Writ Petition (Civil) No. 43-2019 (Supreme Court of India).

[164] Airforce Group Insurance Society v. R. Subramaniakumar, Company Appeal (AT)(Ins) No. 546 and 552 of 2021.

[165] MS Sahoo and Harshita Garg, *Don't let sectoral laws dilute IBC,* Financial Express(Nov. 6, 2023), https://www.financialexpress.com/opinion/dont-let-sectoral-laws-dilute-ibc/3297817/.

resolution is the NCLT. All of these regulatory/judicial apparatus function under the umbrella of the MCA. Having a dedicated regulator, a quasi-judicial forum, and a dedicated regulatory and academic apparatus, all functioning under the same nodal ministry ensures that all issues of law, policy, and procedure are appropriately dealt with by individuals who are equipped with specialised knowledge and expertise in relation to issues of insolvency resolution. The benefit of such efficient allocation of expertise/resources is often lost in the event of sectoral dispensations being accommodated under the IBC. The insolvency resolution of such companies, primarily under the auspices of the IBC and the regulatory/adjudicatory apparatus set up under the IBC, may end up becoming a hotchpotch involving multiple regulators, ministries and regulatory/judicial apparatus.

Furthermore, it is worth considering that the argument that certain unique characteristic features of an industry merits it to be exempted from the overall framework of the IBC may prove to be a dangerous slippery slope. Every industry has certain unique characteristic features on the basis of which arguments can be made that such industry ought to be excluded from the scheme of the IBC.[166] However, allowing such sector specific considerations to encroach the framework under the IBC amounts to effectively creating a different insolvency framework for each sector, thereby converting an otherwise sector agnostic market-wide law to a sectoral law.[167]

Primacy of Aircraft Laws – Consequences on insolvency resolution of airline companies

It is trite to mention that the most crucial property of an airline company undergoing the insolvency resolution process is the fleet of aircraft that are in its possession. As has been correctly observed in both the Jet Airways Order and the Go Air Order, the provisions of the IBC would have no meaning in respect of airlines as CDs, if the sole essence of the airline company's business, i.e., the aircraft is taken away. It would leave no scope for the successful insolvency resolution of the airline, and lead to its corporate death.

In effect, the Notification in terms of which the lessors have unbridled right to repossess their aircraft, notwithstanding the prevailing moratorium, has the potential to affect the continuation of the CD as a going concern and impede its successful resolution. As regards the proposed amendments in terms of the Aviation Bill, the RP/CoC is attempting to provide breathing room by way of the Waiting Period, during which the RP may enter into an arrangement with the lessors to retain possession of the aircraft pursuant to undertaking Retention Obligations. By providing such breathing room, the Aviation Bill definitely proposes a better middle ground between protecting the right of the lessors on one hand, while at the

[166] For instance, in 2018, companies engaged in the power sector made a representation that power sector should be given special dispensation from the provisions of the Reserve Bank of India's Framework for Resolution of Stressed ssets dated 12 February 2018 *(repealed)* which *inter-alia* stipulated that in the event of failure to resolve the stress of a company under this framework, the borrower is required to be referred to CIRP under IBC. The representation was made on the following grounds: (a) coal shortage and taking away of captive mines in some cases; and (b) non-availability of long-term power purchase agreements for the industry. Similar representation was made by companies engaged in the steel sector who sought dispensation from the applicability of provisions of IBC to companies in the steel sector. *See* Jyoti Mukul, *Why IBC must be sector – agnostic,* Business Standard (July 2, 2018), https://www.business-standard.com/article/opinion/why-ibc-must-be-sector-agnostic-118070100732_1.html.

[167] *Id.*

same time providing the RP with an opportunity to retain custody of the aircraft for the purposes of managing the affairs of the CD as a going concern.

Having said that, a few practical challenges emerge even under the proposed Aviation Bill. First, the Aviation Bill proposes a Waiting Period which is the earlier of: (i) two calendar months from the date of commencement of insolvency proceedings; or (ii) the date on which the creditor/lessor would have otherwise been entitled to take possession of the Aircraft Object. Typically, until the moratorium becomes applicable, the lease agreements entered into in relation to the aircraft confer the lessors with the right to take immediate custody/ possession of the aircraft in the event of any default committed by the airline in making payment of its lease rentals. Consequently, the insolvency administrator/CoC may not realistically have any meaningful breathing room to make arrangements to undertake Retention Obligations and consequently maintain custody/control over the aircraft. As against that, the entire idea behind the moratorium of 180 days, extendable up to 270 days with an outer time limit of 330 days during the CIRP, is to preserve the assets with the CD while the CoCs, along with the RP, is looking at various options for resolution of the CD.

Secondly, in any event, an essential pre-condition for the Retention Obligation required to be undertaken by the insolvency administrator, is to cure all pre-existing defaults towards the lessor. However, typically, an airline company under stress may not have the necessary wherewithal to cure all its defaults towards its lessors. Consequently, notwithstanding the Waiting Period, realistically, the insolvency administrator may not be in a position to retain custody/control of the aircraft.

One solution to the issue of arranging funds for the purposes of undertaking the Retention Obligation could be raising interim finance by the RP. However, there are two major challenges to relying on interim finance: (i) first, it has been observed that the lenders have either been hesitant to extend interim finance to distressed entities or have extended the bare minimum interim finance required for the completion of the insolvency resolution process.[168] A study indicates that in 85% of the cases where interim finance was raised, the amount raised was less than ₹5 Crore.[169] Accordingly, it may be ambitious to rely on interim finance to undertake Retention Obligations; (ii) second, "interim finance" under the IBC is treated as "insolvency resolution process cost" and consequently is accorded super-priority status while the claims against the CD are being discharged. However, as set out in the foregoing paragraphs, the Aviation Bill stipulates the following hierarchy of claims in the context of insolvency resolution process wherein NCRI and claims of creditors holding Registered Interest (including lessors) will have higher priority even over priority payments prescribed under IBC. In the absence of the super- priority status hitherto enjoyed by interim financiers, it may become even more difficult to raise interim finance to fund the Retention Obligations of the insolvency professional.

[168] Insolvency and Bankruptcy Board of India, *Quarterly Newsletter for July-September, 2022: Interim Finance-A Saviour*.
[169] Iyer V. V. et al, *An analysis of interim finance ecosystem as a supporting tool for the IBC regime*, Anusandhan: Exploring New Perspectives On Insolvency, 259 & 276(2022).

RECOMMENDATIONS

As underscored herein above, the most important asset of an airline company, which is crucial for its insolvency resolution, is the aircraft. However, in terms of the Notification, upon the commencement of the CIRP of an airline company, the lessors are provided with near unbridled right to strip the airline company off its most valuable asset. In view of this, while the Notification no doubt protects the interests of the lessors, it is likely to prejudicially affect the prospects of the insolvency resolution of an airline company. As regards the legal framework envisaged in the Aviation Bill, while it attempts to balance the interests of both the lessors and the airline company, there are practical challenges which may create substantial roadblocks for the RP to undertake Retention Obligations and retain possession of the aircraft.

In addition to the specific consequences on the insolvency resolution of the concerned airline company, having a sector specific law as the primary legislation for insolvency resolution of companies engaged in that sector may have the effect of diluting the rigour of the IBC as a whole. This may also affect the rights of FCs of such airline companies.

In this context, the researchers recommend certain modifications to be considered for introduction within the framework ofthe IBC to ensure the balancing of interests between the lessors and the airline company undergoing the insolvency resolution process.

(i) Allowing lessors to enjoy rights of representation, participation and voting in the meetings of CoC of the airline company

The legal framework under the IBC envisages that the primary decision making in a CIRP is by the CoC consisting of FCs of the CD. The Hon'ble Supreme Court in the matter of *Swiss Ribbons Private Limited and Anr v. Union of India and Ors.*[170] observed that the following factors justify the powers conferred to FCs: (i) financial contracts involve large sums of money given by fewer persons, whereas operational creditors (OCs) are much larger in number and the quantum of dues is generally small; (ii) FCs have specified repayment schedules and agreements which entitle such creditors to recall the loan in totality on defaults being made, which the OCs do not have; (iii) further, FCs are, from the start, involved with the assessment of the viability of CDs and are, therefore, better equipped to engage in restructuring of loans as well as the reorganisation of the CD's business in the event of financial stress.

It is crucial to note that all the unique intelligible characteristic features of a FC which justify their forming part of the CoC, as recognised in *Swiss Ribbons,*are applicable even in the case of lessors, even though in a strict legal sense they qualify as OCs. In the aviation sector, airline companies typically enter into lease agreements with certain identified lessors involving a huge financial liability. The lease rentals payable under the lease agreements have to be paid as per a specified repayment schedule. Further, the aircraft companies conduct heavy due diligence and assess the viability of the operations of the airline company before entering into the lease agreement. As seen above, the global aircraft leasing business is predominantly controlled by a select

[170] Swiss Ribbons Private Limited v. Union of India, Writ Petition (Civil) No. 99 of 2018 (Supreme Court of India).

group of 8-10 large players, who possess a good understanding of the aviation business globally. Further, considering the importance of aircraft in the insolvency resolution of an airline company, the aircraft lessors arguably are one of the most important stakeholders. Taking into account all these facts, the lessors may be conferred with all the powers enjoyed by FCs in a CIRP of the CD such that the lessors are actively involved in the insolvency resolution process of the airline company. This would give a realistic opportunity to an airline company to revive with the participation of its lessors and FCs, in contrast to the present proposal to let the lessors repossess aircrafts to the detriment of all other stakeholders of the airline company, i.e. FCs, vendors, workmen, shareholders, etc.

(ii) Treating lessors at par with secured creditors in the liquidation waterfall

Section 53 of the IBC may be suitably amended such that lease rentals payable to lessors may be treated second in priority, at par with the claims of workmen and secured creditors during the liquidation process. This will ensure that during the liquidation process, the claims of the lessors are accorded the highest priority after the insolvency resolution process and liquidation costs. Additionally, section 30(2)(b) of the IBC may also be suitably clarified to stipulate that in case of lessors, the minimum amount payable to OCs in terms of section 30(2)(b) of the IBC will be calculated as per the amended waterfall mechanism under section 53 of the Code. The amended mechanism places claims of lessors second in priority after the claims of workmen and employees. This would create a better level playing field for lessors and FCs, both of which provide strategic financing for an airline company as compared to the present distribution waterfall envisaged under section 53 of the IBC or the Aviation Bill.

(iii) Allowing airline companies to take benefit of interim moratorium

From the experiences of Jet Airways and Go Air, it can be easily surmised that the moment any creditor or the debtor itself files an application for insolvency resolution of the airline company (Insolvency Application), the lessors immediately commence taking measures towards exercising their rights as an IDERA Holder and repossessing their aircraft. During this period, since the CD has not been subjected to the insolvency resolution process, the benefit of the moratorium is not available to the CD/or its assets. Considering the extant Aircraft Laws confer near unbridled right on the lessor to repossess its aircraft within a short span of five working days, the CD may stand stripped of its most valuable assets even before the commencement of its CIRP. Accordingly, in the case of insolvency resolution of airline companies, the benefit of the moratorium ought to be extended to the CD/its asset immediately upon the filing of the Insolvency Application.

(iv) Allowing airline company to take benefit of prepackaged insolvency resolution process

The Central Government introduced Chapter III – A into the scheme of the IBC,[171]

[171] Inserted *vide* the Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021.

introducing the framework for prepackaged insolvency resolution (Prepack Framework). A pre-packaged insolvency resolution allows a hybrid of both “formal” and “informal” resolution processes, providing both: (a) flexibility to the CD and its creditors to amicably arrive at a mechanism for the resolution of stress of the CD; and (b) providing it legal sanctity by way of a stamp of approval from a court/tribunal.[172]

As mentioned hereinabove, the airline industry is a highly technical and consequently a highly regulated sector. Additionally, compared to other sectors, the number of players engaged in the airline sector is relatively fewer. In light of these factors, there may not be too many prospective resolution applicants who have the inclination or the capability to submit resolution plans for an airline company. Furthermore, in the absence of a Prepack Framework, the existing promoters/personnel/management of the CD may not be incentivised to actively participate in the CIRP of the airline company, which, more often than not, leads to a change in the management and control of the CD as the only scenario for its resolution. This may prejudice the ability of the RP to effectively manage the affairs of the airline company as a going concern during its insolvency resolution process.

To remedy this issue, the benefits of Prepack Framework can also be extended to airline companies. The CD may be allowed to submit a “base resolution plan”, setting out the terms of the insolvency resolution and the manner of settlement of its dues with the various stakeholders of the CD. Pursuant to arriving at a mutually agreed upon terms of settlement, the terms of such settlement may be approved by the Adjudicating Authority (AA) by way of a formal insolvency resolution process.

It is noteworthy that in the United States, the debtor typically starts negotiating with the creditors in relation to arriving at a settlement even prior to the filing of an Insolvency Application. Typically, the Insolvency Application is filed only once the creditors and the airline company reach a finality in relation to the terms of their settlement. However, in India, considering that the Prepack Framework is currently inapplicable to CDs other than micro, small and medium enterprises, the benefit of employing such methods for an expeditious and streamlined resolution of stress in airline companies is currently unavailable.

Furthermore, in case the lessors seek to renegotiate the terms of their leases with the CD post the completion of its insolvency resolution process, the lessors are constrained to be in a state of uncertainty. This is because, until a resolution plan is approved and such approval attains finality, there is no clarity on which resolution applicant would take over the management and control over the affairs of the airline company. However, in the event the benefit of Prepack Framework is extended to airline companies, the lessors will have clarity that the management/control over the affairs of the CD shall remain with the existing promoters/shareholders of the airline company. This will provide a sense of certainty to the lessors while renegotiating the terms of their leases.

[172] Ministry of Corporate Affairs, *Report of The Insolvency Law Committee on Pre-Packaged Insolvency Resolution Process* 109 (2021).

(v) Preservation of aircraft and fleet

It is reiterated that without its aircraft being available, the failure of the insolvency resolution process of a CD is a very high possibility. Accordingly, *in addition to introducing all of the above-mentioned modifications*, the framework under the IBC should ensure that the rigour of the protections provided under section 14(1)(d) of the IBC is not diluted during the 330-day period available under the IBC for insolvency resolution of a CD. In lieu of this, the lessors can of course be given more powers in the decision-making process in the CoC, as well as in the distribution waterfall for an airline company. Furthermore, the services being provided by lessors qualify as an "essential service" under section 14(2A) of the IBC. Consequently, the Central Government should take measures towards ensuring that so long as current dues are being met, the lessors do not take any measures towards repossessing their aircraft.

In this kind of an approach, it may be justifiable for the Central Government to issue necessary directions to the DGCA that it shall not entertain any IDERA Application if such an application is made subsequent to the filing of an Insolvency Application against the airline company. This may in turn require withdrawal of the Notification with an object that the CD is not stripped off of its most invaluable asset at the very initiation of the insolvency resolution process.

(vi) Enactment of cross-border insolvency resolution framework

A key characteristic feature of the airline sector is the cross-border nature of its operations. For instance, an airline company may have both passengers and lessors from different parts of the world. It may have assets in different parts of the world where it conducts its operations. Consequently, an insolvency resolution of an airline company will see the involvement of multiplicity of jurisdictions in different capacities. It is noteworthy that in the insolvency resolution of Jet Airways, parallel insolvency resolution proceedings were instituted both by the NCLT – Mumbai and the District Court of Netherlands (where Jet Airways had regional sub-offices). In this regard, the RP of Jet Airways appointed by NCLT – Mumbai and the Administrator appointed by the District Court of Netherlands had to execute a "*Cross Border Insolvency Protocol*", approved by the National Company Law Appellate Tribunal (NCLAT). The objective was to promote cooperation and coordination with each other in order to conduct the insolvency resolution of Jet Airways in a smooth and streamlined manner.[173]

While the NCLAT in Jet Airways provided a judicial solution to the problems arising due to a multiplicity of insolvency resolution processes instituted in different jurisdictions, it would be beneficial if the scheme of the IBC provided for an exhaustive cross-border insolvency resolution framework in India. This will inspire confidence in various stakeholders of the CD, particularly those situated outside India, that the scheme of the IBC is well equipped to handle all the issues which may arise in the insolvency resolution of the airline company on account of the involvement of a multiplicity of jurisdictions.

[173] Jet Airways (India) Ltd v. State Bank of India, Company Appeal (AT)(Insolvency) No. 707 of 2019.

Summing up, while there are strong arguments in favour of the protection of the interest of lessors and their right to repossess aircraft in case of default by the lessee, it is equally important that a realistic opportunity is provided for revival of a troubled airline, giving due consideration to the commitment of the Indian state as a signatory to CTC and the Protocol. This is essential, considering its importance to the overall economy and the limited number of airline operators in India. While this may require a rebalancing of approach, merely looking at the rights of one stakeholder may jeopardise the interest of all other stakeholders, i.e. FCs, vendors, employees, and most importantly, the consumers. It is in this context that the aforementioned changes to the scheme of the IBC may be considered. They would allow the balancing of interest of stakeholders, whereby lessors can have a gInreater say in the insolvency resolution process, in lieu of temporarily giving up their right to repossession for 330 days. At the same time, they would afford to the airline and all its stakeholders, a reasonable opportunity to make efforts for its revival. In the long run, of course the development of an indigenous industry on the leasing and MRO side may be required to reduce the overall dependency on overseas leasing companies, which may not have the same interest in the overall economic situation as an indigenous and local operator.

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EVALUATING THE ARCHAIC NATURE OF THE 'GIBBS RULE' IN CROSS-BORDER INSOLVENCY: A CASE FOR EMBRACING MODIFIED UNIVERSALISM

Avinash Subramanian and Aashirwa Baburaj

ABSTRACT

The international landscape of insolvency law has witnessed significant changes in recent years. In the evolving landscape of international business and globalization, traditional approaches to handling such cases, exemplified by the Gibbs Rule, have come under scrutiny from the legal and investor community alike. The Gibbs Rule has long served as a reference point for English courts in addressing cross-border insolvency issues. However, their origin in a bygone era and their rigid application in today's interconnected and globalized society often lead to inequities and inefficiencies in the modern insolvency landscape. In a world where financial transactions span multiple jurisdictions and involve intricate web-like structures, the strictly territorial approach fails to address the practical realities of complex international insolvency cases. As a result, stakeholders encounter cumbersome legal battles, often with competing interests that lead to delays, forum shopping, creditor hold outs, increased costs, and an overall decreased returns to creditors. Contrastingly, the modified universalism approach recognizes the need for cooperation and coordination in cross-border insolvency proceedings. This approach, championed by several jurisdictions and international organizations, advocates for a more holistic perspective. This paper aims to present a comprehensive critique of why the Gibbs Rule is considered archaic and out of sync with the contemporary approach of modified universalism in cross-border insolvency proceedings. The authors also seek to analyze the provisions of the Insolvency and Bankruptcy Code, 2016 (IBC/Code), which governs insolvency proceedings in India, along with the draft framework that was introduced by the Government of India based on the UNCITRAL Model Law on Cross Border Insolvency, 1997 (Model Law) and explore the extent to which the IBC incorporates within it the principles of modified universalism.

Keywords: Gibbs rule, Cross-border insolvency, Modified universalism, Coordination, Foreign proceeding, Centre of main interest

INTRODUCTION TO CROSS-BORDER INSOLVENCY

Cross-border insolvency regulates the treatment of financially distressed debtors where such debtors have assets, creditors or operate in more than one jurisdiction. In an increasingly globalised economy, businesses often transcend national borders, making traditional insolvency proceedings inadequate. Cross-border insolvency involves harmonising diverse legal regimes to ensure a fair and efficient resolution of financial distress.[1] A robust cross-border insolvency framework allows stakeholders, including creditors and debtors, to navigate the challenges presented by conflicting laws, diverse judicial systems, and varying legal, and socio-economic environments. Some of the key elements of a robust cross-border insolvency framework in the era of globalisation include recognising foreign proceedings, coordinating multiple insolvency proceedings, and facilitating communication and cooperation among jurisdictions. Various international models, such as the Model Law, aim to standardise and streamline cross-border insolvency processes.

The introduction of the Gibbs Rule in the 19th century in the annals of common law, marked an early recognition of the challenges posed by cross-border transactions. Despite the decision being rendered more than a century ago, the Gibbs Rule has not been set aside and plays a material role in resolving insolvencies of debtors having cross-border presence. In an increasingly globalising world, where economies have merged through free trade, the relevance of cross-border insolvency is extremely important to avoid anomalies that impact this globalisation. One such anomaly is the presence of the Gibbs Rule in the 21stcentury that holds sway in cross-border restructurings and insolvencies. Through this article, the authors seek to present a comprehensive critique of why the Gibbs Rule is considered archaic and out of sync with the contemporary approach of modified universalism in cross-border insolvency proceedings.

HISTORICAL BACKGROUND OF THE GIBBS RULE

Origins and development

The Gibbs Rule was propounded by Lord Escher MR in *Antony Gibbs & Sons v. La Société Industrielle et Commerciale des Métaux* in 1890(Gibbs).[2] The defendant (La Société Industrielle et Commerciale des Métaux), was a French trading company that had entered into certain contracts to purchase copper from the plaintiff (Antony Gibbs & Sons), an English company, through a broker on the London Metal Exchange. The contracts were governed by English lawand were stated to be subject to the rules and regulations of the London Metal Exchange. In the course of time, the defendant ran into financial difficulties and defaulted on its contractual obligations by being unable to purchase further copper from the plaintiff. The defendant, thereafter, entered into liquidation proceedings in France according to the laws thereunder, during which time too, it may be noted, it was unable to purchase copper from the plaintiff.

**The paper has been written with assistance from Reuben Mascreen, former Senior Associate at AZB & Partners, Mumbai.*

[1] Ryan Halimi, *An Analysis of the Three Major Cross-Border Insolvency Regimes,* 24 Int'l Immersion Program Papers (2017).

[2] Antony Gibbs & Sons v. La Société Industrielle et Commerciale des Métaux, (1890) [L.R.] 25 Q.B.D. 399.

The plaintiff submitted a claim in the French liquidation proceedings for damages caused to it in respect of the loss sustained by the plaintiff on resale of copper. The portion of the plaintiff's claim comprising non-acceptance of copper prior to commencement of the liquidation proceedings was accepted by the Liquidator, in respect of which the plaintiff received its *pro rata* share of the distribution. However, the portion of the plaintiff's claim pertaining to non-acceptance of copper after the liquidation proceedings commenced, was rejected by the Liquidator, on the basis that such a claim was not admissible under French law. Aggrieved by the French Liquidator's rejection of the latter part of its claim, the plaintiff, thereafter, commenced legal proceedings before the English courts. On appeal before the Court of Appeal, the defendant contended that under French law, the judgment of liquidation operated as a discharge of the debt.

The Court of Appeal rejected this argument and stated that since the law of the contract, entered into between the parties was English law, the parties had never agreed to be bound by French law, including French insolvency law. Thus, the French liquidation proceedings could not have discharged the debt owed by the defendant, and the plaintiff was well and truly entitled to maintain its action upon the English law governed contracts before the English courts.

The principle laid down by Lord Escher MR, known as the *Gibbs Principle or Gibbs Rule, thus states that a discharge of any debt or liability under the bankruptcy law of a foreign jurisdiction is a discharge there from in England if, and only if, it is a discharge under the law applicable to the contract.*[3] Similarly, a foreign composition under a scheme of arrangement would not be regarded as effective unless it operates as a discharge according to the law of the debt.[4]

Examination of legal and economic landscape at the time of formulation of the Gibbs Rule

To comprehend the formulation of the Gibbs Rule in the context of cross-border insolvency, it is essential to delve into the legal and economic landscape of the late 19th century.

Gibbs was decided at a time when cross-border insolvency law was not only at a nascent stage, but global trade was miniscule as compared to the 21st century. Lord Escher MR of the Court of Appeal decided Gibbsin the year 1890. More than a century later, global trade and commerce have rapidly advanced, and the growing number of multinational corporations have made legal commentators and corporations question the relevance of the Gibbs Rule in today's time. Companies today may be incorporated in one jurisdiction, have their securities listed in a different jurisdiction, and borrow from numerous creditors under multiple jurisdictions. In fact, given the spread of large multinational corporation, companies borrow in multiple markets and consequently, incur debts governed by a plethora of national laws. One such instance is the Chinese owned and controlled Evergrande Group, that has its place of incorporation in the Cayman Islands, has undertaken certain borrowings in the United States, has its securities listed on the Hong King stock exchange and carries on most of its operations in China. There is, therefore, a distinct possibility of a disconnect between the

[3] A.V.Dicey et al., Dicey, Morris & Collins on the Conflict of Laws, para 31R-092 (Sweet & Maxwell 2012).

[4] *Id.*, para 31R-096.

jurisdiction in which the debt was obtained, the company's place of incorporation, listing of its securities or the place where it chiefly carries on its operations. Yet, upon a strict application of Gibbs, it would be impossible for such a company to find a suitable jurisdiction to commence insolvency or restructuring proceedings because the effect of Gibbs is to prevent recognition of a discharge of debt flowing from those proceedings, where the debt is not governed by the *lex concursus* (law governing the insolvency proceeding).[5] Justice Kannan Ramesh, in his critique of the Gibbs Principle, has observed that Gibbs assumes (perhaps rightly at the time it was decided, but not applicable in present day) that a debtor borrows in only one market, under one law, and therefore, assigns primacy to the choice of law of the contract governing the debt over the subject matter jurisdiction of the insolvency court.[6] The expansion of markets and corporations since 1890, when the Gibbs Rule was propounded, now demand a more structured approach to insolvency proceedings involving entities with cross-border operations.[7] It would be worthwhile to note that from 2018 to 2021, the average annual revenue generated from English law governed documents to the gross domestic product (GDP) of the United Kingdom in the maritime sector, commodity trading sector, insurance sector, International Swaps and Derivatives Association was GBP 17 billion, USD 11.6 trillion, EUR 661.5 trillion, GBP 80 billion, respectively.[8]

CRITIQUE OF THE GIBBS RULE

Straying away from the Principle of Collectivity

The reasoning given by Lord Esher MR in Gibbs, is that the parties had agreed that English law should govern the contracts and had never agreed to be bound by French law, more particularly, French insolvency law.[9] This is evident from the rhetorical question posed by Lord Esher MR in Gibbs, "*[w]hy should the plaintiffs be bound by the law of a country to which they do not belong, and by which they have not contracted to be bound?*"

Thus, the rationale used in the Gibbs ruling is that the question of discharge of debt ought to be characterised as a contractual issue rather than a bankruptcy or an insolvency issue. Accordingly, the focus is on what law the parties have agreed to apply, thereby, giving primacy to the parties' choice rather than the policy considerations that are attendant in an insolvency scenario.

As observed by Justice Heenan of the Supreme Court of Western Australia in *Re Bulong Nickel Pty Ltd.*, a bankruptcy court exercises its jurisdiction not merely to adjudicate upon the rights and liabilities of contractual parties, but to safeguard the interests of other creditors, the general community within which the debtor has been carrying on its business, and to ensure that the administration of its affairs is undertaken in a manner which ensures equality between creditors according to their degree and priority.[10] A discharge in a bankruptcy

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[5] Justice Kannan Ramesh, *The Gibbs Principle: A Tether on the Feet of Good Forum Shopping,* 29 Sing. Acad. L. J. 42, para 35, at 55 (2017).

[6] *Id.*

[7] *Id.*

[8] *Economic Value of English Law,* Legal UK (Oct. 05, 2021), https://legaluk.org/wp-content/uploads/2021/09/The-value-of-English-law-to-the-UK-economy.pdf.

[9] Antony Gibbs & Sons v. La Société Industrielle et Commerciale des Métaux, (1890) [L.R.] 25 Q.B.D. 399, at 410.

[10] Re Bulong Nickel Pty Ltd., [2002] WASC 226.

setting invariably involves the exercise of statutory cram down such that dissentient minority creditors are overreached by the decision of the majority. This is on account of the reason that bankruptcy is based on the philosophy that policy is given primacy over contractual rights. Look Chan Ho in his book, "Cross-Border Insolvency: Principles and Practice", states that the claimants' pre-insolvency entitlements arising from contracts are the subject-matter of party autonomy.[11] However, the post-insolvency treatment of the claimants' pre-insolvency entitlements cannot be exclusively the subject-matter of party autonomy.

The Principle of Collectivity that undergirds an insolvency process is another foundation stone upon which the argument against contractual obligations entered into between parties can be negated. Professor Ian F. Fletcher, in his book, "Insolvency in Private International Law", states that the Principle of Collectivity amounts to a recognition of the 'common pool problem', that occurs when more than one person has rights over the same finite number of resources.[12] Professor Ian F. Fletcher states, "*[b]y regarding all those with claims against the insolvent debtor as members of a collectivised entity, the law transforms what were originally multiple relationships between each creditor and the debtor into a unified whole for the purpose of administering and distributing such value as remains in the debtor's estate.*"[13]

The Principle of Collectivity in insolvency law, thus, requires the transformation of contractual entitlements in distinct pre-insolvency contractual relationships into the collective rights of creditors to participate in the distribution of the debtor's estate under the governing insolvency law. Once insolvency or restructuring is under way, an individual creditor no longer has any basis to insist on the satisfaction of hispre-insolvency entitlements. This includes his entitlement to have any contractual debt that is owed to him discharged only under the law of the contract. In other words, the broader policy imperative overrides individual party autonomy.

Inconsistency arising from an application of Gibbs

Justice Kannan Ramesh further highlights an intriguing consequence resulting from the application of the Gibbs Principle when combined with other private international law rules within English insolvency law. According to Gibbs, the English court will not acknowledge a debt discharge if the insolvency proceedings occurred outside the jurisdiction of the governing law of the contract.

There may, however, arise a situation wherein the debtor's movable assets in England may have been transferred to the foreign trustee in bankruptcy, who might have also been appointed by the English court as a receiver for the rents and profits of immovable assets in England, pursuant to recognition of a foreign proceeding under Article 17 of the Cross-Border Insolvency Regulations, 2006 (CBIR) (which were enacted in England to give effect to the Model Law).

It has been pointed out that under these circumstances, the bankrupt individual remains obligated to fulfil contracts in England but has been stripped of their assets. Professor Fletcher

[11] Look Chan Ho, Cross-Border Insolvency: Principles and Practice (Sweet & Maxwell 2016).
[12] Ian Fletcher, Insolvency in Private International Law, para 1.08 (2nd ed. 2005).
[13] *Id.*

echoes this sentiment, criticising the unjust situation where English insolvency law acknowledges the lawful removal of all the debtor's property through recognition of foreign insolvency processes yet simultaneously holds the debtor liable to be sued in England for liabilities arising from those same proceedings under the Gibbs Rule. This, according to the author, exemplifies the outdated nature of the Gibbs Principle, undermining the modern trend of international judicial cooperation in cross-border insolvency, and introduces potential injustice by obstructing the effect of discharge of debt under a foreign insolvency judgment. In essence, "*what English insolvency law gives with one hand, it takes away with the other.*"[14]

Failure to address the globalized nature of modern businesses

(a) Multinational corporations and their impact on insolvency

The Gibbs Principle, conceived in an era less defined by the widespread global interconnectedness of modern businesses, falls short in addressing the unique challenges posed by multinational corporations. In today's globalised economy, corporations often operate seamlessly across borders. The Gibbs Principle's focus on contractual obligations may not adequately consider the intricacies of an insolvency involving entities with diverse international footprints.[15] When a multinational corporation faces financial distress, the Gibbs Principle may not provide the flexibility required to navigate the complex web of legal jurisdictions.

The lack of coordination inherent in the Gibbs Principle may contribute to increased costs and delays in cross-border insolvency cases. Legal battles arising from jurisdictional conflicts and disputes over contractual interpretation can escalate expenses and prolong the resolution process. The inefficiencies can lead to value erosion, affecting creditors and stakeholders alike. Critics have argued that a more harmonised, internationally accepted framework is essential to streamline proceedings, minimise costs, and enhance the overall efficacy of cross-border insolvency resolutions.[16]

(b) Global distribution of creditors and stakeholders

The Gibbs Principle's failure to account for the global distribution of creditors and stakeholders is a significant critique. In modern business scenarios, creditors and stakeholders are dispersed worldwide. The principle's emphasis on traditional contractual obligations may not seamlessly accommodate the diverse interests and expectations of these global participants.

This oversight can lead to challenges in enforcing and recognising foreign insolvency proceedings, hindering effective communication and collaboration amongst stakeholders from different jurisdictions. Critics assert that a more globally conscious approach is required to address the diverse interests of creditors and stakeholders involved in cross-border insolvency cases.[17]

[14] Ramesh, *supra note* 5, para 34, at 55.

[15] Gregg Galardi et al., *Implications of the Rule in Gibbs on the Effectiveness of Schemes of Arrangement to Compromise US Law-governed Debt,* Glob. Restructuring Rev. (Dec. 09, 2022), https://globalrestructuringreview.com/review/restructuring-review-of-the-americas/2023/article/implications-of-the-rule-in-gibbs-the-effectiveness-of-schemes-of-arrangement-compromise-us-law-governed-debt.

[16] Ramesh, *supra note* 5.

[17] *Id.*

THE SHIFT TO MODIFIED UNIVERSALISM

Introduction to Modified Universalism

Pure universalism envisions a singular insolvency framework that mirrors the global economic structure and oversees all international insolvency cases. Within such a system, each business entity would undergo a primary insolvency proceeding managing all of its assets on a global scale.[18] This central forum would oversee the case, gather assets, regulate reorganisation, and facilitate creditor payments worldwide. Equally positioned creditors in various countries would receive fair treatment. The case would adhere to a single legal framework dictating the substantive rights of involved parties, thereby eliminating conflicts arising from differing laws that might impact the rights of creditors or the debtor and its proprietors. Additionally, a unified set of procedural rules would govern the commencement, administration, and closure of the insolvency process, thereby offering transparent guidelines.[19] However, it should be noted that the approach of pure universalism is merely aspirational and theoretical in nature because there is a decided lack of harmony in the global economic structure, and each country has its own insolvency regime with its own principles and goals.[20]

Modified Universalism upholds the fundamental cooperative aspect of pure universalism while giving precedence to the authority of local courts to exercise discretion concerning "the fairness of the home country procedures" and safeguarding the interests of creditors within the local jurisdiction.[21] Essentially, "*modified universalism represents a moderated version of pure universalism, considering practical aspects within the current stage of international legal development*."[22] In this context, Modified Universalism permits a multinational corporation to have a single primary case in its home country, with the insolvency proceedings predominantly governed by the laws of that home country. Nonetheless, Modified Universalism acknowledges that additional support may be required through supplementary cases in other countries where assets or creditors are situated. According to this perspective, a local court typically applies domestic law in its proceedings and retains the authority to assess the fairness of home country procedures and safeguard the interests of local creditors when deemed necessary.[23]

Historical cases that shaped the concept of Modified Universalism

Re HIH Insurance[24]

The case of *HIH Casualty & General Insurance Ltd., Re*of 2008 (HIH Insurance) stands as a pivotal milestone in the development and application of Modified Universalism principles

[18] Jay Lawrence Westbrook, *A Global Solution to International Default,* 98(7) Mich. L. Rev. 2276, 2292-93 (2000).

[19] Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum,* 65 Am. Bankr. L. J. 457, 461 (1991).

[20] Edward Adams and Jason Fincke, *Coordinating Cross-Border Bankruptcy: How Territorialism Saves Universalism,* 15 Colum. J. Eur. L.43 (2009).

[21] Emilie Beavers, *Bankruptcy Law Harmonization In The NAFTA Countries: The Case of The United States and Mexico,* 2003 Colum. Bus. L. Rev. 965, 982 (2003).

[22] David Neiman, *International Insolvency and Environmental Obligations: A Prelude to Resolving the Conflicting Policies of a Clean Slate Versus a Clean Site in Transnational Bankruptcies,* 8(3)Fordham J. Corp. & Fin. L.789, 826 (2003).

[23] Adams and Fincke, *supra note* 20.

[24] *In re HIH Casualty & General Insurance Ltd,* [2008] UKHL 21.

within the realm of cross-border insolvency. This landmark case, heard in the Australian courts, marked a significant departure from traditional territorialism embodied in the Gibbs Rule and contributed to the evolution of a more cooperative and harmonised approach in managing international insolvency cases.

The HIH Insurance case involved the collapse of an Australian insurance giant with extensive international operations. Rather than adopting a purely territorial approach, the Australian court took a modified universalist stance by recognising the importance of international cooperation in insolvency matters. The court acknowledged the need to respect foreign judgments, thereby aligning with the Principles of Modified Universalism.

Some of the key principles laid down in the HIH Insurance case were:

a) Recognition of foreign proceedings: In HIH Insurance, the Australian court recognised the validity of insolvency proceedings in foreign jurisdictions.[25] This marked a departure from the traditional insistence on territorialism, highlighting the importance of acknowledging and cooperating with foreign courts to ensure a more comprehensive resolution.

b) Coordinated approach: The case underscored the necessity of a coordinated approach to cross-border insolvency, where different legal systems collaborate to achieve a fair and efficient resolution. This resonates with the key Principles of Modified Universalism, emphasising global cooperation over jurisdictional boundaries.

c) Fair treatment of creditors: Modified Universalism seeks to ensure fair treatment for creditors across jurisdictions. In HIH Insurance, the court's recognition of foreign proceedings aligned with this principle, emphasising equitable distribution of assets to creditors regardless of their geographical location.[26]

The HIH Insurance case has served as a notable illustration of the application of Modified Universalism in practice and has paved the way for a more harmonised and cooperative framework in cross-border insolvency.

Cambridge Gas[27]

In 1997, a Swiss businessman Mr. Giovanni Mahler launched a shipping business, backed by a $300 million loan sourced from the New York bond market. The business, which acquired five gas transport vessels, proved unsuccessful and culminated in a Chapter 11 proceeding in the US Bankruptcy Court in New York. The issue for consideration before the Privy Council, on appeal from the Manx Court in the Isle of Man, was whether an order from the New York court could be enforced in the Isle of Man.

The business' corporate structure was such that investors, either directly or indirectly, held ownership in Vela Energy Holdings Ltd (Vela), a Bahamian company. Vela, in turn, owned Cambridge Gas Transportation Corporation (Cambridge Gas), a Cayman Islands company.

[25] *Id.*

[26] *Id.*, para 51 at 921.

[27] Cambridge Gas Transportation Corpn. v. Official Committee of Unsecured Creditors of Navigator Holdings plc,[2006] UKPC 26.

Cambridge Gas owned about 70% of the shareholding, directly or indirectly, in Navigator Holdings Plc (Navigator), an Isle of Man company. Navigator, owned all the shares of an Isle of Man company which in turn owned companies, which each owned one ship.

In 2003, Navigator sought relief under Chapter 11 of the US Bankruptcy Code, triggering a legal tussle. The investors proposed a plan to sell ships to previous investors, but the bondholders rejected it, suggesting their own plan that vested Navigator's assets in creditors, extinguishing the equity interests of the investors. The court favoured the creditors' plan, using a structure that vested Navigator's shares in the creditors' committee to facilitate control over shipping companies and the plan implementation. A confirmation order from the New York court outlined its intention to seek assistance from the Manx court and such a letter was sent. Subsequently, the committee of creditors petitioned the Manx court for vesting the shares of Navigator in their representative's favour.

Two critical features of this case may be pointed here. *Firstly,* Navigator being an Isle of Man company, with 70% of its common stock owned by Cambridge Gas, raised jurisdictional concerns under conflict of laws principles, namely that the shares of Navigator were situated in the Isle of Man and as such were subject to the jurisdiction of the Manx court only. Lord Hoffmann, at para 6 stated that the New York court was aware that the order vesting title to the common stock of Navigator in the creditors' committee could not automatically have effect under the law of the Isle of Man. For the same reason Lord Hoffman accepted in paras 12 to 13 that if the judgment were a judgment *in rem* it could not affect title to shares in the Isle of Man. *Secondly,* Cambridge Gas, a Cayman Islands company, contested that it had not submitted to the jurisdiction of the US Bankruptcy Court, a claim deemed technical since the Chapter 11 proceedings was presented by Navigator itself. Lord Hoffmann acknowledged that a judgment *in personam* would lack recognition in the Isle of Man due to the absence of personal jurisdiction over Cambridge Gas.

The Privy Council, eventually, determined that the plan could be executed in the Isle of Man. The rationale of the Privy Council revolved around the unique nature of bankruptcy proceedings, distinguishing them from judgments *in rem* or *in personam*. The Privy Council stated that the purpose of bankruptcy proceedings, on the other hand, is not to determine or establish the existence of rights, but to provide a mechanism of collective execution against the property of the debtor by creditors whose rights are admitted or established.

The Privy Council, further in paras 21 to 22 stated that the principle of universality, underlay in common law principles of international insolvency, and were sufficient to confer jurisdiction on the Manx court to assist in a manner akin to domestic insolvency proceedings.

Agrokor[28]

Agrokor d.d.'s ground breaking restructuring, the largest in Europe during 2017 and 2018, reshaped the landscape for the Croatia-based conglomerate. As the holding company of an integrated food-related group headquartered in Croatia, Agrokor d.d. faced financial challenges, with annual revenues and funded debt both reaching around EUR 7 billion. With 60,000 employees, Agrokor directly contributed to approximately 15 percent of Croatia's GDP. Recognising

[28] *In re* Agrokor dd, [2017] EWHC 2791 (Ch).

the company's vital role, the Croatian Government enacted the Law on Extraordinary Administration Proceeding in Companies of Systemic Importance on April 6, 2017 (LEA). Subsequently, on April 10, 2017, the Croatian court initiated extraordinary administration proceedings for Agrokor. Subsequently, creditors holding over 80% of claims against Agrokor voted to approve a settlement agreement providing for a comprehensive restructuring.

On October 24, 2018, the U.S. Bankruptcy Court for the Southern District of New York granted Agrokor d.d. and its affiliates full Chapter 15 recognition for Croatian restructuring proceedings. The court in its opinion, favoured the principle of modified universalism over Gibbs' territorial approach. This landmark decision assures foreign companies of a route to U.S. enforcement for non-U.S., non-U.K. restructuring of English-law-governed debt.

Judge Glenn, in the Agrokor ruling, critiqued the Gibbs Rule through a detailed analysis, and concluded that the rule is inconsistent with modern international insolvency law and modified universalism favoured by the Model Law and Chapter 15. As a result, Judge Glenn determined that the Gibbs Rule lacks a legitimate justification for declining Agrokor's settlement agreement in the United States.[29]

Pertinently, Judge Glenn further reasoned that a key principle in contemporary insolvency law is the entitlement of creditors in the same class to receive an equal distribution. The Gibbs Rule, however, could lead to a situation where a creditor with a claim governed by English law receives a higher percentage recovery compared to other creditors holding similar claims, thus undermining the fundamental principle of equal distribution.

INDIA'S DRAFT LEGISLATION AND THE PURSUIT OF MODIFIED UNIVERSALISM

The authors now invite the reader's attention to the manner in which Indian law addresses issues pertaining to cross-border insolvency. It examines India's endeavour to integrate the Model Law and analyses its pivot towards embracing the fundamental principles of modified universalism.

Indian legal framework on Cross-Border Insolvency

In India, the IBC serves as the primary statute dealing with the insolvency and liquidation of corporate entities. The IBC, in its current form, provides for a perfunctory treatment of cross-border insolvency under section 234 and 235. Notably, the initial draft of the IBC (the bill dated December 21, 2015) did not entail any provision addressing international or cross-border insolvency cases.[30] The subsequent addition of section 234 and section 235 resulted from recommendations made by the Joint Parliamentary Committee *vide* their report dated April 28, 2016.[31]

Section 234 provides the Central Government with the authority to enter into agreements with foreign countries to enforce the provisions of the IBC.[32] The aforementioned section

[29] *Id.*, para 52 at 86.

[30] The Insolvency and Bankruptcy Code, 2015 (to be introduced in Lok Sabha), https://ibbi.gov.in/en/legal-framework/act?page=2.

[31] Lok Sabha, *Report of the Joint Committee on the Insolvency and Bankruptcy Code, 2015* (April, 2016), https://ibclaw.in/wp-content/uploads/2019/08/Report-of-the-Joint-Committee-of-Parliament-Apr-2016.pdf at 220.

[32] Insolvency & Bankruptcy Code, 2016, § 234(1).

underscores the importance of reciprocity and also grants the Central Government the power to notify conditions for applying the IBC to assets situated beyond the territorial jurisdiction of India.[33] Further, section 235 pertains to letters of requests, providing a mechanism for the Resolution Professional (RP) or the Liquidator to seek assistance when the assets of the corporate debtor (CD) under IBC are located in a foreign country.[34] In such a case, the RP may make an application before the Adjudicating Authority i.e., the relevant National Company Law Tribunal (NCLT) and upon receiving such an application, the NCLT may issue a letter of request directed to the concerned authority in the foreign country where the assets of the CD are located.[35] It is important to note that this section only applies if the Central Government has made a treaty or arrangement with the foreign country under section 234 of the Code. Currently, no such agreements have been entered into, rendering the provisions ineffective and the framework cursory in nature.

In essence, the Indian insolvency law is territorial in nature with the exception of section 234 and section 235 which has a limited application unless implemented.

With the aim to address the limitations of the existing legal regime pertaining to cross-border insolvency mechanism, or the lack thereof, the Insolvency Law Committee submitted a Report on cross-border insolvency on October 16, 2018 (ILC Report).[36] This Report recommends the incorporation of the Model Law, with modifications, into the Code to establish a framework for cross-border insolvency (Draft Provisions).[37] Further draft regulations for implementation of the Draft Provisions were submitted by the Cross Border Insolvency Rules/ Regulations Committee in its report dated June 2020.[38]

Recommendations of the ILC Report and the Draft Provisions

The Principle of Modified Universalism serves as the foundational framework upon which the Draft Provisions have been built. This is evidenced by the proposed integration of key features of the Model Law into the Draft Provisions — namely access, recognition, coordination, and cooperation.[39]

Applicability

The draft framework is applicable to all CDs (as defined under the Code)[40] and is applicable under the following circumstances where:[41]

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[33] *Id.* § 234(2).

[34] *Id.* § 235(1).

[35] *Id.* § 235(2).

[36] Ministry of Corporate Affairs, *Report of Insolvency Law Committee on Cross Border Insolvency* (Oct., 2018), https://www.mca.gov.in/Ministry/pdf/CrossBorderInsolvencyReport_22102018.pdf. [hereinafter ILC Report].

[37] *Id.*

[38] Ministry of Corporate. Affairs, *Report on the Rules and Regulations for Cross-border Insolvency Resolution* (June, 2020), https://ibbi.gov.in/uploads/whatsnew/2021-11-23-215206-0clh9-6e353aefb83dd0138211640994127c27.pdf.

[39] ILC Report, *supra note* 36.

[40] Insolvency & Bankruptcy Code, 2016, § 3(7), 3(8) (As per Section 3(7), "corporate person" means a company as defined in clause (20) of section 2 of the Companies Act, 2013, a limited liability partnership, as defined in clause (n) of sub-section (1) of section 2 of the Limited Liability Partnership Act, 2008, or any other person incorporated with limited liability under any law for the time being in force but shall not include any financial service provider." As per Section 3(8), "corporate debtor" means a corporate person who owes a debt to any person.).

[41] ILC Report, *supra note* 36, Draft Part Z, § 1(2) at 50.

a) foreign courts or representatives have sought assistance in India in connection with a foreign proceeding;

b) assistance is sought in a foreign country in connection with a proceeding under the IBC;

c) foreign proceeding and a proceeding under the IBC in respect of the same CD are taking place concurrently; or

d) foreign creditors have an interest in requesting commencement of, or participation in a proceeding under the IBC.

Moreover, the Draft Provisions establish a prerequisite based on reciprocity, mandating that foreign countries seeking application must have either integrated the Model Law into their domestic legal frameworks or entered into agreements with the Central Government.[42]

By mandating reciprocity, the Draft Provisions steer the current legal framework, from a territorial approach, towards modified universalism, and acknowledging that insolvency proceedings may need support through commencement of secondary cases in other jurisdictions where assets or creditors are located.[43]

Access and Recognition

Following the establishment of reciprocity, a foreign representative[44] may file an application before the NCLT for the recognition of a foreign proceeding.[45]

Akin to the Model Law, the Draft Provisions crucially differentiate between two types of foreign proceedings: (i) foreign main proceedings and (ii) foreign non-main proceedings.[46] This categorization is determined based on the Principle of the Centre of Main Interest (COMI).[47]

Foreign main proceedings refer to proceedings taking place in a country where the CD establishes its COMI.[48] In the process of establishing the COMI, the NCLT is mandated to conduct an assessment whether such a location is easily ascertainable by third parties, including creditors of the CD.[49] Additionally, the Central Government may also define additional factors for determining COMI through subordinate legislation.[50]

Conversely, foreign non-main proceedings refer to proceedings in jurisdictions where the CD does not have its COMI, these proceedings occur in a foreign country where the CD maintains an establishment.[51]

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[42] *Id.* § 1(4) at 51.

[43] Jay Lawrence Westbrook, *A Global Solution to Multinational Default,* 98(7) Mich. L. Rev. 2276, 2299 (2000).

[44] *Id.* § 2(h) at 53 ("[F]oreign representative means any person or body authorized in a foreign proceeding to administer the reorganization or the liquidation of the corporate debtor's assets or affairs or to act as a representative of the foreign proceeding and includes any person or a body appointed on an interim basis.")

[45] ILC Report, *supra note* 74, Draft Part Z, § 12 at 56.

[46] *Id.* § 15(2) at 58.

[47] *Id.*

[48] *Id.* § 15(2)(a) at 58.

[49] *Id.* § 14(3) at 58.

[50] *Id.* § 14(4) at 58.

[51] *Id.* § 2(c) at 52 ("establishment means any place of operations where the corporate debtor carries out a non-transitory economic activity with human means and assets or services.")

The Draft Provisions delineate two categories of relief contingent upon the nature of the foreign proceeding. The first is provided upon the recognition of the foreign proceeding as a foreign main proceeding; whereby the NCLT is mandated to institute a moratorium (Mandatory Relief).

Moreover, upon the recognition of a foreign proceeding, regardless of its classification, the NCLT has the authority, at the request of a foreign representative, to bestow certain other reliefs upon its discretion (Non-Mandatory Relief).[52] Such relief encompasses a spectrum of measures, including the declaration of a moratorium, facilitation of witness examination, gathering of evidence, or the provision of information pertaining to the CD.[53] Additionally, the NCLT may entrust the foreign representative with the administration or realisation of the CD's assets provided that the interest of creditors in India are adequately protected.[54] This category of relief also extends to any supplementary relief that may be accessible to an RP or Liquidator under the IBC.[55]

Cooperation & Coordination

The Draft Provisions also establish a framework for cooperation and coordination between foreign courts and representatives. This framework encompasses cooperation and communication between the NCLT and foreign courts or representatives, as well as cooperation and direct communication between the RP and Liquidators of foreign courts or representatives.[56] The Draft Provisions also provide for coordination in concurrent insolvency proceedings under the IBC and any other foreign jurisdiction(s).[57]

Following the recognition of a foreign main proceeding, initiation of proceedings under the IBC is permissible only if the CD has assets in India.[58] The effect of such proceedings is confined to the CD's assets in India and those assets that should be administered in the proceeding under the IBC.[59]

In situations where concurrent legal proceedings are taking place, namely in a foreign country and under the IBC, the NCLT is required to cooperate and coordinate actions.[60] Where IBC proceedings are already taking place at the time of application of recognition of the foreign proceeding, any Non-Mandatory Relief provided by the NCLT must be consistent with the proceedings under the IBC.[61] Further, if the foreign proceeding is recognised in India as a foreign main proceeding, the Mandatory Reliefs specified in the Draft Provisions shall not apply.[62]

[52] *Id.* § 18(1) at 60.
[53] *Id.*
[54] *Id.* § 18(2) at 60.
[55] *Id.* § 18(1)(f) at 60.
[56] *Id.* § 21, 22 at 63.
[57] *Id.* § 24-26 at 64-66.
[58] *Id.* § 24(b)(i) at 64.
[59] *Id.* § 24(b)(i) at 64.
[60] *Id.* § 25 at 65.
[61] *Id.* § 25(a)(i) at 65.
[62] *Id.* § 25(a)(ii) at 65.

However, where the IBC proceedings have been initiated after recognition of a foreign proceeding, any Mandatory or Non-Mandatory Relief granted by the NCLT may be adjusted or terminated if it contradicts the provisions of the IBC.[63]

Furthermore, in instances where a CD is involved in multiple foreign proceedings, the Draft Provisions make it imperative for the NCLT to engage in cooperative and coordinated efforts with other jurisdictions.[64] The NCLT has the authority to adjust a Non-Mandatory Relief, as stipulated in the Draft Provisions, to align with the requirements of the foreign main proceedings.[65] In cases where multiple foreign non-main proceedings are acknowledged, the NCLT is empowered to either grant, modify, or terminate any relief as necessary to ensure seamless coordination among these foreign proceedings.[66]

By facilitating communication and collaboration between the NCLT, foreign courts, and representatives, as well as between RPs and foreign liquidators/ administrators, these provisions acknowledge the interconnected nature of contemporary insolvency cases in the era of globalisation and transnational operations of businesses. The recognition of foreign main proceedings is coupled with a mandate for the NCLT to cooperate and coordinate actions when concurrent legal proceedings are underway. The authority granted to the NCLT to adjust relief based on the requirements of foreign main proceedings reinforces the modified universalistic approach, recognising the necessity of aligning diverse legal systems for effective cross-border resolution.

Pitfalls of the proposed framework

The Draft Provisions, akin to the Model Law, highlight a crucial aspect: when India recognises a main insolvency proceeding in another country, any subsequent domestic insolvency case in India — the recognising country — must be a proceeding with a limited scope.[67] This secondary proceeding is granted only if the debtor's assets are situated in India and exclusively affect assets within India.[68] In Modified Universalism, the emphasis is on recognising and accommodating foreign insolvency proceedings while allowing some flexibility for domestic proceedings. The stipulation that the secondary case in India is permitted only if the debtor's assets are located in the country implies a practical consideration rather than a strict territorialist stance. It acknowledges the need for localised proceedings but within the context of a more universally accepted framework that envisions cooperation and coordination.[69] Thus, the incorporation of the Model Law into India's domestic insolvency laws can be perceived as a pivotal stride in transitioning from the territorial Principle to Modified Universalism.

However, a critical examination of the Model Law, basis which the Draft Provisions have been proposed reveals significant concerns that warrant consideration.

[63] *Id.* § 25(b) at 65.
[64] *Id.* § 26 at 66.
[65] *Id.* § 26(a) at 66.
[66] *Id.* § 26(b),(c) at 66.
[67] *Id.* § 24(b)(i) at 64.
[68] *Id.*
[69] Adams & Fincke, *supra note* 20 at 51 ("Modified universalism recognises the problems of a global system where debtors can easily choose a substantive law that will govern their insolvency and that is contrary to expectations and interests of creditors. It thus authorises the commencement and prosecution of secondary cases to liquidate local assets and protect local creditors in a particular country.").

While the Model Law establishes a framework for recognising and cooperating on restructuring and insolvency procedures, it does not inherently facilitate the recognition and enforcement of foreign judgments arising from these processes.[70] The deficiency of a standardised framework for enforcement and recognition of insolvency related judgments poses a potential challenge.

A clear illustration of the deficiency of the Model Law can be seen in the decision of the Court of Appeal in *Re OJSC International Bank of Azerbaijan*[71] The OJSC International Bank of Azerbaijan (IBA) underwent voluntary restructuring in Azerbaijan, wherein its debts were proposed to be restructured. According to Azeri law, the restructuring plan became binding on all creditors upon approval by the required majority. However, certain debts governed by English law remained unaffected as the creditors neither participated in the restructuring nor submitted to the Azeri court's jurisdiction, citing the English common law rule in Gibbs. The foreign representative of IBA secured recognition of the Azeri proceeding as a foreign main proceeding in the UK, thereby imposing an automatic stay on enforcement actions. IBA sought an indefinite continuation of the stay in English courts to prevent the potential undermining of the successful Azeri restructuring outcome even after the restructuring had come to an end. IBA argued that the English court had the authority under the CBIR to grant a permanent stay, considering it a procedural step supporting a foreign insolvency process, which would restrict the creditors' enforcement rights without discharging the claims themselves. Rejected by the court of first instance, the foreign representative of IBA thereafter appealed to the Court of Appeal.

Recognizing the binding nature of Gibbs upon the Court of Appeal, IBA sought a permanent stay on English law rights. The Court of Appeal, however, dismissed the application, stating a permanent stay was deemed unnecessary to safeguard IBA's creditors, as the restructuring had concluded and IBA had resumed trading successfully. The Court of Appeal further reasoned that the Model Law's applicability was confined only to procedural aspects of cross-border insolvency cases, and that there was nothing in the CBIR to indicate that the procedural power to grant a stay could override substantive rights guaranteed by Gibbs.

In the absence of a standardised framework, a creditor with claim over assets in a non-main jurisdiction could enforce its rights over assets in that jurisdiction irrespective of the restructuring plan being approved by the court in the main jurisdiction. A clear facet of this risk is the application of Gibbs, whereby creditors would be allowed to bypass the effects of the insolvency related judgment approving the restructuring plan if the underlying debt is not governed by the law of that particular country.

For example, consider a scenario involving a multinational company, "ABC", having its COMI in the US and facing financial distress. Now, let us suppose that in the UK, a creditor holds a claim against ABC and has security over specific assets as per a contract governed by English law. Given that the COMI is in the US, the main legal proceedings would be initiated there. Accordingly, the restructuring plan, vital for ABC's resolution, is approved by the US court overseeing the main proceedings. However, by virtue of Gibbs and the lack of a

[70] U.N. Comm'n on Int'l Trade Law, UNCITRAL Model Law on Recognition and Enforcement of Insolvency-Related Judgments with Guide to Enactment, at 11, U.N. Sales No. E.19.V.8 (2019) [hereinafter MLREIJ].

[71] *Re* OJSC International Bank of Azerbaijan [2018] EWCA Civ 2802

standardised framework for enforcement of the judgment in the US main proceeding, the UK creditor may decide to independently enforce its rights over the assets in the UK (unless the UK based creditor participates in the US main proceeding). This means that even though the US court-approved restructuring plan has specific provisions for the use and distribution of assets in the UK, the UK creditor may act outside the scope of this plan, since the discharge of debt, governed by the English law, by a US would not be recognised under Gibbs.

The CBIR (UK's adoption of the Model Law) has proven inadequate to enforce insolvency related judgments from foreign countries, as highlighted in *Re OJSC International Bank of Azerbaijan*.[72] Recognising this limitation, the UNCITRAL took a significant step in 2018 by introducing the Model Law on the Recognition and Enforcement of Insolvency-Related Judgments (MLREIJ). The MLREIJ complements the Model Law and establishes a framework concerning the recognition and enforcement of insolvency related judgements.[73] It is pertinent to note that as of today, no country has adopted the MLREIJ;[74] the UK has however, recently issued a consultation paper for considering the implementation of this framework.[75]

The MLREIJ provides the adopting countries with two recourses. (a) First, to adopt the comprehensive MLREIJ, as an autonomous model law overseeing the recognition and execution of foreign insolvency-related judgments, or (b) alternatively, to amend their existing Model Law by integrating Article X,[76] thereby incorporating the MLREIJ provisions into their current legal framework.[77] Article X, if adopted, extends the relief available under the Model Law by giving courts discretionary power to recognise and enforce foreign insolvency-related judgments, where it is appropriate to do so.[78] However, it may be noted, that recognition and enforcement under Article X is still subject to the discretion of the domestic courts, which may apply Gibbs while exercising their discretionary power.[79]

Judicial integration of Modified Universalism: The Jet Airways Chronicle

In the absence of a dedicated framework to address distressed businesses with assets across multiple jurisdictions, judicial authorities establish a protocol to manage concurrent insolvency proceedings in different foreign countries. An illustrative case is that of Jet Airways (India) Ltd. (Jet), where concurrent proceedings unfolded in India and the Netherlands.

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[72] *Re* OJSC International Bank of Azerbaijan [2018] EWCA Civ 2802.

[73] MLREIJ, *supra note* 70, art. 2(d) ("Insolvency-related judgment": (i) Means a judgment that: a. Arises as a consequence of or is materially associated with an insolvency proceeding, whether or not that insolvency proceeding has closed; and b. Was issued on or after the commencement of that insolvency proceeding; and (ii) Does not include a judgment commencing an insolvency proceeding.").

[74] Video: *Conference dedicated to the 5th anniversary of the UNCITRAL Model Law on Recognition and Enforcement of Insolvency-Related Judgments,* U.N., https://uncitral.un.org/en/5MLIJ.

[75] *Implementation of two UNCITRAL Model Laws on Insolvency Consultation,* Gov.UK (July 10, 2023), https://www.gov.uk/government/consultations/implementation-of-two-uncitral-model-laws-on-insolvency/implementation-of-two-uncitral-model-laws-on-insolvency-consultation.

[76] MLREIJ, *supra note* 70, art. X ("Notwithstanding any prior interpretation to the contrary, the relief available under [insert a cross-reference to the legislation of this State enacting article 21 of the UNCITRAL Model Law on Cross-Border Insolvency] includes recognition and enforcement of a judgment.").

[77] *Id.*, para 41 at 25.

[78] *Id.*

[79] *Leading from the Front: UK*'s *Cross-Border Insolvency Regime to be Upgraded Following UNCITRAL Consultation,* Ashurst (August 29, 2023), https://www.ashurst.com/en/insights/uks-cross-border-insolvency-regime-to-be-upgraded-following-uncitral-consultation/.

In India, the State Bank of India, alongside other creditors, initiated insolvency proceedings against Jet in NCLT, Mumbai.[80] Pursuant to this, the NCLT was apprised of a concurrent proceeding concerning the liquidation of the assets of Jet occurring in the Netherlands where on an application made by the creditors of Jet before the District Court, Netherlands (Dutch Court), Jet was declared bankrupt and a Liquidator was appointed under Dutch law for realisation of its assets (Dutch Liquidator). The Dutch Liquidator, thereafter, filed an application for recognition of the Dutch proceedings before the NCLT which was rejected. Subsequently, the NCLT declined to stay the Indian proceedings and declared the bankruptcy order by the Dutch Court as void. This order was appealed before the National Company Law Appellate Tribunal (NCLAT).[81]

Amidst this, a mutual agreement was entered into between the RP appointed in the Indian proceedings and the Dutch Liquidator to coordinate the two insolvency processes. This agreement, termed the Cross-Border Insolvency Protocol (Jet Protocol), was granted legal sanction by the NCLAT in its ruling.[82]

The Jet Protocol recognised India as the COMI, designating the Indian proceedings as the main proceedings. In accordance with the Jet Protocol, a moratorium was established on the Dutch assets of the debtor, allowing the Dutch Liquidator to attend meetings of the Committee of Creditors (CoC) in India, without any voting rights. The Dutch Liquidator was tasked with consolidating claims by creditors in the Netherlands and forwarding them to the RP.

The Jet Protocol comprehensively covered access, recognition, cooperation, and coordination principles, laying the groundwork akin to the Model Law. Both countries, rather than adhering strictly to their insolvency models, opted for flexibility, and embraced Modified Universalism. This approach manifested in a primary proceeding in India, complemented by an ancillary proceeding in the Netherlands, emphasizing cooperation between the jurisdictions.[83]

CONCLUSION

In summary, the advantages of embracing modified universalism over the approach of territorialism embodied in the Gibbs Rule in cross-border insolvency are clear and compelling. Modified Universalism recognises the interconnected nature of today's global financial landscape, offering a flexible and collaborative framework that transcends jurisdictional boundaries. By prioritising cooperation among nations and fostering a more inclusive approach to insolvency proceedings, it promotes efficiency, fairness, and predictability. This model ensures that the interests of all stakeholders are considered, ultimately contributing to a more effective and harmonised resolution of cross-border insolvency cases. As we strive for a cohesive and responsive international insolvency system, the benefits of modified universalism emerge as a cornerstone in navigating the challenges of our interconnected world.

[80] State Bank of India v. Jet Airways (India) Limited, (2019) SCC OnLine NCLT 7875.

[81] Jet Airways (India) Limited v. State Bank of India, (2019) SCC OnLine NCLAT 385.

[82] Jet Airways (India) Limited v. State Bank of India, (2019) SCC OnLine NCLAT 1216.

[83] Bob Wessels, *Modified Universalism in European Cross-border Insolvency?* Prof. Dr. Bob Wessels (Jan. 9, 2019), https://bobwessels.nl/blog/2019-01-doc3-modified-universalism-in-european-cross-border-insolvency/.

India has made significant strides in improving its position on the World Bank's Ease of Doing Business Index through a series of targeted reforms. India is already entering into free trade agreements with Australia and is at advance stages of entering into free trade agreement with the UK. A translation of such free trade agreements can lead to increased market access for Indian goods and services in such partner countries. This can create new opportunities for Indian businesses to expand their exports and reach a larger consumer base.

It is the need of the hour to protect creditor interest, free flow of capital and at the same time resolve distress in multinational corporations in an efficient manner under a cross-border insolvency framework to steer India's path to becoming a developed country by 2027 and achieving a USD 5 trillion economy by 2025.[84] The adoption of the Draft Provisions undergirded with the philosophy of Modified Universalism would be a huge stride in its efforts to become more investor friendly while at the same guarding the interests of the various stakeholders involved in a cross-border insolvency process. These efforts underscore the nation's commitment to creating a more business-friendly environment and attracting foreign investment.

[84] Ministry of Com.& Indus., *Vision of a USD 5 Trillion Indian Economy,* Press Information Bureau(Oct. 11, 2018), https://pib.gov.in/Pressreleaseshare.aspx?PRID=1549454.

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RESCUING LENDERS: LIFTING OF THE RELATED PARTY AND CONTROLLING PARTY VEIL

Saloni Thakkar, Urmika Tripathi and Simrann Venkkatesan

ABSTRACT

The introduction of the Insolvency and Bankruptcy Code, 2016 (IBC/Code) overhauled India's insolvency regime and introduced a comprehensive reorganisation procedure i.e., the 'corporate insolvency resolution process' (CIRP). One of the key characteristics of a CIRP is that it is based on a 'creditor-in-control' model. A committee of creditors (CoC)[comprising of the financial creditors (FCs) of the corporate debtor (CD)] is constituted and is tasked with important decision-making powers such as approval of a resolution plan for the debtor, raising interim finance. Critically, section 21(2) of the IBC provides that a FC who is a 'related party' of the CD does not have any right of representation, participation or voting in a meeting of the CoC. This restriction does not apply to FCs (regulated by a financial sector regulator) who are related to the debtor solely on account of conversion of debt into equity or instruments convertible into equity, which is a common lender right in financing transactions. However, other typical lender protection rights such as the right to appoint a nominee director, rights following invocation of shareholder pledge/s, lender protection veto rights on critical matters, have not been carved out and could arguably fall within the definition of a 'related party' under the IBC.

In addition to losing their seat on the CoC, an FC who is classified as a 'related party' may also receive differential treatment (in terms of recoveries) as comprising of the FCs. In India it is common practice for lenders to negotiate lender protection rights such as right to appoint a nominee director or an observer on the board of directors of the borrower; veto rights on certain critical matters to protect the investment of the lender. Recent case laws have delved into the question of whether such lender protection rights would classify the subject lender as a 'related party' of the CD.

This paper analyses the IBC provisions and case laws on classification of FCs as 'related parties' under the IBC. It specifically discusses how the broad definition of 'related party', which is arguably aimed at covering promoters/direct and indirect shareholders/ controlling entities, may also end up covering pure play creditors based on common lender rights and underscores the need to create a predictable insolvency regime for lenders. It argues that applicability of the 'related party' provisions under the IBC and their implications (i.e., restriction from being a member of the CoC or differential treatment under resolution plans) should be restricted to shareholders/promoter loans and not third-party creditors.

Keywords: Control, Lender's rights, Debt, Equity, Exclusion, Forbearance, Related party

INTRODUCTION

The introduction of IBC in 2016 overhauled India's insolvency regime. Prior to the enactment of the IBC in 2016, India's restructuring, and insolvency regime was fragmented laws; bankruptcy of individuals was governed by the Presidency Towns Insolvency Act, 1909 and Provincial Insolvency Act, 1920; rescue regime for industrial companies was governed by the Sick Industrial Companies (Special Provisions) Act, 1985; insolvency of corporates was governed by the (Indian) Companies Act, 1956 (amongst other laws). In addition, the Reserve Bank of India (RBI) issued several directions to financial institutions regulated by it (banks, financial institutions, etc.) on restructuring and resolution of debtors.

The IBC has consolidated laws regarding insolvency resolution, reorganisation and liquidation of corporate entities, partnership firms and individuals.[1] It has introduced a comprehensive reorganisation procedure i.e., the CIRP- a 'creditor-in-control' based reorganisation mechanism which provides the advantage of a time-bound and efficient resolution framework, moratorium against legal proceedings, extinguishment of past liabilities, among others.

Once a CD is admitted into a CIRP, its existing board of directors is suspended, and the management and control of the CD is vested in the Resolution Professional (RP).[2] The RP is required to constitute a CoC comprising of FCs.[3] While the RP is vested with the powers of the board of directors of the CD, important decisions require the prior approval of the CoC- such as resolutions for approval of the resolution plan for the CD,[4] raising interim finance, creating security interest over the assets of the CD, undertaking any related party transaction, and amendment of constitutional documents of the CD, among others.[5] Therefore, a seat on the CoC is an important right for FCs of the CD in a CIRP.

Critically, section 21(2) of the IBC provides that an FC who is a 'related party'[6] of the CD does not have any right of representation, participation or voting in a meeting of the CoC. This

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[1] The provisions of the Code relating to insolvency resolution and bankruptcy of individuals and partnership firms has not yet been notified (barring the notification of provisions for insolvency resolution and bankruptcy of personal guarantors to corporate debtors, which were notified in November 2019).

[2] The Insolvency and Bankruptcy Code, 2016, § 17.

[3] 'Financial Creditors' as defined under Section 5(7) of the IBC are typically banks, financial institutions, debenture holders who have lent against the consideration for the time value of money.

[4] The Insolvency and Bankruptcy Code, 2016, § 30(4).

[5] *Id.*, § 28.

[6] 'Related Party' of a corporate debtor is defined under Section 5(24) of the Insolvency and Bankruptcy Code, 2016 as follows:

> "(24) "related party", in relation to a corporate debtor, means-
> (a) a director or partner of the corporate debtor or a relative of a director or partner of the corporate debtor;
> (b) a key managerial personnel of the corporate debtor or a relative of a key managerial personnel of the corporate debtor;
> (c) a limited liability partnership or a partnership firm in which a director, partner, or manager of the corporate debtor or his relative is a partner;
> (d) a private company in which a director, partner or manager of the corporate debtor is a director and holds along with his relatives, more than two per cent. of its share capital;

restriction does not apply to FCs (regulated by a financial sector regulator) who are related to the debtor solely on account of conversion of debt into equity or instruments convertible into equity, which is a common lender right in financing transactions.[7] However, other typical lender protection rights such as the right to appoint a nominee director, rights following invocation of shareholder pledge/s, lender protection veto rights on critical matters, have not been carved out and could arguably fall within the definition of a 'related party' under the IBC. In addition to losing their seat on the CoC, an FC who is classified as a 'related party' may also receive differential treatment (in terms of recoveries) as compared to other FCs.[8]

The February 2020 Report of the Insolvency Law Committee (ILC Report 2020) also took note that the restriction under section 21 of the IBC may result in unintended consequences for pure-play FCs.[9] Recent case laws[10] have delved into the question of whether the presence of lender protection rights would classify the subject lender as a 'related party' of the CD.

This paper analyses the IBC provisions and case laws on classification of FCs as 'related parties' under the IBC. It specifically discusses how the broad definition of 'related party', which is arguably aimed at covering promoters, direct and indirect shareholders, controlling entities, may also end up covering pure play creditors on the basis of common lender rights. The paper argues that applicability of the 'related party' provisions under the IBC and their implications (i.e., restriction from being a member of the CoC or differential treatment under resolution plans) should be restricted to shareholders and promoter loans and should not be extended to any bona fide third-party.

(e) a public company in which a director, partner or manager of the corporate debtor is a director and holds along with relatives, more than two per cent. of its paid- up share capital;

(f) anybody corporate whose board of directors, managing director or manager, in the ordinary course of business, acts on the advice, directions or instructions of a director, partner or manager of the corporate debtor;

(g) any limited liability partnership or a partnership firm whose partners or employees in the ordinary course of business, acts on the advice, directions or instructions of a director, partner or manager of the corporate debtor;

(h) any person on whose advice, directions or instructions, a director, partner or manager of the corporate debtor is accustomed to act;

(i) a body corporate which is a holding, subsidiary or an associate company of the corporate debtor, or a subsidiary of a holding company to which the corporate debtor is a subsidiary;

(j) any person who controls more than twenty per cent. of voting rights in the corporate debtor on account of ownership or a voting agreement;

(k) any person in whom the corporate debtor controls more than twenty per cent. of voting rights on account of ownership or a voting agreement;

(l) any person who can control the compositionof the board of directors or corresponding governing body of the corporate debtor;

(m) any person who is associated with the corporate debtor on account of –

(i) participation in policy making processes of the corporate debtor; or

(ii) having more than two directors in common between the corporate debtor and such person; or

(iii) interchange of managerial personnel between the corporate debtor and such person; or

(iv) provision of essential technical information to, or from, the corporate debtor;"

[7] The Insolvency and Bankruptcy Code, 2016, § 21(2) second proviso.

[8] In the case of 'M.K. Rajagopalan v. Dr. Periasamy Palani Gounder' (2024) 1 SCC 42 (India), the Supreme Court affirmed that differential treatment may be meted out to financial creditors who are 'related parties' of the corporate debtor (i.e., they may not be entitled to the same recoveries as other financial creditors).

[9] Ministry of Corporate Affairs, *Report of the Insolvency Law Committee*, para 11.8, at 47(Feb. 2020), https://www.mca.gov.in/Ministry/pdf/ICLReport_05032020.pdf.

[10] IDBI Trusteeship Services Ltd. v. Abhinav Mukherji, (2022) SCC OnLine NCLAT 267.

OVERVIEW OF IBC PROVISIONS ON 'RELATED PARTY'

Key IBC provisions on 'related party'

Definition of a related party: Section 5(24) of the IBC

'Related Party' in relation to a CD has been defined under section 5(24) of the IBC to mean *inter alia* the following:[11]

a) Based on relationship with CD and management powers:

   (i) a key managerial personnel, director or partner of the CD or their relatives;

   (ii) any person on whose advice, directions or instructions, a director, partner or manager of the CD is accustomed to act;

   (iii) any person who is associated with the CD on account of (i) participation in policy making processes of the CD; or (ii) having more than two directors in common between the CD and such person; or (iii) interchange of managerial personnel between the CD and such person; or (iv) provision of essential technical information to, or from, the CD; or

   (iv) any person who can control the composition of the board of directors or corresponding governing body of the CD;

b) Based on corporate structure and voting rights

   (i) anybody corporate whose board of directors, managing director or manager, in the ordinary course of business, acts on the advice, directions or instructions of a director, partner or manager of the CD;

   (ii) a body corporate which is a holding, subsidiary or an associate company of the CD, or a subsidiary of a holding company to which the CD is a subsidiary;

   (iii) any person who controls more than 20% of voting rights in the CD on account of ownership or a voting agreement; or

   (iv) any person in whom the CD controls more than 20% of voting rights on account of ownership or a voting agreement.

Constitution of the CoC: Section 21 of the IBC

As discussed above, section 21(2) of the IBC, *inter alia* provides that a FC who is a related party of the CD, will not have the right of representation, participation or voting in the CoC.[12] However, this provision excludes a FC regulated by a financial sector regulator, if it is eligible to be classified as a related party of the CD solely on account of conversion or substitution of debt into equity shares or instruments convertible into equity shares or completion of such transactions as may be prescribed,[13] prior to the insolvency commencement date.[14]

[11] The Insolvency and Bankruptcy Code, 2016, § 5(24).
[12] The Insolvency and Bankruptcy Code, 2016, § 21(2).
[13] Currently, no additional transactions have been prescribed for the purposes of Section 21 of the IBC.
[14] The Insolvency and Bankruptcy Code, 2016, § 21(2) second proviso.

Implications of lender being classified as a 'related party'

The key implications of a FC being classified as a 'related party' *inter alia* are:

a) A related party is not entitled to be a part of the CoC[15](which is tasked with critical decision-making powers on approval of resolution plans, raising interim finance, among others);

b) A related party would most likely receive differential recoveries *vis-à-vis* other unrelated FCs under a resolution plan, given the Supreme Court order in *M. K .Rajagopalan v. Dr. Periasamy Palani Gounder* which held that there was no provision in the IBC which mandates that the related party should be paid in parity with the unrelated party;[16]

c) The look-back period for avoidance transactions (such as preferential transactions, undervalued transactions and extortionate credit transactions) is longer for transactions with related parties as compared to those with unrelated parties (two years for related party transactions versus one year for unrelated parties);

d) Assignment of 'related party' debt to a third party may also run into challenges as the assigned debt may carry the related party taint and the assignee may also not be allowed to have a seat on the CoC.[17]

Lender protection rights that may trigger 'related party' definition

Lenders often negotiate several protections rights in typical credit transactions, especially when lending to corporates with a high default risk. These rights *inter alia* may include:

a) security rights over the assets of the borrower/its group - such as a mortgage over immovable properties, pledge over shares of the borrower, hypothecation over the receivables of the borrower, among others.

b) information rights such as the right to receive information regarding the financial affairs of the borrower;

c) right to appoint a nominee director or an observer on the board of directors of the borrower/its holding company;

d) veto rights on certain critical matters to protect the investment of the lender, such as restrictions against:

- availing further financial indebtedness;
- creation of any further encumbrance or security over the assets of the borrower;
- related party transactions;
- alteration of the share capital of the company;
- changes in business plans of the borrower.

e) ability to convert their debt into equity.

[15] The Insolvency and Bankruptcy Code, 2016, § 21(2).
[16] M.K. Rajagopalan v. Dr. Periasamy Palani Gounder, (2024) 1 SCC 42, para 178, at 159.
[17] Please see case laws of Citi Securities and Rare ARL as discussed below.

Inadvertently, some of these rights, such as the right to appoint a nominee director, veto rights over operational matters, invocation of pledge over the shares of the borrower may result in the lender falling within the scope of the definition of '*related party*' under section 5(24) of the IBC. For instance, exercise of veto rights relating to the business plan of the CD could arguably qualify as '*participation in policy making processes of the corporate debtor*'.

We may also consider rulings of the Bombay High Court in the case of *World Crest Advisors LLP v. Catalyst Trusteeship Limited* dated June 23, 2022[18] and *World Crest Advisors LLP v. Catalyst Trusteeship Limited* dated September 4, 2023.[19] In these decisions, the court observed that lenders (as a pledgee) can exercise voting rights over pledged shares upon invocation. The definition of a related party includes "*any person in whom the corporate debtor controls more than twenty per cent. of voting rights on account of ownership or a voting agreement*".[20] Therefore, invocation of pledge by a lender and exercise of voting rights on these shares may also result in the lender being classified as a 'related party'.

The ILC Report 2020 too noted that the aforesaid exemption did not account for all situations in which a regulated FC may be deemed to be a related party of an otherwise unrelated CD and further took note of instances such as debt asset swaps and pledge invocation which may result in a pure-play FC qualifying a 'related party' under section 21 of the IBC.[21] Therefore, the Insolvency Law Committee agreed that the scope of exemption under section 21 should be broadened to allow the Central Government "*to prescribe additional transactions solely by completion of which a financial creditor which, is regulated by a financial sector regulator and not otherwise related to the corporate debtor, should not be considered as a 'related party' of the corporate debtor under this definition*".[22]

Status of assignees of 'related party' debt?

Section 21 of the IBC is silent on the eligibility of a third-party assignee of a 'related party' debt to participate, vote or be represented in the CoC. The ILC Report 2020 also noted this issue and observed that Insolvency Tribunals had taken varying approaches on for determining eligibility of third party assignees of 'related party' debt under section 21 of the IBC.[23] In certain cases, the Tribunal had looked at the legality and validity of the assignment debt and the underlying intention of the parties to determine whether the assignee had a legitimate right to be a part of the CoC.[24] Alternatively, certain decisions have held that the assignees of related party debt is ineligible to participate in the CoC under section 21(2), on the ground that the assignee of a debt cannot have a better title than the assignor itself.[25]

Observations were made in the ILC Report 2020 that the restriction under section 21(2) is aimed at eliminating conflict of interest in the CoC and preventing promoters from acquiring control of the CD during CIRP based on a 'related party' debt.[26] It was further noted in ILC

[18] (2022) 169 CLA 302 (India).

[19] 2023 SCC Online Bom 1879 (India).

[20] The Insolvency and Bankruptcy Code, 2016, §5(24)(k).

[21] Ministry of Corporate Affairs, *supra note* 9, para 11.3, at 45.

[22] *Id.*, para11.4 at 46.

[23] *Id.*, para 11.8 at 47.

[24] IFCI Limited v. Anshul Gupta I.A. (IB) 1477/HBD of 2023 (order dated February 6, 2024) in CP IB No 203/7/HBD/2022.

[25] Pankaj Yadav v. State Bank of India Ltd. 2018 SCC Online NCLAT 389 (India).

[26] Ministry of Corporate Affairs, *supra note* 9, para11.9, at 47.

Report 2020 that a third-party assignee of a 'related party' debt who is not related to the CD should not be disabled from being a part of the CoC. The restriction and disability are not linked to the debt itself but to the relationship existing between the creditor (who is a related party) and the CD and therefore, it was recommended in the ILC Report 2020 that "*when a related party financial creditor assigns her debt to a third party in good faith, such third party should not be disqualified from participating, voting or being represented in a meeting of the CoC.*"[27]

However, the ILC Report 2020 also cautioned against cases where the related creditor has assigned its debt to an unrelated party with the intention of circumventing the restriction under section 21 of the IBC and for indirectly participating in the CoC through such third party unrelated assignee.[28] Therefore, the ILC Report 2020 recommended that -

> prior to including an assignee of a related party financial creditor within the CoC, the resolution professional should verify that the assignee is not a related party of the corporate debtor. In cases where it may be proved that a related party financial creditor had assigned or transferred its debts to a third party in bad faith or with a fraudulent intent to vitiate the proceedings under the Code, the assignee should be treated akin to a related party financial creditor under the first proviso to Section 21(2).[29]

CASE LAWS ON TREATMENT OF 'RELATED PARTY' DEBT

This part discusses the recent case laws on treatment of FCs as 'related parties' and assignees of 'related party' debt under the IBC.

NCLAT decision in *IDBI Trusteeship Services Ltd. v. Abhinav Mukherji*

The NCLAT, in the case of *IDBI Trusteeship Services Ltd. v. Abhinav Mukherji* examined the agreements between the CD and the debenture holders to determine the issue of whether ECL Finance Limited and IDBI Trusteeship Services Ltd., would be treated as related parties of the CD based on *inter alia* their rights enshrined in the Article of Association (AoA).[30] Their rights in the AoA included: the right to appoint a nominee director and observer on the board of the CD,[31] right to appoint and remove key managerial personnel,[32] clauses with respect to 'business plans', provisions that stated that a director cannot take any decision without the written approval of the debenture holders, control over account with project revenues.[33] In addition, an irrevocable power of attorney existed in favor of the debenture holders (to conduct business activities).[34]

The creditors submitted before the NCLAT that the restrictive clauses in the AoA of the borrowing company i.e., Saha Infra tech were only inserted to ensure that the CD does not attempt to siphon off in any way the assets based on which the loan was advanced.[35] It was

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[27] *Id.*, para 11.9 at 48.
[28] *Id.*, para 11.10 at 48.
[29] *Id.*
[30] IDBI Trusteeship Services Ltd. v. Abhinav Mukherji, (2022) SCC OnLine NCLAT 267, para 1.
[31] *Id.*, para 6 at 59.
[32] *Id.*, para 45 at 37.
[33] *Id.*, para 37.
[34] *Id.*, para 55.
[35] *Id.*, para 34.

further submitted that right to nominate a director does not mean positive control of the board of directors but should be interpreted only as some sort of "financial discipline" or cash monitoring abilities.[36]

However, the NCLAT relied on the rights of the creditors and held that the creditor had positive control and should be classified as a 'related party' of the CD.[37] It may be noted that the said order of NCLAT has been challenged and an appeal is pending before the Supreme Court.[38] The Supreme Court has *vide* order dated September 12, 2022 directed the parties to maintain status quo until further orders.[39]

NCLT decision in *Housing & Urban Development Corporation Ltd.*

In *Housing & Urban Development Corporation Ltd.,*[40] a major secured FC had the right to appoint nominee directors to the board of the CD as per the terms of the loan agreement, without any right to manage or influence the management of the CD. The NCLT held that the since the board does not act on the advice and directions of such a nominee director, the FC is not a 'related party' in terms of section 5(24) of the IBC.

NCLT decision in *IFCI Limited v. Anshul Gupta*

The NCLT in the matter of *IFCI Limited (IFCI) v. Anshul Gupta*, *RP of Gati Infrastructure Bhasmey Power Private Ltd*. (Gati),[41] analysed the scope of "or completion of such transactions as may be prescribed" provided in section 21(2) to evaluate whether IFCI Limited by virtue of being equity shareholder was a 'related party' in terms of section 5(24)(j) of IBC of Gati, the CD, and whether was rightly ousted from the CoC.

IFCI held 38.73% of the total equity shares of Gati. IFCI sought the exemption in terms of second proviso to section 21(2) of IBC. IFCI had financed Gati by subscribing to 49% of Gati's shareholding in accordance with the terms of *inter alia* a share subscription agreement, share buyback agreement and a shareholder's agreement. Further financing was also extended via underwriting and rupee loan agreement.[42] On account of a default by Gati in repayment of the facility, IFCI, exercised its put option in accordance with the equity/share subscription agreement and share buyback agreement, requiring the promoters of Gati to make certain payments against buyback of 1,50,05,166 shares.[43] The promoters of Gati failed to honour the put option.

The RP of Gati argued that the benefit under second proviso to section 21(2) of IBC was not available to IFCI as there is no conversion or substitution of debt into equity shares nor any other conversion or substitution of instruments convertible into equity shares.[44] IFCI argued (a) that it had no intention of controlling or managing the business of Gati;(b) that it is a

[36] *Id.*, para 36.
[37] *Id.*, para 37.
[38] IDBI Trusteeship Services Limited v. Abhinav Mukherji (Diary No. - 23954/2022 and Civil Appeal No. 6268/2022).
[39] *Id.*
[40] Housing & Urban Development Corporate Ltd. I.A. (IB) 514/KB of 2022 decided on August 30, 2023 (NCLT) (India).
[41] IFCI Limited v. Anshul Gupta, *supra note* 24.
[42] *Id.*,para 2 at 3.
[43] *Id.*, para 2(vii) at 3.
[44] *Id.*, para 4 (v) at 6.

public financial institution and regulated by the RBI and Ministry of Finance, Government of India; (c) that the core business of IFCI is lending for industrial development and (d) therefore, IFCI in real sense has no relationship with the Gati except being a financier.[45] The subscription to equity of Gati was a part of funding the lacuna of debt financing with a clear-cut buy back arrangement. Accordingly, the subscription of shares of Gati by IFCI was to ensure the recovery of the facility advanced only. IFCI further highlighted that it had already exercised its put option, but due to the failure of Gati's promoters, it was still holding equity in Gati and therefore, IFCI argued thatit is covered by the second proviso to section 21(2) of IBC and is eligible to be included in the CoC with voting rights.[46]

The NCLT noted that the equity shares of Gati held by IFCI were not acquired on account of conversion or substitution of debt into equity shares or instruments convertible into equity shares.[47] Further the NCLT observed that section 21(2) goes beyond this condition and further says "*or completion of such transactions as may be prescribed*".[48] NCLT stated that, the intent of legislature while adding the words "*or completion of such transactions as may be prescribed*" would have been to include "*such transactions which creates compelling circumstances to financial creditors to continue as equity holder and thus reluctantly inviting the tag of related party to corporate debtor*".[49] Further, NCLT also noted that IFCI from its end had terminated its shareholder relationship with Gati but since debt remained unpaid, IFCI continued to be the shareholder of Gati. Considering the above facts of the case, the NCLT held that IFCI was eligible to be covered under second proviso to section 21(2) of IBC and thereby be made part of CoC with voting rights.[50]

Supreme Court decision in *Phoenix Arc Pvt. Ltd. v. Spade Financial Services Ltd.*

In the matter of *Phoenix Arc Pvt. Ltd. v. Spade Financial Services Ltd.*, the issue of whether a FC is a related party and hence, should not be allowed to be a part of the CoC of AKME Projects Limited (the CD) was raised before the Hon'ble Supreme Court.[51] While deciding the said issue the Hon'ble Supreme Court was required to interpret various provisions of the IBC including the relevance of the timing of classifying a party as a related party in light of the phrase "is a related party" in the first proviso of section 21(2) of the IBC.[52]

Interestingly, the NCLT came to the specific finding that Spade Financial Services Ltd. (Spade) and AAA Landmark Pvt. Ltd. (ALPL) were related parties of the CD but, that the relationship had ended by the time the CIRP of the CD had commenced.[53] To clarify, ALPL was classified as a partner of the CD and Spade a related party, since they had entered into two transactions on the basis of the advice, instructions or directions of the board of the CD therein, under section 5(24)(f) of the IBC.[54]

[45] *Id.*, para 7 at 9-10.
[46] *Id.*, para 3 at 5-6.
[47] *Id.*, para 12 at 12
[48] *Id.*, para 13 at 12.
[49] *Id.*, para 13 at 12 - 13
[50] *Id.*, para 18 at 16
[51] Phoenix Arc Pvt. Ltd. v. Spade Financial Services Ltd., (2021) 3 SCC 475, para 5, at 489.
[52] *Id.*, para 71 at 514.
[53] *Id.*, para 17 at 492.
[54] *Id.*, para 19 at 492.

The NCLT and NCLAT had held that ALPL and Spade (a) are FCs of the CD and (b) have to be excluded from the CoC formed in relation to the CIRP initiated against the CD since they were related parties to the CD.[55]

The parties had submitted before the Hon'ble Supreme Court that Spade and ALPL were no longer related parties of the CD (even though, in terms of the earlier finding, they were so during the relevant period when the transactions constituting their alleged financial debt took place).[56] The submission before the Hon'ble Supreme Court was that the statute applies *in praesenti* as on the date of the admission of an application seeking the initiation of the CIRP and does not extend to a look back period.[57] It was further substantiated by urging that if the expression is a related party is not construed in its literal sense, *in praesenti*, it will result in an ambiguity without a yardstick on how far back in point of time the relationship should be assessed.[58] Further, it was also submitted that the definition of "related party" under section 5(24) of the IBC, uses phrases such as "is accustomed to act" or "is associated" to define a related party in the present tense. In essence, it had been emphasized that the existence of a live link of being a related party in the present is a requirement of the statutory provision.[59] Accordingly, an issue of interpretation in relation to the first proviso of section 21(2) of the IBC was raised and analysed by the Hon'ble Supreme Court was whether the disqualification under the proviso would attach to a FC only *in praesenti*, or if it also extends to those FC who were related to the CD at the time of acquiring the debt.[60]

The Hon'ble Supreme Court also considered the key observations made in the ILC Report 2020 (discussed above) in relation to the eligibility of assignees of related party debt to participate in the CoC.

Based on the analysis of various provisions of the IBC, ILC Report 2020 and precedents set by the judiciary, the Hon'ble Supreme Court was inclined towards the submissions made by Phoenix Arc Pvt. Ltd., that the interpretation which the court adopts must facilitate and not defeat the fulfilment of the objectives of the IBC.[61] The aim of the CoC is to enable coordination between various creditors so as to ensure that the interests of all stakeholders are balanced, and the value of the assets of the entity in financial distress is maximised.[62] Accordingly the Hon'ble Supreme Court held that:

(i) as such, the FC who *in praesenti* is not a related party, would not be debarred from being a member of the CoC;[63]

(ii) however, in case where the related party FC divests itself of its shareholding or ceases to remain a related party in a business capacity with the sole intention of participating in the CoC and influence its decision making at the cost of other

[55] *Id.*, para20 at 493.
[56] *Id.*
[57] *Id.*, para 72 at 515.
[58] *Id.*
[59] *Id.*, para 73 at 515.
[60] *Id.*, para 88 at 520.
[61] *Id.*, para 91 at 521.
[62] *Id.*, para 78 at 517.
[63] *Id.*, para 103 at 527.

> FCs will sabotage the CIRP, by diluting the vote share of other creditors, thus, it would be in keeping with the aim of the first proviso to section 21(2) of the IBC, to consider the former related party creditor, as one debarred under the first proviso.[64]

The Hon'ble Supreme Court held that Mr. Arun Anand, Spade, and ALPL were related parties of the CD during the relevant period, when the transactions on the basis of which Spade and ALPL claim their status as FCs took place.[65] Further that in light of the pervasive influence of Mr. Anil Nanda (the promoter/director of the CD) over these entities allowing them in the CoC would definitely affect the other independence of the FCs.[66] The Hon'ble Supreme Court was of the view that while Spade and ALPL's status as related parties may no longer stand, this was due to commercial contrivances through which these entities sought to enter the CoC,[67]and that this would be averse to the objectives of the IBC. Therefore, it was concluded (while setting aside (partially) the judgement of NCLAT) that ALPL and Spade could not be classified as FCs.[68]

It would be interesting to watch out for an extension of this trail of argument in relation to the issue of categorisation of a lender as a related party or controlling party pursuant to exercising any of the lender's financing rights elaborated above on occurrence of a default and the inter linkages of the look back period if any. There is an argument for the view that at the time of funding, the lender was not a related party and that only for the purposes of protecting the further deterioration of the company, has the lender exercised certain rights available under the financing documents which are only etched within the company's operations for safeguarding its investments and returns.

Judicial trend on treatment of related party debt post Phoenix Arc Pvt. Ltd. (supra)

NCLAT decision in Citi Securities & Financial Services v. Sudip Bhatacharya

In the matter of *Citi Securities & Financial Services Private Limited v. Sudip Bhatacharya* (*RP of RNEL*) *& Ors.*[69] NCLAT *vide* its order dated September 16, 2022 upheld the classification of Citi Securities & Financial Services Private Limited (Citi Securities) as a related party FC even though it was itself unrelated to the CD therein i.e. Reliance Naval & Engineering Limited (RNEL)by observing simply that -

> 21 … The purpose and object was obvious that Reliance Infrastructure Ltd. being related party could not have participated in the CoC of the Corporate Debtor, hence, Assignee has been brought into for the sole purpose of participating in the CoC which Assignee as per the case of the Appellant is not a related party. Further, the debt of Rs.2538 Crore has been assigned for amount of Rs.114.93 Crores speaks for itself. Further, the Reliance Infrastructure Ltd. had Hypothecation Deed and Mortgage. The time and manner in which assignment has been made clearly indicate that Assignment is not bonafide and was made only to put the Appellant in the CoC with ulterior motive to watch the interest of the related party….[70]

[64] *Id.*

[65] *Id.*

[66] *Id.*, para 105 at 528.

[67] *Id.*, para 105 at 528.

[68] *Id.*, para106 at 528.

[69] 2022 SCC Online NCLAT 4041 (India), CA AT 240/2022.

[70] *Id.*, para 21 at 25.

NCLAT held that the assignment deed executed by Citi Securities and Reliance Infrastructure Limited was not in good faith and rather showed that the arrangement was made with a view to get backdoor entry into the CoC to have control over the CIRP of the RNEL through Citi Securities.[71]

NCLAT decision in Rare Reconstruction Ltd. v. Avishek Gupta

In another case of *Rare Reconstruction Ltd. v. Avishek Gupta*,[72] the NCLAT again based on the consideration of facts of the case at hand, *vide* order dated February 29, 2024 held that the assignee of a related party debt i.e. Rare Reconstruction Ltd. (Rare ARL) was a related party FC of the CD i.e. Sarga Hotel Private Limited (Sarga Hotel).[73] Brief facts of the case were that Srei Equipment Finance Limited (SEFL) entered into an assignment agreement dated September 9, 2020 with Rare ARL to assign a loan under facility agreement dated August 29, 2018 which had been sanctioned by SIFL. It may be noted that SIFL had subsequent to the sanctioning of the loan to Sarga Hotel, transferred its entire lending, interest bearing and leasing business including the said loan dated August 29, 2018 to SEFL *vide* a business transfer agreement.[74]

The cut-off date in the assignment agreement was defined as August 12, 2020 i.e. the date on which the CIRP had commenced against Sarga Hotel initially.[75] Further, the RBI superseded the board of management of Srei Infrastructure Finance Limited (SIFL) and SEFL by order dated October 08, 2021, Mr. Rajneesh Sharma was appointed as the administrator for conducting the CIRP of SIFL and SEFL (Administrator).[76] Subsequently, on July 24, 2022, the Administrator filed an avoidance application alleging the said loan by SIFL in favour of Sarga Hotel was fraudulent and wrongful transaction under section 66 of the Code.[77] The Administrator filed another application and further apprised the NCLAT that the majority of funds amounting to ₹25 crore used to pay upfront consideration by Rare ARL to SEFL in relation to the purported assignment was indirectly provided by SEFL itself.[78] NCLAT refrained from recording any findings with regard to funding provided to Rare ARL but noted that such pleadings made raise serious doubt with regard to the entire assignment transaction.[79] It was further noted by the NCLAT that

> It is relevant to reiterate again that the fact that appellant filed its claim on 09.09.2020 in first CIRP on the same date on which it took assignment from SEFL, a date on which it took assignment from SEFL, a related party to Corporate Debtor makes it crystal clear that assignment in favour of appellant was made only for participating in CIRP of Corporate Debtor as assignee of SEFL, hence, appellant the assignee has rightly been held to be related party to the Corporate Debtor.[80]

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[71] *Id.*, para 22 at 25-26.

[72] M/s Rare Asset Reconstruction Limited v. Sh. Abhishek Gupta, 2024 SCC OnLine NCLAT 268 (India).

[73] *Id.*, para 29 at 37.

[74] *Id.*, para 2 at 2.

[75] This order initiating CIRP against Sarga Hotel of the NCLT was set aside by NCLAT vide its order dated August 27, 2021. Subsequently Yes Bank filed an application under Section 7 of the IBC which was allowed and CIRP was initiated again on February 11, 2022 against Sarga Hotel.

[76] *Id.*, para 2.6 at 4.

[77] *Id.*, para 2.6 at 4.

[78] *Id.*, para 2.6 at 4.

[79] *Id.*, para 29 at 37.

[80] *Id.*, para 29 at 37.

SUGGESTED AMENDMENTS TO THE IBC

Arguably, the objective of the subject provisions for exclusion of related parties from the CoC is aimed at ensuring that biased entities, or entities which were responsible for the default/ distress at the borrower level do not form a part of the CoC. The legislative intent for having a wide and stringent interpretation of "controlling party" and "related party" is perhaps, to avoid any back door entry of parties whose decisions may adversely impact the financial health of the CD or parties who may potentially hinder the insolvency resolution of the CD. However, there is a concern that in this case, the regulations may be targeting the exceptions, and not the rule, which ordinarily ought to be avoided.

In the absence of specific carve-outs for lenders, the broad definition of 'related parties' under the IBC and the *Abhinav Mukherji* case increases the risk for pure play lenders being classified as 'related parties', despite these rights being typical and aimed at protecting the lender (and not providing it with control).

The UNCITRAL Legislative Guide on Insolvency Law provides that creditors who are related persons or persons who are for any reason not impartial should not be appointed to a creditor committee.[81]

The objective of lender protection rights such as veto rights, right to appoint a nominee director is to ensure sufficient oversight over the borrower's affairs and ensure that the lender is protected against value destructive actions or transactions by the borrower's management. These rights are not aimed at exercising positive control over the borrower. Even the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 provides an exception from the requirement to make an open offer, for any change in shareholding resulting from acquisition by an invocation of pledge by a banks and financial institutions.

It may, therefore, be a better approach for the scope of the restrictive provisions on 'related parties' to be restricted to related parties who directly or indirectly exercise positive control over the debtor and not pure play or external FCs who are impartial. In *Arcelor Mittal India Pvt. Ltd. v. Satish Kumar Gupta*, the Supreme Court dealt with meaning of the term 'control' (in the context of section 29A of the IBC which places eligibility restrictions on bidders submitting resolution plans for a CD) and held that control refers to positive or proactive control (as opposed to mere negative or reactive control) and would not cover the mere power to block special resolutions of a company.[82]

Given the existing market practice of including typical lender protection rights, including the right to nominate a director to the board of the borrower, exercising veto powers over certain matters, it may be useful to clarify that such rights (which are exercised with the objective of mitigating credit risk rather than to exercise control over the day-to-day management of the debtor) would not result in classification of the lender as a "related party" under the IBC.

[81] Recommendation 131, UNCITRAL Legislative Guide on Insolvency Law.

[82] *Id.*

CONCLUSION

Clarifying the scope of the provisions related to 'related party' under the IBC (insofar as it applies to FCs) to ensure that impartial FCs will not be treated as a related party on the basis of typical lender protection rights is critical. These rights are prominently seen in lending transactions where the borrower is at a high default risk. This makes it even more critical to protect the rights of such creditors and ensure that the cost of credit is not further affected. Clarity in this regard will also ensure that predictability of outcome is maintained.

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COMPREHENDING BANK INSOLVENCY RESOLUTION VIS–A–VIS ANALYSIS OF BANKING REGULATIONS UNDER THE UMBRELLA OF UNIDROIT LEGISLATIVE GUIDE ON BANK INSOLVENCY

Vivek Saurav, Richa Kashyap and Bhanu Saxena

ABSTRACT

In recent times, concerns regarding the vulnerability of banks have re-emerged at the vanguard of the international financial arena. This growing importance is exemplified by the recent failures of three major institutions in the United States. This occurrence raises concerns regarding the sustainability and effectiveness of existing financial stability frameworks amidst an ever-evolving financial landscape. To no one's surprise, these changes occur concurrently with significant international discussions regarding bank insolvency. The UNIDROIT Working Group on Bank Insolvency (WG), responsible for drafting the Legislative Guide (the Guide), an international soft law document, is at the forefront of these discussions. The primary objective of this Guide is to provide comprehensive instructions on the worldwide intricacies of bank liquidation processes. The Guide, slated for ratification in 2024, aims to address significant deficiencies in the worldwide legal framework concerning bank insolvency, particularly, pertaining to smaller and medium-sized banks. Although the ongoing discussions within the WG offer valuable perspectives on the developing structure of the Guide, it is critical to bear in mind that both its structure and its content remain fluid and subject to potential modifications and enhancements. In this context, India's assumption of the chair of the UNIDROIT General Assembly in 2022-23 is notable. This pivotal leadership role aligns with the ongoing discourse regarding bank insolvency and provides India with a unique opportunity to contribute its specialized knowledge to the Guide's development. The manner in which India attempts to resolve the complex issues associated with bank resolution contributes to our knowledge of the nation. The oversight of financial organization resolutions was proposed to the Financial Resolution and Deposit Insurance Corporation (FRDIC) by the 'Committee to Draft Code on Resolution of Financial Organisations' (the Committee), established in 2016. A subsequent effort was made to consolidate the fragmented regulatory framework pertaining to bank resolution in India through the formulation of the Financial Resolution and Deposit Insurance Bill of 2017 (FRDI Bill). The Bill's objective was to establish a centralized system for monitoring financial institutions, assisting with bankruptcy proceedings, and proactively mitigating dangers to their stability. Its primary objective was to ensure the fulfilment of obligations, including the repayment of depositors. The paper aims to analyse the exemplification and future prospects of the establishment of the FRDIC and the introduction of the FRDI Bill in India's commitment to enhancing financial stability and protecting the interests of depositors. The entire international banking community is striving for a secure and resilient global banking system, with India's leadership, the developing Guide, and the ongoing UNIDROIT discussions and related implementations.

Keywords: Bank Insolvency, UNIDROIT, Financial Stability, Depositors Interest, Bail-In, Banking Regulation

INTRODUCTION

Recent times have seen bank failures assume renewed importance. The recent failure of three large banks in the United States exemplifies this, while also raising questions on the adequacy of current financial stability frameworks. Interestingly, these developments come when crucial intergovernmental deliberations on bank insolvency are underway.

The ongoing deliberations of the WG aim to develop an international soft law instrument, in the form of a Guide, covering the key features of bank liquidation proceedings. This Guide is scheduled to be adopted by 2024. Once adopted, this will address gaps in the international legal architecture on bank insolvency, especially vis-a-vis small and medium-sized banks. The intended recipients of the Guide are lawmakers and policymakers who are interested in improving or enhancing their bank liquidation systems. The ongoing discussions of the WG reveal its draft structure, giving us a sense of how this Guide will further be developed. However, the content & structure of the same remains a work-in-progress.[1]

Importantly, India assuming chairmanship of the UNIDROIT General Assembly for 2022-23, in the backdrop of the ongoing deliberations, is a significant development. This represents an invaluable opportunity to inform the forthcoming Guide, based on the Indian experience of grappling with various issues surrounding bank resolution generally. In India, the Committee proposed setting up a FRDIC, to resolve financial firms. The FRDI Bill, drafted following the Committee's Report, was an attempt to consolidate India's existing scattered regulatory framework on bank resolution. It sought to provide a consolidated framework for monitoring financial firms, pre-empt risk to their financial position, and resolve them if they are bankrupt so as to honour their obligations (such as repaying depositors).

The FRDI Bill was withdrawn due to wide-ranging concerns about the implications of the law, but it laid down several notable provisions, which were essential in any law on bank resolution. In the absence of the FRDI Bill, the current framework for bank resolution in India comprises several laws, including the Banking Regulation Act, 1949. However, this paper focuses on the regulatory framework proposed by the FRDI Bill. In this context, this paper highlights an important aspect of the ongoing WG deliberations – the role of resolution tools. Within this, we look at two specific tools, bridge banks/bridge service providers (BBs/BSPs) and bail-in, to highlight aspects of India's regulatory framework on bank resolution and offer some suggestions, which may assist the WG's deliberations.

OVERVIEW OF RESOLUTION TOOLS

The assortment of instruments accessible in bank liquidation processes differs throughout countries. Some governments have limited options for liquidation, allowing only for partial and incremental measures. Conversely, in many countries, the bank liquidation process offers a more extensive range of options. The Guide covers within the ambit of its ongoing discussions, aspects of a toolkit used in bank liquidation proceedings, namely, tools such as BSPs/BBs and bail-in. The Guide follows other international instruments, including "the

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[1] Ulka Bhattacharyya and Riddhi Vyas, *Understanding resolution tools in bank insolvency: UNIDROIT & India*, Shardul Amrchand Mangaldas & Co. (June 30, 2023, 11:00 AM), https://www.amsshardul.com/insight/understanding-resolution-tools-in-bank-insolvency-unidroit-india/.

Financial Stability Board's 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (Key Attributes)".[2] These Key Attributes are considered as an international standard for resolution regimes for the financial industry and have influenced the development of bank resolution laws in many countries worldwide.

In India, the Committee suggested a broad resolution toolkit including tools such as acquisition/merger/amalgamation, bridge institutions, bail-in, and liquidation. Practical experience, even within the existing regulatory framework in India, has also been to use a combination of acquisition/amalgamation, bail-in and bailouts.

BRIDGE SERVICE PROVIDERS/ BRIDGE BANKS: UNDERSTANDING BSP/BB AND THE INDIAN FRAMEWORK

Generally, a BSP/BB is an entity intending to take over the ownership/control of and continue operating certain critical functions of a failing institution (this can result in contagion, seriously affect third parties, or erode market participants' trust in general), for a specified period of time. This is done to prevent a knee jerk reaction in the market, which may lead to further deterioration of the failing institution. In jurisdictions with a more extensive array of resolution tools, it may be feasible to transfer a portion of the insolvent bank's operations, assets, or liabilities to another bank or to a BSP/BB.

In India, the FRDI Bill, contemplates BSPs as a resolution tool. The intention is to create a BSP to transfer the assets and liabilities of a Specified Service Provider (SSP) under resolution, to such BSP, with the aim of eventual resolution of the BSP [cl. 50(1)]. A BSP is used where an immediate sale cannot be conducted but is likely in the future. In such cases, the Resolution Corporation (RC), which is the primary resolution authority established under the FRDI Bill [cl. 3] to monitor financial firms, anticipate risk of failure, take corrective action, and resolve them in case of such failure, may transfer the business of a failing bank to a new BSP, owned, and operated by the RC [cl.50]. The FRDI Bill provides three ways in which a BSP is resolved – first, by transferring the business of the BSP to any other entity capable of acting as an SSP; second, by sale of shares of the BSP to a private sector purchaser; or third, by liquidation [cl.50(12)].[3]

UNDERSTANDING BAIL-IN AND BAIL-OUT

What is Bail-in?

Bail-in is a resolution tool that enables continuity of essential functions of a failing bank, by internal recapitalisation. Conceptually, bail-in promotes market discipline, by reducing claims of shareholders and creditors, who are responsible for monitoring banks and preventing excess risk-taking, in the first place. This contrasts with a bailout, where recapitalisation is external, often based on public funds. Bailouts were a key part of the aftermath of the Global Financial Crisis in 2008, particularly in relation to government support for "too big to fail" banks.[4]

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[2] Financial Stability Board, *Principles for Cross-border Effectiveness of Resolution Actions* (Nov. 3, 2015, 10:00 AM).

[3] Ulka, *supra note* 1.

[4] Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Oct. 15, 2014, 10:00 AM), https://www.fsb.org/wp-content/uploads/r_141015.pdf.

The significance of bail-in for loss absorption and recapitalisation is highlighted in the Key Attributes, and is bolstered by the FSB Principles for Effective Execution of Bail-in (2018),[5] detailing how financial regulators may develop bail-in strategies for global systemically important banks (G-SIBs), in whose resolution, bail-in is a core strategy.[6]

Bail-in refers to a legal authority to modify the obligations of a financially troubled systemically important financial institution (SIFI) by converting or reducing the value of unsecured debt while the institution is still operating. In a bail-in scenario, SIFI in question continues operational and its status as a continuing legal entity is preserved. The objective is to mitigate the possibility of financial failure by revitalizing a troubled financial organization, mostly by reorganizing its debts, and without the need for government funding, save for the provision of emergency liquidity support. To assure the existence of the institution, it would be necessary to increase the capital to a level that exceeds the statutory standards, even under stressful scenarios.[7] This objective can be accomplished through one of the following methods: converting existing debt into equity as part of the debt restructuring process; injecting funds from new shareholders; or employing a hybrid strategy that combines the two. As an alternative to government-funded rescues of SIFIs, a private-sector solution is sought.[8]

What is Bail-out?

A bailout refers to "*the provision of financial assistance to a firm or country that is at risk of bankruptcy. It might manifest as loans, cash, bonds, or stock acquisitions. A bailout may or may not need repayment and is frequently accompanied by increased government supervision and restrictions*". The purpose of a bailout is to provide assistance to a sector that has the potential to impact a large number of people globally and is at risk of collapsing as a result of long-lasting financial difficulties. Bailout policies encompass a range of approaches, with the most prevalent being the provision of direct loans or assurances for third-party (private) financing to the company being saved. These direct loans typically include terms that are biased against the business being rescued. Occasionally, parties involved may get direct assistance. Acquiring stocks is a frequent occurrence. The government or financing authority imposes stringent conditions, including organizational reorganization, prohibition of dividend payments to shareholders, management changes, and, in certain instances, a salary cap on executives until a specified timeframe or the recovery of debts. Additionally, there may be a temporary easing of regulations that might affect the finances of the business that has been saved. Bailouts provide several benefits. Firstly, they guarantee the ongoing existence of the company being saved during challenging economic conditions. Furthermore, the occurrence of a total breakdown in the financial system can be prevented when sectors of significant magnitude that are at risk of failure begin to deteriorate. In such instances, the government intervenes to prevent the financial failure of institutions that are crucial for the efficient operation of the broader markets. Bailouts may come with drawbacks. Anticipated bailouts foster a moral hazard by

[5] Financial Stability Board, *supra note* 4.

[6] Charles A.E. Goodhart, *The Regulatory Response to the Financial Crisis* (Edward Elgar Publishing 2009); *See also*, Charles A. E. Goodhart, *The regulatory response to the financial crisis*, CESifo Working Paper, No. 2257, Center for Economic Studies and Ifo Institute (CESifo), Munich (March 2008), https://www.econstor.eu/bitstream/10419/26302/1/560533586.PDF.

[7] C. W. Calomiris, *An Incentive Robust Programme for Financial Reform*, 39-72 (The Manchester School 2011).

[8] Allen N. Berger and Raluca A. Roman, *TARP and other Bank Bailouts and Bail-ins around the World Connecting Wall Street, Main Street, and the Financial System*, 1-4 (Academic Press 2020) https://doi.org/10.1016/C2017-0-00528-1.

enabling not just promoters but also other stakeholders (customers, lenders, suppliers) to engage in financial transactions with risks that exceed the recommended level. This occurs due to their reliance on a bailout as a contingency plan in the event of difficulties.[9]

Overview of the Global Financial Crisis (GFC) and its aftermath

The beginning of the 21st century saw a significant disruption to the worldwide financial system with the emergence of the GFC in 2008.[10] It originated from the collapse of the United States housing market, which then caused a series of events resulting in the failure or near-failure of significant financial institutions worldwide. The current crisis has shown the weaknesses of the financial industry, highlighting the lack of regulation, excessive risk-taking, and insufficient capitalization in banks.[11] The aftermath of the GFC witnessed governments across the globe resorting to bailout measures to salvage "too big to fail" financial institutions deemed critical to the functioning of the economy. To stop these institutions from collapsing, the government launched massive interventions and taxpayer-funded bailouts with the goal of stabilizing markets and preventing a total financial catastrophe.[12]

Principles of Bail-in as a resolution tool

The concept of bail-in has emerged as a crucial mechanism in the resolution framework for distressed financial institutions. It operates on several key principles that aim to address failures while maintaining essential banking functions and minimizing systemic risks.[13]

a) **Loss absorption and recapitalization:** An insolvent bank uses bail-in as an internal mechanism to absorb losses. The bail-in method permits the writing down of shareholder and creditor claims or the reclassification of some liabilities into equity when a bank is in trouble. By allocating liabilities among stakeholders,this strategy seeks to recapitalize the bank internally as opposed to relying on outside funding or government involvement.[14]

b) **Hierarchy of claims:** An essential tenet of bail-in is the implementation of a hierarchical structure that dictates the sequence in which the claims of various stakeholders are documented or converted. By following this hierarchy, claims are typically prioritized, beginning with shareholders and progressing to unsecured creditors, in an effort to minimize losses in a pre-established sequence.

c) **Continuity of essential functions:** A primary aim of bail-in measures is to guarantee the uninterrupted operation of critical banking operations in the event of a bank failure.

[9] T. Hoshi and A.K. Kashyap, *Will the U.S. Bank Recapitalization Succeed? Eight lessons from Japan,* 97(3) Journal of Financial Economics 398-417 (2010).

[10] Alan S. Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* 263 (Penguin Books 2013).

[11] Ben S. Bernanke, *The Federal Reserve and the Financial Crisis* 64 (Princeton University Press 2013).

[12] Adair Turner, *Between Debt and the Devil: Money, Credit, and Fixing Global Finance* 213 (Princeton University Press 2016).

[13] Jianping Zhou, *Chapter 23. Resolving Systemically Important Financial Institutions: Mandatory Recapitalization of Financial Institutions Using "Bail-Ins",* IMF eLIBRARY (Dec. 11, 2013); International Monetary Fund, *In From Fragmentation to Financial Integration in Europe. USA* (Jan. 2, 2024), https://doi.org/10.5089/9781484387665.071.ch023.

[14] R. J. Herring and J. Carmassi, *The Resolution of Cross-Border Banks: Issues for Depositors, Shareholders, and Authorities* (Brookings Institution Press 2016); *See also*, E. H. G.Hüpkes, *Chapter 6. Cross-Border Resolution: A Global Solution to a Global Problem, In Law & Financial Stability. USA,* International Monetary Fund (Jan. 10, 2024), https://doi.org/10.5089/9781513523002.071.ch006.

Bail-in, through internal recapitalization and liability restructuring, enables the bank to maintain essential functions, including deposit management, provision of fundamental banking services, and preservation of economic financial stability.[15]

Bail-in as a resolution tool for distressed financial institutions

The International Monetary Fund (IMF) has released a paper discussing the concept and economic rationale of bail-in as a resolution tool for distressed financial institutions.[16] Bail-in is "*a statutory power that allows resolution authorities to restructure the liabilities of a distressed institution by converting or writing down its unsecured debt. The paper highlights the need for bail-in as a way to reduce the risks posed by too-big-to-fail institutions and protect taxpayers from exposure to bank losses.*"[17] It also explores the potential risks and benefits of bail-in, as well as the design elements and procedural considerations that would ensure its effective implementation.[18] Some key conclusions of the paper include:

a) Implementing a bail-in strategy might help to alleviate the risks to the financial system that arise from chaotic liquidations, lessen the need for reducing debt levels, and safeguard the value of assets that would otherwise be lost.

b) The commencement of bail-in measures should occur when it is expected that a capital infusion will restore financial stability to a distressed institution; state support in the form of liquidity should function as a precautionary measure until the bank regains stability.

c) Bail-in should not be viewed as a substitute for other methods of resolving situations like these; rather, they should be used in tandem with them as part of an all-encompassing strategy to address the issue of institutions that are too big to fail.

d) To ensure efficiency, the bail-in design must have explicit activation triggers, constrained restructuring scope, and priority order in the case of liquidation.

Additionally, the paper investigates potential market risks and mitigation strategies, including the impact on the financing costs of banks and the repercussions on their liability structure. This statement underscores the importance of establishing a meticulously designed and comprehensive framework to ensure the effective execution of bail-in measures in various nations. It also addresses the difficulties associated with the reorganization of corporate debt within a larger banking conglomerate. In essence, the study provides a comprehensive analysis

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[15] Charles A.E. Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years* 1974–1997 (Cambridge University Press 2011).

[16] Jianping Zhou, Virginia Rutledge, Wouter Bossu, Marc Dobler, Nadege Jassaud, and Michael Moore, *From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions*, International Monetary Fund (Apr. 24, 2012), https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/From-Bail-out-to-Bail-in-Mandatory-Debt-Restructuring-of-Systemic-Financial-Institutions-25858.

[17] D. S. Hoelscher, *Chapter 9. Guidelines for Bank Resolution. In Building Strong Banks through Surveillance and Resolution. USA,* International Monetary Fund. (Jan. 5, 2024),https://doi.org/10.5089/9781589060432.071.ch009.

[18] Robert R. Bliss and George G. Kaufman, *A comparison of U.S. corporate and bank insolvency resolution, Economic Perspectives,* Vol. 30, 2nd, No. 2 Federal Reserve Bank of Chicago (2006), https://www.chicagofed.org/publications/economic-perspectives/2006/2qtr-part4-bliss-kaufman; See also, Robert R. Bliss , George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation,* Working Paper, No. 2006-01Federal Reserve Bank of Chicago(2006),https://www.chicagofed.org/publications/working-papers/2006/wp-01.

of bail-in as a strategy for mitigating financial crises and underscores the importance of its effective implementation in order to protect taxpayer funds and address threats to the financial system's stability.

RESEARCH ISSUES AND ANALYSIS

How bail-in might impact banks' funding costs and liability structures?

Bail-ins can affect the liability structures and funding costs of financial institutions. It is anticipated that the implementation of bail-in measures will diminish or potentially eradicate the implicit subsidy provided to systemically important financial institutions (SIFIs by "too big to fail"). As a consequence, ratings assigned to banks—ratings that have historically considered a degree of public support—could be adjusted downwards to account for the lack of government guarantees. This may lead to an average downgrade of senior, unsecured debt. The elimination of the "too-big-to-fail" premium by the bail-in facilitates the restoration of market discipline by bringing bank financing costs closer to risk. Furthermore, it reinstates equilibrium between SIFIs and non-SIFIs through the differentiation of banks based on their risk-taking methodologies. By more closely aligning funding with risks, the consolidation or elimination of the least sustainable components of the banking system may contribute to the enhancement of financial stability.

Nevertheless, the possibility of higher financing expenses for unsecured debt due to bail-in measures may lead to alterations in the responsibility frameworks of banks. Contingency capital securities may gain popularity as banks increase their capital to cut senior loan costs. Banks may also switch to short-term, secured borrowing like covered bonds to reduce funding costs and avoid bail-in. Various elements, including bail-in framework design and execution, will affect financing costs and liability arrangements. The framework must properly assess market risks and guarantee that debt restructuring maintains the balance between banks' marginal costs and benefits. To avoid systemic risk from spreading to other financial sectors and manage contagion concerns, actions should be taken.

On the whole, bail-in can change the liability structures and funding costs of banks for better or worse. The objective is to synchronize the expenses associated with funding with the level of risks involved and diminish the subsidy given to institutions that are considered too large to fail. However, this may also result in alterations to the types of liabilities held by banks and potentially raise the expenses related to unsecured debt.

Contractual instruments with write-off or conversion components, such convertible bonds or CoCos, are not the same as statutory bail-in procedures. There are two distinct methods for creditor-financed recapitalization: bail-in and CoCos. Private financial contracts with principal and prearranged coupon payments are known as CoCos. They can be written down or automatically converted into equity upon the occurrence of a predefined trigger event. However, resolution authorities have the legal authority to remove or dilute current shareholders through bail-in. They can also use it to write down or convert contractual contingent capital instruments in a certain order: unsecured senior debt comes first, followed by subordinated debt and then those that haven't been converted to equity. A bail-in would grant the resolution authority the authority to replace the bank's management, given the scope of the resolution procedure. Implementing a legislative framework for bail-in and utilising contractual contingent convertibles as triggers, particularly those with high capital ratios, can resolve the issue. Contingent capital would serve as the initial line of defence, and bail-in measures would be implemented to assist SIFIs that remain embroiled in a financial crisis subsequent to the conversion of contingent capital.[19]

In comparison to alternative resolution mechanisms like purchase and assumption (P&A) and bridge bank powers, what distinguishes a bail-in mechanism?

The primary differentiating factors between bail-in and alternative resolution mechanisms, are as follows:

a) **The essence of the proceedings:** The process of procuring buyers for a financially troubled systemically significant institution, which may prove to be arduous given its scale or temporal limitations, is not an integral part of bail-in. On the other hand, P&A powers entail the transfer of a business to numerous purchasers, which necessitates the implementation of rigorous due diligence measures to safeguard the rights of creditors. In contrast, bridge bank powers sanction the establishment of a provisional financial institution to retain the liabilities and assets of a bank that has ceased operations.

b) **Objective:** The main purpose of bail-in is to primarily revive the sustainability of a financially troubled organization and avert runs on the institution caused by insolvency. P&A transactions and bridging bank powers sell going-concern assets to close a bankrupt organization.

c) **Value Preservation:** Bail-ins are better at protecting value than fire sales because they don't require the transfer of company operations. Transferring assets and liabilities between different legal entities is sometimes a part of P&A deals and linking bank powers. This can be complicated and needs a full legal investigation.

d) The idea of bail-in should not be viewed as a replacement for other approaches to addressing financial concerns; rather, it should be regarded as a supplemental measure to those other approaches. When it comes to the problem of banks that are too big to fail, it needs to be regarded as an integral component of a comprehensive solution, and it ought to be used in conjunction with other approaches to resolving the issue.

In essence, bail-in provisions are distinct from alternative dispute resolution mechanisms with regard to their objectives, value preservation, complementarity, and the nature of the proceedings. The principal aim of bail-in measures is to reinstate the fiscal stability of a troubled entity and avert any depreciation, while P&A transactions and bridge bank powers are designed to streamline and coordinate the liquidation process of an insolvent institution.

[19] Viral V. Acharya, Hyun S. Shin, and Tanju Yorulmazer, *Crisis Resolution and Bank Liquidity,* Vol. 24, No. 6 Review of Financial Studies 2166-2205 (2010), https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1539740_code142715.pdf?abstractid=1539740&mirid=1&type=2.

How could the statutory bail-in framework address group issues and cross-border challenges?

The implementation of the statutory bail-in framework can effectively tackle group concerns and cross-border challenges by taking into account certain crucial factors[20]:

a) **Jurisdictional Cooperation:** The success of implementing a legislative bail-in for SIFIs relies on the collaboration of all pertinent jurisdictions, considering that SIFIs frequently operate internationally. All countries should implement the bail-in terms to achieve a balance sheet correction through debt restructuring.

b) **Legal Framework:** The bail-in structure must offer a definitive legal foundation for the restructuring procedure. The specification should clearly state that the authorities in the home nation has the power to begin, authorize, and execute the restructuring process. This guarantees that the governing authority of the home jurisdiction assumes responsibility for resolving the troubled institution and offers essential financial assistance until the bank achieves stability.

c) **Scope of Application:** In an ideal situation, the statutory bail-in powers ought to encompass all obligations of the troubled bank, such as liabilities held overseas and claims subject to foreign legislation. This guarantees that the process of restructuring the debt is thorough and encompasses all pertinent commitments of the organization.

d) **Entity-Specific Approach:** Banks often undergo bankruptcy or reorganization processes on a case-by-case basis, focusing on the unique company involved. Within the framework of bail-in, this signifies that the authorities are only permitted to utilize the bail-in authority on the debt of a member of a banking group if that specific member has beyond the applicable level for bail-in. This technique ensures that the bail-in power is deployed precisely and without harming viable group members.

e) **Cross-Border Recognition:** The challenges pertaining to the identification of financial activities occurring in multiple countries should be adequately addressed by the bail-in mechanism. Guidelines "*such as choice-of-law rules, principles of comity, and special statutory frameworks that nations have implemented for recognition*" should be taken into account. These measures can help in recognizing and implementing bail-in procedures initiated by the home jurisdiction in other relevant jurisdictions.

f) **Intra-Group Restructuring:** The restructuring can reorganize debt inside a banking group. The framework should handle the particular challenges of debt restructuring across numerous nations. Changing from entity-specific resolution may need major legislative changes in relevant nations. Resolution authorities must have the capacity to take exceptional actions to support a resolution involving related entities from different jurisdictions. By addressing these considerations, the statutory bail-in framework may effectively handle collective concerns and cross-border hurdles, guaranteeing the successful implementation of bail-in to resolve financial challenges in problematic organizations.

[20] Ross Leckow and Ceyla Pazarbasioglu, *Resolution of Cross-Border Banks– A Proposed Framework for Enhanced Coordination*, International Monetary Fund (June, 2010), https://www.elibrary.imf.org/downloadpdf/book/9781616352295/ch06.xml.

A framework for enhanced collaboration has been established by the IMF to tackle the challenges associated with the resolution of institutions that conduct business in multiple nations.[21] The IMF methodology encourages the recognition of bank-resolution measures executed in a foreign nation, provided that the domestic framework conforms to particular "core coordination standards". The standards encompass a fundamental degree of congruence among instruments used for national resolution as well as levels of prudential oversight that are sufficiently efficient.[22] Upon the fulfilment of these coordination requirements, governments may be incentivized to enact the necessary legislation to streamline the transnational execution of bank resolution procedures, such as bail-in initiatives.[23]

Issues faced and lesson learnt- CYPRUS bank failure

Through an open bank bail-in, Bank of Cyprus, the largest bank in Cyprus with a 30% market share, was recapitalized. Acquire zero-rated own funds (equity plus AT1 plus T2) in order to recapitalize, deposits in excess of the insured quantity of 100,000 euros are converted into shares. At the outset, 37.5% of the surplus amount was converted into shares subsequent to a provisional assessment conducted by the resolution unit. With the intention of ascertaining the ultimate bail-in amount, deposits surpassing 100,000 euros were withheld pending the conclusion of the independent valuation.

Following an impartial assessment of the fair value of assets and liabilities conducted by a certified valuer, the conversion amount rose to 47.5%. Bail in the amount of 3.8 billion euros (approximately 25% of total deposits) was imposed on 20,000 depositors; existing shares were annulled. The resolution scheme lacks adequate preparation. At present, there are no advanced resolution planning requirements. The losses inflicted on depositors caused a disruption in the banking system, which negatively impacted financial stability and confidence in the banking system. Strict capital constraints across the entire bank are implemented to address the problem of liquidity outflows. The competent authorities of EU Member States in which Bank of Cyprus maintained branches or subsidiaries implemented separate measures to fortify their banking systems with a ring fence. Barriers to the operational execution of parole in disclosing insured depositors, trustee clients, minor clients, and set-off deposits against loans, among other responsibilities. Delay was caused by issues with the integrity of the data used to conduct the independent valuation. Difficulties with counterparties and correspondent institutions disrupted the flow of transactions.[24]

Bail-in resolution strategies and the function of Deposit Insurance Agencies (DIA)

The extent to which countries participate in financing resolution is highly variable.[25] While

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[21] IMF, *Chapter 6 Legal Aspects of Bank Insolvency. In Current Developments in Monetary and Financial Law,* Vol. 1. USA: International Monetary Fund(Jan. 4, 2024), https://doi.org/10.5089/9781557757968.072.ch006.

[22] Robert R. Bliss & George G. Kaufman, *A Comparison of U.S. Corporate and Bank Insolvency Resolution,* Economic Perspectives, FRB of Chicago Working Paper (2006), https://ssrn.com/abstract=906577;See also, Robert R. Bliss & George G. Kaufman, *U.S. corporate and bank insolvency regimes: An economic comparison and evaluation,* working paper, No. WP-2006-01Federal Reserve Bank of Chicago, https://ideas.repec.org/p/fip/fedhwp/wp-06-01.html.

[23] Luc Laeven and Fabián Valencia, *Systemic Banking Crises Database: An Update,* IMF Working Paper, WP/12/163 (June 1, 2012), https://www.imf.org/external/pubs/ft/wp/2012/wp12163.pdf.

[24] European Commission, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution,* DG Internal Market and Services Working Document, European Central Bank, (Luxembourg) (Jan. 6, 2011), https://www.ecb.europa.eu/pub/pdf/other/ecconsultationeuframeworkbankrecovery2011en.pdf.

[25] Viral, *supra note* 19.

certain domestic regulations impose restrictions on the utilisation of deposit insurance funds, others permit their application for a wide range of purposes. Thus, the extent to which the bail-in impacts deposit insurers will depend on regional conditions and the nationwide regulatory structure regulating deposit insurance and resolution.[26]

The risks to the DIA

Deposit insurers are exempt from bail-in policies since the DIA does not have any financial claims on either the troubled institution or the restructured institution. If the DIA fails, there are no outstanding credits that can be subjected to a "bail-in" process. However, in many legal systems, DIA money are seen as assets that may be utilized to resolve a bankrupt institution. Thus, DIAs might be relied upon to contribute to the funding of resolving a bankrupt organization in a more comprehensive manner. This study delineates several obstacles or dangers that may ensue from these novel regulations and recommendations. More precisely, the utilization of deposit insurance money for settlement presents five possible dangers.[27] Primarily, DIA had the potential to acquire a stake in a financial institution. Though DIAs are generally not considered as creditors, some legislative frameworks provide the possibility of a DIA making a financial contribution to restore the capital of a struggling institution. If a DIA is barred from having an equity interest in financial establishments, it will be required to divest promptly. The potential danger is in the possibility that, during a rapid and forced liquidation of assets, the DIA may not get an equitable valuation for its holdings.

Furthermore, DIA money might be utilized to endorse a resolution technique that is either ineffective or overly expensive. The chosen resolution approach may consume a greater amount of DIA cash compared to alternate options. In addition, there is a possible risk that arises from making an incorrect evaluation of the value of assets. It is possible that the Department of Internal Affairs will be subjected to many rounds of financial appeals if the assets of the failing institution are not appropriately estimated. It is possible that in order to properly recapitalize the organisation, it will be required to seek more funding in a second round of funding if the assessment that was conducted in the original research reveals that the assets are valued at an inadequate level. It is possible that if the value of assets is overestimated, it will result in efforts to impose a bail-in of creditors that is more comprehensive and to use money from the DIA in a manner that is not essential.[28]

Moreover, should the restructured institution encounter setbacks, the DIA will be placed in a doubly perilous situation. This means that the DIA will initially contribute to the resolution of the institution, and thereafter be required to pay out to insured depositors due to the bank's failure. An instance of failure will result in elevated expenses for the DIA. Furthermore, asset encumbrance amplifies the quantity of securitized assets, diminishes the liabilities that may be rescued, and escalates the expense of resolving issues for both the resolution agency and the DIA. Ultimately, the credibility of the DIA can be weakened if the money for resolving

[26] Core Principles and Research Council Committee, *Deposit Insurance and Bail-in: Issues and Challenges* Research paper (Draft for Public Consultation), International Association of Deposit Insurers (2014), https://www.iadi.org/en/assets/File/Public_Consultation/Bail-in_Research_Paper_Final_Draft_for_IADI_Public_Consultation.pdf.

[27] P. H. Dybvig, *Bank runs, deposit insurance, and liquidity*,91(3)Journal of Political Economy 401-419 (1983).

[28] G. Rawcliffe and D.Weinfurter, *Resolution Regimes and the Future of Bank Support*, Global Special Report - Fitch Ratings (Dec. 2010), https://www.fitchratings.com/#events.

financial issues exhausts the deposit insurance fund, if reconstructed institutions later collapse, or if the DIA is perceived as lacking authority within the broader safety-net system.

Precautions to be taken by DIA

The primary hazards stem from the utilization of DIA monies in a resolution. Authorities may contemplate a sequence of measures intended to reduce such risks or establish protections for the DIA money. Prioritize the establishment of a clear and open methodology for assessing the DIA's contribution. A framework should clearly state the objective of the DIA's contribution, establish guidelines to determine the maximum boundaries of the contribution, and create methods for quality control. This must have a proficient valuation system, which should be subject to court monitoring or other means of dispute. Another approach entails strengthening the institutional framework that evaluates the DIA's contribution to the settlement process. The DIA should be involved in the resolution financing decision-making process if DIA funds are utilised. Moreover, it ought to possess the jurisdiction to supervise and assess the application of its funds subsequent to their completion. Furthermore, crisis prevention and management systems possess the capacity for further development.[29]

Choosing to avert a crisis is the most advantageous course of action, and in the event that banking difficulties threaten financial stability, it is imperative to implement timely and effective measures. The DIA holds an important part in the formulation and execution of these policies. Moreover, it is critical that the DIA occupies an appropriate position in the claims hierarchy. The net costs of resolution for the DIA and the amount of funds available for resolution both diminish as the ranking rises. At the outset, it is critical that the authorities ensure that all systemically significant institutions possessed the capacity to sustain losses; otherwise, the DIA's participation in financing the resolution would be unnecessary.

UNIDROIT WORKING GROUP DISCUSSIONS

After the 2008 GFC, nations around the world created a regulatory framework to address the collapse of huge financial institutions that are too significant to fail while maintaining financial system stability. Notwithstanding this substantial advancement, there are nevertheless crucial deficiencies that persist. Currently, no global framework exists to handle the successful resolution of small and medium-sized banks. Domestic legislation alone determines the formation of bank liquidation regulations, which vary substantially throughout the world.

The goal of the project is to "*address the current gap in the international legal framework through the development of a soft law instrument that covers the fundamental elements of bank liquidation processes on a global scale.*"

From 2021 to 2023, the WG is slated to complete the development of a guideline document over the course of five sessions. By 2024, completion and implementation of the text are anticipated. The investigation is carried out in collaboration and with the assistance of the BIS Financial Stability Institute.[30]

The "UNIDROIT Secretariat" and the "BIS Financial Stability Institute" worked in tandem to

[29] Core Principles and Research Council Committee, *supra note* 26.

[30] BANK INSOLVENCY STUDY LXXXIV – BANK INSOLVENCY,https://www.unidroit.org/work-in-progress/bank-insolvency/#1637156948432-1d04168e-7a08.

coordinate a "Bank Liquidation" exploratory workshop. It was conducted virtually from June 7-8, 2021, prior to the Governing Council's second meeting of its centenary session. The exploratory session was attended by forty of the foremost international stakeholders and experts in deposit insurance, insolvency legislation, and bank crisis management. The objectives of the study were twofold: (a) to determine the optimal framework for a document delineating the project's scope; and (b) to assess the necessity of a global instrument pertaining to bank insolvency.

Inauguration of the two-day event was conducted by Professor Maria Chiara Malaguti, the President of UNIDROIT. The Secretary-General of UNIDROIT, Professor Ignacio Tirado, delivered introductory remarks. Subsequently, five sessions were scheduled to delve into distinct facets of the subject matter:

a. Introduction to the project and institutional involvement, featuring an introduction by the Chair of the FSI, Dr. Fernando Restoy
b. The scope of the project
c. The institutional setting
d. The content of the system
e. Cross-border elements of bank insolvency

A Working Group has been formed in adherence to the Institute's established operating methodology. Its members have been selected based on their specialised knowledge in the areas of deposit insurance, bankruptcy legislation, and bank crisis management. The contributions of experts are grounded in their individual experiences and encompass a wide range of legal systems and geographic regions.

The Working Group is composed of the following expert members:

- Stefania Bariatti, (Chair), Professor, University of Milan (Italy)
- Anna Gelpern, Professor, Georgetown Law (United States)
- Christos Hadjiemmanuil, Professor, University of Piraeus (Greece)
- Matthias Haentjens, Professor, University of Leiden (the Netherlands)
- Marco Lamandini, Professor, University of Bologna (Italy)
- Rosa Lastra, Professor, Queen Mary University of London (United Kingdom)
- Matthias Lehmann, Professor, University of Vienna (Austria)
- Irit Mevorach, Professor, University of Warwick (United Kingdom)
- Janis Sarra, Professor, University of British Columbia (Canada)
- Reto Schiltknecht, Doctor of Laws, Attorney-at-law and Research Associate (Switzerland).

In addition, UNIDROIT has invited relevant international and transnational organisations, as well as a number of central banks, supervisors, resolution authorities and deposit insurance corporations to participate in the Working Group as observers.

- Bank for International Settlements (BIS) / Financial Stability Institute (FSI) *[co-host]*

- Australian Prudential Regulation Authority (APRA)
- Banca d'Italia
- Banco de España and Fondo de Garantía de DepósitosenEntidades de Crédito (Spain)
- Bank of England
- Bank of Ghana
- Banque de France / Autorité de Contrôle Prudentiel et de Résolution (ACPR)
- Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) (Germany)
- Central Bank of Argentina
- Central Bank of Brazil
- Central Bank of Nigeria (CBN) and Nigerian Deposit Insurance Corporation (NDIC)
- Central Bank of Paraguay
- De Nederlandsche Bank (DNB)
- Deposit Insurance Corporation of Japan (DICJ) and Financial Services Agency of Japan (JFSA)
- European Banking Institute (EBI)
- European Central Bank (ECB)
- European Commission
- Federal Deposit Insurance Corporation (FDIC) (United States)
- Federal Reserve Bank of New York
- Swiss Financial Market Supervisory Authority (FINMA)
- Fondo de Garantías de Instituciones Financieras (Fogafín) and Superintendencia Financiera de Colombia (Colombia)
- Financial Stability Board (FSB)
- Hong Kong Monetary Authority (HKMA)
- International Association of Deposit Insurers (IADI)
- International Insolvency Institute
- International Monetary Fund (IMF)
- Istituto per la vigilanzasulleassicurazioni (IVASS)
- Monetary Authority of Singapore (MAS)
- National Bank of Belgium
- National Bank of Moldova
- Perbadanan Insurans Deposit Malaysia (PIDM)
- People's Bank of China (PBC)
- Reserve Bank of India (RBI)
- Single Resolution Board (SRB)
- South African Reserve Bank (SARB)
- United Nations Commission on International Trade Law (UNCITRAL)
- Effective Insolvency and Creditor/Debtor Regimes Group.

Concetta Brescia Morra (Professor, Roma Tre University) participates in the Working Group as an individual expert observer. Moreover, Marco Bodellini (Queen Mary University of London) and David Ramos Muñoz (University Carlos III of Madrid) act as advisors to the UNIDROIT Secretariat for this project.

After conducting a thorough analysis of the Reports, the authors have compiled a summary of the talks and identified potential areas for further implementation.

The 1st Working Group Meeting

"*UNIDROIT Working Group on Bank Insolvency First session (hybrid) Rome, 13-14 December 2021.*[31] *The first session of the Working Group on Bank Insolvency took place in a hybrid format on 13 and 14 December 2021. The Working Group was attended by 10 Working Group members and 28 observers, including representatives from international and transnational organisations, central banks, deposit insurance corporations and resolution authorities, as well as members of the UNIDROIT Secretariat.*"[32]

The primary agenda was to address the absence of standardized practices in bank insolvency proceedings, specifically focusing on smaller banks across different jurisdictions.

Scope and definitions

The discussion kicked off by exploring the definition of a "bank" from a functional perspective. Consideration was given to defining a bank based on its core functions, potentially centering on deposit-taking or a broader scope encompassing lending activities. Notably, the integration of technological advancements, including Fintech and digital banks, emerged as a crucial point. The group deliberated on ensuring that the guidance remains adaptable to the evolving landscape of banking models and technological progress, warranting a forward-looking and flexible approach.

Objectives of a bank insolvency regime

The WG engaged in a detailed debate on the primary objectives of bank insolvency proceedings. The participants generally agreed on the significance of value maximization and depositor protection as pivotal objectives. However, the discussion delved deeper, contemplating the need for a concise set of objectives and a potential hierarchical structure among them. This aspect involved deliberations on how these objectives should interplay and possibly overlap with the broader resolution objectives, with arguments presented for both minimizing and leveraging this overlap.[33]

Institutional models and procedural aspects

The conversation then shifted towards discussing the institutional models for insolvency proceedings. The group weighed the benefits of administrative proceedings against other

[31] UNIDROIT, *Working Group on Bank Insolvency*, First session (hybrid) Rome, Study 84 – W.G. 1 – Doc. 3(Dec. 2021), https://www.unidroit.org/wp-content/uploads/2022/02/S84-WG1-Doc-3.SummaryReportWeb-1.pdf.

[32] IADI, *Core Principles for Effective Deposit Insurance Systems,* revised (2014), https://www.iadi.org/en/assets/File/Core%20Principles/cprevised2014nov.pdf.

[33] UNIDROIT, *Principles on the Operation of Close-Out Netting Provisions* (2013), https://www.unidroit.org/wp-content/uploads/2021/06/netting-English.pdf.

approaches, emphasizing the importance of outcomes, flexibility, and accommodating constitutional variations across different jurisdictions. Judicial review emerged as a critical aspect, leading to an agreement that while there should be no annulment of administrative decisions, ensuring expeditious judicial reviews was imperative for the efficacy of the process.

Grounds for opening insolvency proceedings

An in-depth analysis of the grounds for initiating insolvency proceedings followed, highlighting the inadequacy of traditional insolvency indicators in the context of bank failures. The participants acknowledged the need for adapted criteria, such as forward-looking indicators signalling imminent failure, consideration of public policy concerns, and the relationship between license withdrawal and insolvency proceedings. The alignment of conditions for resolution and grounds for insolvency was also a focal point, with arguments presented for a more synchronized approach.[34]

Preparation and creditor hierarchy

The discussion emphasized the linkage between supervision and preparation for insolvency proceedings, with an emphasis on proportionality to mitigate costs and resource strains for both banks and regulatory bodies. Specific aspects like the implications of a bank being listed, disclosure requirements, and the feasibility of moratoria in the preparation phase were deliberated upon. Regarding creditor hierarchy, the group veered away from prescribing an absolute hierarchy but agreed to explore the relative ranking of specific claims, particularly emphasizing depositor preferences, recognizing their significance for stakeholders' incentives and funding options.

Conclusion and future directions

The session concluded with a consensus on the need for a flexible, adaptable framework for bank bankruptcy procedures. Participants acknowledged the complexity of the task and emphasized the need for ongoing discussions on key aspects like institutional frameworks and creditor hierarchy. They agreed on the importance of adopting a nuanced strategy that considers jurisdictional variations while aiming for a cohesive global guiding framework. The discussions also highlighted the need to maintain coherence with current frameworks while allowing future flexibility and adaptation. This extensive synopsis succinctly encapsulates the in-depth deliberations, contemplations, and evaluations presented throughout the initial session of the WG. As a result, it establishes a strong groundwork for subsequent sessions and the formulation of global recommendations in this pivotal field. It was decided to continue this crucial discussion at the subgroup level.

The 2nd Working Group Meeting

"*The second session of the Working Group took place in a hybrid manner (in Rome/online) on 11-13 April 2022.*[35] *The Working Group's second session, held from April 11 to April 13, 2022, was a*

[34] UNCITRAL, *Legislative Guide on Insolvency Law* (2004-2019), https://uncitral.un.org/en/texts/insolvency/legislativeguides/insolvency_law.

[35] UNIDROIT, *Working Group on Bank Insolvency Second session (hybrid) Rome,* Study 84 – W.G. 2 – Doc. 3 (April 2022), https://www.unidroit.org/wp-content/uploads/2022/07/Website-version_Study-84-W.G.-2-Doc.-3-Summary-Report.pdf.

hybrid event with 9 Working Group members and 31 observers. The attendees represented a diverse range of international bodies, including central banks, deposit insurance corporations, resolution authorities, and the UNIDROIT Secretariat."

Scope and definitions

The session commenced with deliberations on terminology, debating the use of 'bank liquidation proceedings' versus 'bank insolvency proceedings.' There were concerns about the ambiguity surrounding the term 'insolvency' potentially signifying a financial state rather than a procedural aspect. The group examined regulatory and functional approaches, with an emphasis on determining which entities would be subject to the bank liquidation regime and regulatory perimeters.

Objectives

The WG took financial stability in bank liquidation into consideration. There are those who contend that prioritising financial stability in banking regulation and supervision is crucial, and that it may be necessary to negotiate compromises and provide justifications for particular measures. However, the resolution process could be complicated if financial stability is included as an objective, and bank liquidation proceedings may not provide sufficient justification to deviate from goals that directly benefit stakeholders.

Financial stability was universally agreed upon as a factor to be incorporated into the ultimate instrument. Subgroup 1 was tasked by the WG with the responsibility of identifying trade-offs and evaluating the manner in which objectives ought to be balanced with financial stability. Future definitions of financial stability and depositor protection were proposed.

Institutional models

Subgroup 1's Chair highlighted the subgroup's work on institutional models, adding that the planned cross-jurisdictional survey might provide empirical data on alternative institutional setups. Since systems are rarely wholly court-based or administrative, model selection is not binary.

The group was asked to explore how the future instrument should address institutional models and whether judicial review should be handled under Institutional models (Subgroup 1) or Safeguards (Subgroup 3).

The future instrument should be flexible but also give advice and identify institutional model best practices, according to the WG. Thus, a largely administrative paradigm might be praised without being prescriptive. It was suggested that the instrument realise that jurisdiction-specific factors including judicial and administrative authority efficiency, capability, and competence influence model selection. The WG mandated Subgroup 1 to analyse the pros and cons of administrative and court-based models, hybrid models, and outcomes-based solutions for jurisdictions that cannot adopt a predominantly administrative system.

A private entity might be involved in liquidation, the WG considered. On one side, private bodies can pursue public interests. However, assigning private corporations with public tasks may be constitutionally limited. Finally, some participants preferred to address judicial review in the context of institutional structures (Subgroup 1).

Procedural and operational aspects

One of Subgroup 1's Chairs indicated that procedural and operational components of the liquidation system had been little studied, with an emphasis on whether non-administrative authorities may begin bank liquidation procedures. A secretariat member stated that Subgroup 2 had also studied this matter and that both Subgroups looked to prefer advocating adequate authority engagement if jurisdictions allow creditors to seek for bank insolvency.

In certain court-based systems, creditors can suit for bank liquidation, according to the WG, although the supervisor or resolution body typically initiates the procedure. Should jurisdictions permit bank creditors to initiate insolvency proceedings, it is advisable that future instruments advise the appropriate authorities to be heard.

The discussion centred on the management of the financial institution preceding its downfall. The participants supported the bank's management's provision of insolvency filing authority on the grounds that it could foresee potential financial difficulties. The WG further discussed the potential implementation of sanctions for failure to comply with the directive that the bank's management expeditiously notify the supervisory authority regarding the bank's declining condition. The revised issues paper provided an affirmation regarding whether the liability obligations for liquidation administrators ought to remain at the present levels. Furthermore, the participants expressed curiosity regarding the liquidity-related responsibilities of deposit insurers and central banks, the liability framework that governs bank valuers, and overarching moratoria.

Groups

A member of Subgroup 3 said the writing team addressed corporate bankruptcy legislation and resolution methods to groupings. The Subgroup 3 Report presented the WG with a number of crucial concerns, such as the necessity for the future instrument to suggest solutions at the group level, such as substantive consolidation or procedural coordination, group insolvency planning, and the precise definition of "group".

The WG noted that prudential regulatory rules define 'group' differently from corporate insolvency legislation. Several attendees stressed the necessity to connect the frameworks.

There were both proponents and opponents of advance group insolvency preparation. Although the costs might outweigh the benefits, all participants agreed that proportionality is crucial and that non-systemic banking entities would benefit from prior preparation. Additionally, it was emphasised that the forthcoming instrument should facilitate efficacious responses even in the absence of prior preparation. As an alternative to organisations, networks such as institutional protection strategies might be advantageous.

The WG also considered group-level solutions, such as retaining group synergies post liquidation procedures to maximise value, and how they relate to other factors like the reasons for liquidation. Participants were apprehensive and agreed that the issue needed more investigation, although procedural consolidation was helpful.

Cross-border aspects

The major challenges with respect to cross-border treatments were discussed. Issues such as recognition of foreign proceedings, cooperation, coordination, and treatment of branches in liquidation were highlighted.[36] The subgroup tasked with cross-border aspects was assigned to develop specific recommendations based on existing international standards.

Creditor hierarchy

The treatment of creditors was a significant focus, with debates on the possibility of deviating from the *pari passu* treatment. The implications of different types of depositor preference and treatment of liabilities like stablecoins were considered. However, given ongoing discussions and regulatory uncertainties surrounding stablecoins, caution prevailed in addressing their ranking.

Financial contracts

The group generally agreed on the possibility of close-out netting but debated the potential exceptions and stays in liquidation proceedings. Discussions also involved the necessity of defining financial contracts and their valuation, especially between cleared and non-centrally cleared derivatives.

Safeguards

The safeguard framework was analysed and categorised into the following areas: financial stability, safeguarding the legitimate expectations of creditors, public policy, and due process. The necessity of a "public policy exception in cross-border liquidation proceedings" was deliberated by the participants, who also examined judicial review in the context of balancing the court's and administrative authorities' responsibilities.

Tools

Consensus was reached regarding the transfer tool, during which deliberations revolved around its prerequisites, the hierarchy of tools, and preparatory measures. As a legal principle, participants emphasised that no hierarchy of tools should be established, and they discussed the advantages and disadvantages of various tools.

Funding

Discussions revolved around the need to identify external funding sources and constraints surrounding deposit insurers' roles. Challenges in defining universally acceptable methodologies for the least cost test were acknowledged. The Secretary-General and Co-Chairs suggested aligning recommendations with existing international standards while describing diverse international practices.

Grounds for opening insolvency proceedings

The concept of non-viability emerged as key. Discussions revolved around its vagueness and

[36] UNCITRAL, *Model Law on Cross-Border Insolvency (1997) with Guide to Enactment* (2013), https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/1997-model-law-insol-2013- guide-enactment-e.pdf.

potential shareholder expropriation concerns. Participants agreed that the major issue pertained to the vagueness of many criteria and the subsequent need for clear guidelines in exercising discretionary powers.[37]

Preparation

While recognizing the need for preparation in implementing transfer measures, a consensus on specifics had not yet emerged. Discussions involved treating preparation as a subsection within transfer tools for practicality and scope concerns.

Future work organization

The upcoming session, scheduled for October 17-19, 2022, hosted by the Single Resolution Board in Brussels, was highlighted. The Secretariat committed to supporting intersessional subgroup meetings to advance the work.

The 3rd Working Group Meeting

October 17-19, 2022 marked the third session of the Working Group, which was convened by the Single Resolution Board in Brussels.[38] The session, which took place in Brussels from October 17-19, 2022, was organised by the Single Resolution Board. 10 members of the Working Group and thirty-one observers, representing a variety of international organisations, central banks, deposit insurance companies, resolution authorities, and the UNIDROIT Secretariat, were in attendance.

What are the key objectives of a bank liquidation regime considered by the WG?

The WG is deliberating on a bank liquidation regime that primarily aims to maximise value, ensure financial stability, and safeguard the interests of depositors. The implications and justification for designating these objectives in the Guide were deliberated upon by the WG. Consensus existed regarding the inclusion of value maximisation as an objective, in light of the unique characteristics of institutions. The objective of financial stability was also deemed pertinent, prompting deliberations regarding its contribution to the rationale behind bank-specific liquidation legislation and the maintenance of service continuity. Nevertheless, opinions diverged regarding the necessity of designating depositor protection as a separate objective. Certain participants posited that it could be encompassed within the broader concept of financial stability, whereas others underscored its critical role in preserving confidence in the banking industry. The WG additionally acknowledged the significance of reducing expenses for taxpayers as a primary aim of the bank liquidation regime.

What are the proposed recommendations for the treatment of secured claims and subordination?

The proposed recommendations for the treatment of secured claims and subordination include aligning with existing international standards for the treatment of secured creditors, enforcing

[37] UNCITRAL, *Model Law on Enterprise Group Insolvency with Guide to Enactment* (2019) https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/19-11346_mloegi.pdf.

[38] UNIDROIT, *Working Group on Bank Insolvency* Third session, Brussels, Study LXXXIV – W.G. 3 – Doc. 6 (Oct. 2022), https://www.unidroit.org/wp-content/uploads/2023/01/Website-version_Study-84-W.G.-3-Doc.-6-Draft-Summary-Report.pdf.

priorities resulting from security interests in debt instruments, and respecting specialities in financial collateral arrangements under the bank liquidation regime. Additionally, the draft suggests the implementation of statutory subordination and subordination agreements, which encompass bank-issued debt utilised to satisfy loss absorption obligations. In addition, the draft addresses equitable subordination, which entails reordering the priority of claims resulting from fraud or similar illegal activities. In accordance with established norms, the WG reached a consensus to harmonise the recommendations, reevaluate the concept of "equitable subordination", and provide greater clarity regarding the extent to which administrative authorities or the court may grant distinct priorities to particular claims in particular situations. Furthermore, the proposal incorporates a suggestion for the individual overseeing a bank liquidation procedure to request a provisional suspension of close-out netting in situations where its implementation would compromise the effectiveness of particular liquidation instruments. It is reasonable to propose that the duration of the proposed stay be restricted to no more than two business days.[39]

How does the WG propose to address cross-border aspects and safeguards in bank liquidation proceedings?

What is the suggested structure for the future Guide on bank insolvency?

The WG put up specific proposals to tackle the cross-border elements and protections in bank liquidation processes. The draft advice addresses collaboration and synchronization in a transnational setting, acknowledgment, support, and alleviation, as well as protective measures. The components encompassed are the enforcement of pre-arranged group liquidation plans, information exchange, and centralization of liquidation processes in cases of efficiency. The guidelines for recognition pertain to international legal procedures and specific actions, encompassing several types of remedies. The section on safeguards provides suggestions to guarantee a just and effective procedure, protecting the interests of the local community and proposing reasons for a host jurisdiction to deny acknowledgement, aid, or endorsement to a home jurisdiction. The WG largely endorsed these recommendations and proposed simplifying the guidance. They also recommended considering situations where a bank has debtors in foreign jurisdictions, taking into account aspects of consolidated supervision. Additionally, they suggested developing guidance on treating foreign depositors and other creditors without discrimination. The draft advice incorporates the oversight of banking groups in the definitions and includes a broad concept of non-discrimination. The panellists reached a consensus that the instrument should not mandate a particular model, but rather allow states to select the best suitable institutional arrangements based on characteristics such as their legal system. They endorsed the formulation of principles that advocate certain broad criteria, including efficiency, seamless collaboration with necessary authorities, autonomy, and responsibility. The WG has reached a consensus to enhance the language and conduct a more thorough study, building upon the survey findings.

The suggested structure for the future Guide on bank insolvency includes the following key elements:

[39] UNCITRAL, *Model law on Recognition and Enforcement of Insolvency-Related Judgments* (2018) https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/ml_recognition_gte_e.pdf.

(a) **Introduction:** The introductory chapter will provide an overview of the objectives and rationale for the bank insolvency framework, guiding legislators in reforming or refining their bank liquidation laws.

(b) **Institutional Models:** This section will outline the general requirements for an effective liquidation process, including expertise and independence. It will also discuss the advantages of administrative models and ways to overcome potential drawbacks of court-based regimes.

(c) **Objectives:** The guide will address the proposed objectives of the bank liquidation framework, including value maximization, financial stability, and depositor protection. The meaning and implications of these objectives will be clarified.

(d) **Definitions:** The guide will define key terms such as “Bank,” “Banking group,” “Bank liquidation proceedings,” “Contractual subordination,” and others. The terminology for the proceedings at the heart of the instrument will also be determined.

(e) **Banking Groups:** This section will cover the adoption of ex-ante and ex-post group-level liquidation plans, intra-group financial assistance, and exemptions from general company and insolvency law provisions to facilitate group-level strategies.

(f) **Cross-Border Aspects:** The guide will encompass topics such as recognition, assistance, and relief, cooperation and coordination in cross-border situations, and safeguards to ensure processes are conducted fairly and efficiently.

(g) **Remedies:** The guide will provide guidance on legal challenges and remedies concerning the opening of bank liquidation proceedings, actions during the liquidation process, and the involvement of different types of courts.

(h) **Procedural and Operational Aspects:** The engagement of creditors in bank liquidation proceedings, the selection and compensation of liquidators, transparency, and accountability will be discussed in this section.

(i) **Preparation:** The guide will examine the stages preceding the initiation of a bank failure management process. It will offer suggestions and alternatives to ensure a seamless transition from oversight to failure management.

(j) **Tools and Powers:** This part will concentrate on the advancement of the transfer tool, encompassing its use in insolvency and special resolution regimes, discretionary components, and the extent of liabilities that can be incorporated in a transfer.

(k) **Funding:** This chapter will discuss the financial factors associated with bank insolvency, such as the stability of funding sources and the significance of deposit-based financing models for small and midsize banks.

The forthcoming Guide on bank bankruptcy will undergo additional refinement, incorporating the proposals and debates put forth during the WG sessions.

The 4th Working Group Meeting

On March 29-31, 2023, the WG convened for its fourth session at the BIS Financial Stability Institute in Basel, Switzerland.[40] The session was attended by members and observers from various organizations, including central banks and resolution authorities. The Report outlines the key agenda items and discussions:

a) **Opening and Agenda Adoption**: The session began with the adoption of the agenda and welcome from the Chair of the Financial Stability Institute (FSI), emphasizing the need for good practices for bank failure management.

b) **Update on Intersessional Work**: The Secretariat presented a report on the progress made since the last meeting, which involved the development of an initial version of the Guide by the Drafting Committee.

c) **Consideration of Work in Progress**:This entailed deliberations regarding the preliminary Chapters of the Master Copy, encompassing subjects such as the institutional structures and operations, the operational and procedural dimensions, and the scope and objectives of bank liquidation.

d) **Organization of Future Work**: The participants engaged in a discourse regarding the forthcoming sessions' organisation and the future work schedule.

Additionally, the report highlighted specific details from the discussions on the various chapters:

a) **Chapter 1**: Discussions revolved around the definitions and objectives of bank liquidation frameworks and the need for preconditions for effective frameworks.

b) **Chapters 2 and 3**: These chapters covered institutional arrangements, procedural and operational aspects, and creditor involvement in the process.

c) **Chapter 4**: Discussions focused on the need for preparation, including liquidity support and the treatment of temporary settlement accounts.

d) **Chapter 6**: Topics such as tools for bank liquidation, valuation, and the treatment of financial contracts were discussed. There were also discussions on the treatment of secured creditors and related party claims.

e) **Chapter 8**: Discussions revolved around the ranking of deposit claims, the treatment of temporary settlement accounts, and the treatment of secured creditors and related party claims.

f) **Chapter 9**: This chapter covered the group dimension of bank insolvency, including planning and coordination within banking groups.

[40] UNIDROIT, *Working Group on Bank Insolvency* Fourth session (hybrid) Basel, Study LXXXIV – W.G. 4 – Doc. 5 (March 2023),https://www.unidroit.org/wp-content/uploads/2023/06/Non-confidential-Study-84-W.G.-4-Doc.-5-Draft-Summary-Report_Final.pdf.

What are the different models of administrative institutional frameworks for bank liquidation?

The study explores several forms of administrative institutional frameworks for the liquidation of banks. It emphasizes that the liquidation procedure might take place either through a court-based mechanism or an administrative body. The court is responsible for overseeing the liquidation procedure under the court-based model. Nonetheless, an administrative entity may be appointed as a receiver or play a pivotal role in instigating the court-based procedure. On the other hand, the administrative authority model emphasises the importance of an administrative authority during the liquidation procedure, facilitating the required coordination and planning to guarantee a timely and efficient liquidation. The publication emphasises the necessity for administrative authorities to participate in the evaluation of the advantages of an administrative model. The text provides further details regarding the deposit insurer's involvement in the liquidation process as well as the obligations of bank management. Moreover, this analysis scrutinises the legal protections and the participation of creditors in the process of liquidation, unequivocally differentiating between methods mandated by the court and those administered administratively.

What are the guidelines for handling financial contracts during bank bankruptcy proceedings?

The protocols for managing financial contracts during bank bankruptcy proceedings comprise a number of vital components. At the outset, there was a suggestion that creditors should petition the relevant administrative entity for intervention. In jurisdictions where insolvency proceedings are initiated by the court at the request of creditors, a court decision should not be rendered without the prior sanction of the competent administrative authority. In addition, apprehensions were expressed by the participants regarding draft Recommendation 12, which concerns the participation of creditors in bank liquidations.Particularly in administrative operations, they emphasised the necessity of deviating from standard bankruptcy procedures due to the distinctive qualities of banks.

There were recommendations pertaining to Chapter 3 that it should be reorganized to include bank management duties, liquidation procedures, designated liquidators, and creditors' involvement. The group also emphasized the need to differentiate between transfers and gradual liquidation. Recommendation 12 should be developed considering banks' unique features and administrative agency involvement. Accurate directives should be tailored to banks' unique attributes and administrative authorities' involvement.

Should the Guide provide instructions for revocation of a licence to start bank liquidation proceedings?

The Report analysed the factors and debates related to the decision to cancel a bank's licence, which led to the initiation of bank liquidation procedures. The participants offered divergent opinions about whether the Guide should advocate for a certain method in this situation. A number of participants proposed that the most favorable course of action would be commencing liquidation procedures on the grounds of the bank's license revocation. They stressed the importance of providing assistance to facilitate the commencement of liquidation procedures or the establishment of temporary measures in such situations. Nevertheless, there were also apprehensions over the appropriateness of automatically commencing liquidation procedures following the termination of a license, as there may exist several justifications for terminating a bank's license.

In the end, the Chair determined that the WG was not sufficiently prepared to suggest specific suggestions about this issue. It was recommended that the Drafting Committee carefully examines the stated concerns, makes the language more efficient and suitable, and especially reflects on which parts should be included as specific suggestions.

Essentially, the document provides an impartial analysis of the subject, without offering a clear suggestion for a particular method to initiate bank liquidation procedures through the loss of a bank's license. The Drafting Committee is still deliberating and refining whether the Guide should provide a particular method for this case. Thus, according to the information included in the publication, the Guide does not yet endorse a particular method for initiating bank liquidation procedures through the revocation of a bank's license.

Which specific elements of creditor hierarchy should be addressed in the guidelines for bank liquidation?

When providing guidance on bank liquidation, it is essential to consider every aspect of the creditor hierarchy. The aforementioned aspects comprise the manner in which deposit claims are given priority, the management of temporary settlement accounts, the responsibility of the deposit insurer, and its ability to file a claim in the liquidation estate subsequent to subrogation.

Furthermore, explicit provisions should be made regarding the protocols that regulate the administration of secured creditors and the prioritisation of interbank deposits. In addition to the hierarchy of related party claims and their correlation with depositor protection, consideration should be given to the transfer of related party claims to an acquiring corporation and the sale of assets of an insolvent bank to a related party. Furthermore, the guidelines should encompass regulations concerning the protection against particular activities and transactions involving affiliated parties, as well as the administration of claims initiated by the estate against third parties. The elements mentioned above are of the utmost importance in establishing a comprehensive and unique structure for the prioritisation of creditors throughout the process of bank liquidation.

The 5th Working Group Meeting

On October 17-19, 2023, the fifth session of the Working Group was convened at the UNIDROIT headquarters in Rome.[41]

> The session began with an update on the significant progress made since the fourth Working Group session. In the intersessional period, the Drafting Committee established for this project had updated and further developed the draft Chapters of the future Legislative Guide on Bank Liquidation. Following

[41] UNIDROIT, *Working Group on Bank Insolvency*, Fifth session (hybrid) Rome, Study 84 – W.G. 5 – Doc. 1 rev (Oct. 2023), https://www.unidroit.org/wp-content/uploads/2023/10/Study-84-W.G.-5-Doc.-1-Annotated-Draft-Agenda_rev.pdf.

> a consultation with the three thematic Subgroups, the Chapters had been consolidated in a Master Copy of the draft Guide, which was the main object of discussion during the fifth Working Group session. The Working Group discussed all ten draft Chapters of the future Guide: (i) Introduction; (ii) Institutional Arrangements; (iii) Procedural and Operational Aspects of the Liquidation Procedure; (iv) Preparation and Cooperation; (v) Grounds for opening bank liquidation proceedings; (vi) Liquidation Tools; (vii) Funding; (viii) Creditor Hierarchy; (ix) Group Dimension; and (x) Cross-Border Aspects.[42]

The WG's sixth session is suggested to take place in the month of March 2024. It is highly recommended that the extremely productive intersessional work continue through the scheduling of virtual meetings and the Drafting Committee's efforts.

RECOMMENDATIONS & CONCLUSION

In light with the discussions of the WG to establish an effective bank liquidation procedure, the authors also strongly suggest strengthening the deposit insurance schemes in the banking sector - "*A deposit insurance system can contribute to financial stability, but only if it is adequately funded and if other safeguards—such as a strong bank supervision program—are also in place.*"[43]

In the AESOP anecdote concerning the hare and the tortoise, the turtle consented to the hare's race proposition. Despite the hare's initial advantage in speed over the tortoise, he opted to take a break and recharge by sleeping, motivated by his steadfast conviction in his capability to outrun his adversary. The turtle, which had been travelling at a consistent but lethargic rate, was nearing the endpoint when it awoke. The tortoise emerged triumphant due to the hare's inability to close the gap.

As opposed to a hare, the efficacy of a deposit insurance scheme is analogous to that of a tortoise. At first glance, there appears to be potential for a rapid and uncomplicated national deposit insurance programme to be established through the public declaration of a guarantee for bank deposits. To prevent extensive depositions that could result in the insolvency of stable banks and to restore stability to a troubled banking system, a number of governments have endeavoured to implement a deposit insurance scheme employing this methodology. Unfortunately, in the absence of sufficient financial resources to ensure its viability amidst a profound financial crisis and a resilient framework to supervise institutions, the system is doomed to fail.

Funding deposit insurance, increasing coverage limit and revising premiums

Although the significance of adequate funding is evident, it may not be immediately apparent that financing the system through premiums collected from its member institutions is the most effective approach, even if an initial government loan is necessary for initial capital. By initially allocating financial resources to the system rather than relying solely on a government assurance, it ensures that the governing agency tasked with its operation will manage it with fiscal prudence. Moreover, the organisation can reliably guarantee that it maintains adequate working capital to expeditiously respond to bank failures. The financial burdens

[42] Bank Insolvency – 5th Working Group session held in Rome, (Oct. 25, 2023) https://www.unidroit.org/bank-insolvency-5th-working-group-session-held-in-rome/.

[43] Ricki Tigert Helfer, *What Deposit Insurance Can and Cannot Do*, Finance & Development, International Monetary Fund 36(1) (March 1999), https://www.imf.org/external/pubs/ft/fandd/1999/03/tigert.htm.

linked to bank failure resolution are substantially escalated when the necessary working capital is not obtained from the legislature in a timely manner. This is substantiated by the experiences of the United States and Japan during the savings and loan crisis of the 1980s and the present, respectively. In addition, by remitting premiums to fund the deposit insurance system, member institutions would be incentivized to monitor the operations of the system so as to ensure its fiscal prudence and stability. Evaluate the current restrictions on coverage and consider augmenting them in accordance with the current economic climate and inflation. Deposit insurance offers the confidence of depositors that a superior portion of their funds will be protected in the catastrophic event of a bank's insolvency. Contribute to the financing of the deposit insurance scheme through the modification of bank premiums. It is imperative to ascertain that the funds amassed are sufficient to encompass potential compensation in the event of multiple bank failures.

In the absence of strong bank supervision, the central bank and deposit insurance system might be obliged to provide financial aid to insolvent banks engaged in risky activities that could compromise the financial system's stability. The process of closely overseeing banks through on-site examinations and off-site surveillance in accordance with generally accepted accounting principles is referred to as prudential supervision. It functions as the means by which central banks and deposit insurance systems acquire information and conduct observation. This technology aids in the determination of whether establishments are insolvent or merely encountering challenges with their liquidity. In the absence of efficient regulatory oversight, deposit insurance and other components of the safety net shield irresponsible banks from potential financial losses that may arise from speculating on high-risk assets for profit maximisation. A nation must possess the determination to establish a proficient banking regulatory framework, with the aspiration to enhance its reputation on global financial markets expected to serve as a compelling motivation. Furthermore, the effective execution of the novel system requires the participation of experts who possess profound expertise in the field of banking supervision. This type of training is available from a variety of organisations in developed nations and international financial institutions.

Capital requirements mandated by regulation are crucial for assuring the efficacy of prudential control. Sufficient capital functions as a protective measure against challenges and elevates the costs linked to precarious activities and speculation, as investors confront greater potential losses in the case of a bank insolvency. While possessing a significant quantity of capital is essential, it does not provide adequate protection against the failure of a bank. Defective assets have the potential to swiftly deplete the capital of a financial institution. Moreover, newly established banks, characterised by limited historical data and inexperienced management, present a greater degree of risk in comparison to well-established banks. Banks that conduct business in an emergent or transitioning economy encounter increased risk as a result of their limited prior market knowledge. The criteria established by the Basel Committee are universally applicable to institutions that have received international accreditation and are situated in developed countries. The Committee has emphasised the necessity for banks to maintain significantly high levels of capital under various circumstances.

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EXPLORING THE JOURNEY OF OPERATIONAL CREDITORS FROM ADMITTANCE TO COMPROMISE

Sunit Shah and Yashree Dixit

ABSTRACT

The introduction of the Insolvency and Bankruptcy Code, 2016 (IBC/ Code) has been a landmark reform in the history of Indian economy. The main objective of the Code is to save the life of the companies by imparting fair and equitable treatment to all the stakeholders. However, the practical scenario reveals the different story wherein no powers or rights in actual have been vested in the Code for the operational creditors (OCs). The aim of the Code is the resolution of the viable distressed companies and not the recovery of dues to various creditors. Though resolution has been the goal and the legislature providing various rights and powers to the financial creditors (FCs), but the OCs should not have been left unattended with no say in the corporate insolvency resolution process (CIRP) of the corporate debtor (CD). The realization to the OCs from the proceeds of resolution plan has been very minimal. They have kept knocking on the doors of the defaulting company since a long time. OCs have no rights to participate or vote in the meetings. There are very few studies that have explored the area of OCs under the Code. The present paper highlights the comparative study on realisation of the amount from the resolution plan to OCs and the FCs. Ten companies have been selected for the study which have undergone CIRP between the years 2019-2023. The study also reveals how OCs are disregarded in so far as the distribution from the proceeds of the resolution plan is concerned and have received a large amount of haircuts at the time of the distribution of funds.

Keywords: Operational Creditors, Resolution, Recovery, Powers, Voting Rights

INTRODUCTION

There existed a multitude of laws and platforms to address insolvency and bankruptcy cases, prior to the implementation of the IBC in India. These included the Sick Industrial Companies (Special Provisions) Act of 1985 (SICA), the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI), Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act, 1993, and the Companies Act, 2013. The earlier frameworks involved a "debtor-in-possession" model which was replaced by the IBC's "creditor-in-control" regime.[1] Under the Code, the resolution plan outlines proposed strategies for revitalizing financially distressed businesses and ensuring repayment to creditors. IBC has indeed put one alarm bell ringing with all debt-stricken companies trying its hand at debt restructuring or putting up distressed assets on sale. Surprisingly, more than six years of the said legislation has in fact changed the ground level in the adjudication and justice delivery system in India. The successful journey on the path of "endless hope" has been extremely satisfying. There is no classification of creditors in the insolvency laws of the developed countries like the United Kingdom or the United States or the UNICITRAL Model Law. The challenges related to OCs in the Code, are very complex and exciting.

The National Company Law Tribunal (NCLT) Principal bench, New Delhi in the judgment of *AMR Infrastructure Limited* dated January 23, 2017 stated that, the definition of 'operational debt' does not state that it also includes any debt other than 'Financial Debt'.[2] Thus, 'operational debt' under the Code only covers four categories, that is, goods, services, employment and government dues. The definition of "debt" is defined under section 3(11) of IBC, where *'debt'* means *'a liability or obligation in respect of a claim which is due from any person and includes a financial debt and operational debt.'*[3] According to legal judicial pronouncement *CBRE South Asia Private Limited v. United Concepts and Solutions Private Limited*, National Company Law Appellate Tribunal (NCLAT), New Delhi bench clearly specified that under section 5(21) of IBC, *'operational debt'* means *'a claim in respect of the provision of goods or services including employment or a debt in respect of the [payment] of dues arising under any law for the time being in force and payable to the Central Government, any State Government or any local authority.'*[4]

The OCs are eligible to file an application under section 9 for initiation of the CIRP after a notice of demand has been served to the defaulter under section 8 and neither the payment nor any notice of dispute has been received within 10 days of delivery of the above notice. According to the Insolvency and Bankruptcy (Application to Adjudicating Authority) Rules, 2016, an application of initiation of CIRP is to be filed before the Adjudicating Authority (AA) in Form 5 along with the copy of the demand notice or invoice and an affidavit stating that no notice of dispute has been received. As of September 30, 2023, 49.49% of the 7054 CIRPs

[1] International Finance Corporation, *Understanding the IBC: Key Jurisprudence & Practical Consideration,* (Dec. 20, 2023), https://Ibbi.Gov.in/Uploads/Whatsnew/E42fddce80e99d28b683a7e21c81110e.Pdf.

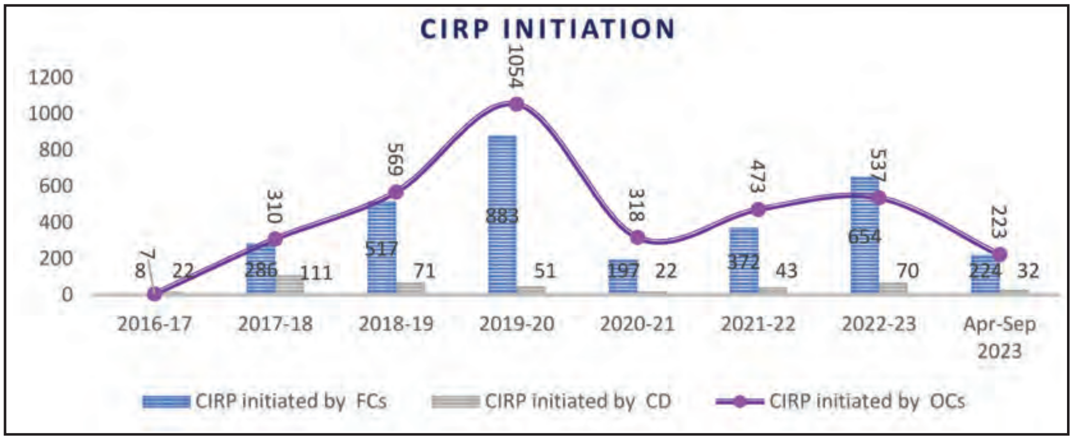
[2] M/s. Nikhil Mehta and Sons v. AMR Infrastructure Limited, 2017, Company Appeal (AT) (Insolvency) No. 07 of 2017.

[3] Insolvency and Bankruptcy Code, 2016, § 3(11).

[4] M/s.CBRE South Asia Private Limited v. United Concepts and Solutions Private Limited, NCLT-New Delhi Bench, (IB)-797/(ND)/2021.

initiated have been instigated by OCs, totaling 3491 instances. Out of these, 725 are closed due to appeal/review/settlement, 679 are withdrawn under section 12A, 281 are successfully resolved, 979 have undergone closure due to commencement of liquidation and 827 cases are ongoing.[5]

Chart 1.1 - CIRP Initiation



PROVISIONS UNDER THE TERM 'OPERATIONAL CREDITOR'

The IBC distinguishes itself by categorizing creditors into FCs and OCs. OC has been defined under section 5(20) read with section 9, of the Code, *as a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred.*[6]

Based on the definition as prescribed under Code, operative requirement is that the claim must bear relation with a provision of goods or services, without specifying who is to be supplier or receiver. This is also specified in the Bankruptcy Law Reforms Committee (BLRC) Report, which specifically mentioned that operational debt is in relation to operational requirements of an entity.[7] The broad and purposive manner in order to include all those who provide or receive operational services from the proprietary concern when it contracted with them for the supply of services.

Creditors are generally those creditors who have supplied goods, raw materials or provided their services to the company by way of electricity, human resources, security and other services in order to maintain the operational status of the company. These OCs are generally engaged with the company in their day-to-day activities and contributing towards the growth of the company, considering which their contribution in the company is equally important and significant as that of FCs who have lent the much-needed monies to the company.

For the sake of distribution of proceeds at the time of realization, the OCs can broadly be classified into three classes namely: - creditors who have supplied goods and rendered

[5] Insolvency and Bankruptcy Board of India, *Quarterly Newsletter for July-September, 2023,* (Dec. 20, 2023), https://ibbi.gov.in/uploads/publication/b4ce3516920836e9ff9b1e816137bf97.pdf.

[6] Insolvency and Bankruptcy Code, 2016, § 5 (20). https://ibbi.gov.in/BLRC Report Vol1_04112015.pdf.

[7] *The Report of Bankruptcy Law Reforms Committee*, Volume 1: Rationale and Design (Dec. 20, 2023), https://ibbi.gov.in/BLRCReportVol1_04112015.pdf.

services to the company; creditors who were actively involved in the operations of the company i.e., employees of the company; and pending obligations of the company towards Central and State Government arising out of statutory dues i.e., taxes, penalties and fines.

FINANCIAL VS OPERATIONAL CREDITORS: A TALE OF UNJUST ENRICHMENT

Indian insolvency law is distinctive to the extent that creditors have been classified into FCs and OCs. There is perpetual tug of war between the FCs and OCs for getting good amount at the time of approval of resolution plan.[8] OCs have dues whose quantum is generally less as compared to the FCs who lend large sums of money either to setup and/or operate a business. FCs are generally in possession of some security against the amount lent and follow specified repayment timelines, which gives them the authority to recall the entire loan amount in case of default. Contracts with OCs on the other hand, are not secured and lack such conditions. Also, financial debts to banks/Financial Institutions (FIs) are easily verifiable as they have their charges registered, conduct timely inspections and maintain proper documentation available in public domains and Information Utilities (IUs) set up for this purpose, whereas transactions with OCs are usually recurring in nature and so the chances of genuine disputes in their case are much higher. Trade credit in India predominantly lacks security and is characterized by its unsecured nature. It is largely wielded by good faith and the relationship between the vendor and the purchaser.

Under the IBC, FCs possess certain prerogatives which are not available to OCs. They play a negligible role in overseeing the CIRP. Their contribution is minimal and their participation does not substantially influence the CIRP. According to section 24(4) of the Code, a representative of the OCs having aggregate dues not less than 10% of the outstanding debt of the debtor entity, is allowed to attend the meetings of the committee of creditors (CoC) without however, being entitled to vote.[9] In the *Swiss Ribbons* judgement, the Hon'ble Supreme Court established a significant distinction, affirming that FCs possess an 'intelligible differentia' over OCs.[10] In another case, the Supreme Court held that CoC's decision to approve a resolution plan must be based on commercial wisdom, and courts cannot interfere with it unless there is a violation of the provisions of the IBC or any other laws governing the insolvency proceedings and the CoC is not required to ensure equal treatment of all stakeholders, and it can approve a resolution plan with discriminatory distributions in certain circumstances.[11] While this ruling is duly respected, OCs consistently advocate for a more active role within the CoC, contending that they too should have a stake in decision-making processes. Specifically, there is an appeal for a more equitable distribution of decision-making authority, especially concerning the approval of resolution plans. Practical observations indicate that many plans literally wipe out the exposure of OCs, while safeguarding the interests of FCs.

It was observed by the BLRC that typically OCs are neither able to decide on matters regarding the insolvency of the entity, nor are willing to take the risk of postponing payments for better

[8] Anant Merathia, Defaulters Paradise Lost (Thomson Reuters 2023, 1st ed).
[9] Insolvency and Bankruptcy Code, 2016, § 24(4).
[10] M/s. Swiss Ribbons Pvt. Ltd.& Anr. v. Union of India& Ors. (2019) 4 SCC 17.
[11] Committee of Creditors of Essar Steel India Limited v. Satish Kumar Gupta and Others, (2020) 8 SCC 531.

future prospects for the entity and therefore, the CoC ought to be constituted of only FCs since they are inherently better positioned than OCs to decide on matters concerning viability. But BLRC further argued that there must be a counter-balance to OCs not having a vote on the CoC.[12] Thus, they concluded that the dues of the OCs must have priority in being paid as an explicit part of the proposed solution. In this regard, the observations of the Hon'ble NCLAT in *Binani Industries*, is also noteworthy.

The NCLAT while interpreting section 30(2)(b) of the IBC, had remarked that providing only liquidation value to OCs based on a misreading of section 30(2)(b) would discourage the creditors to continue supplying goods and services to the CD.[13] Also, in the case of *Hammond Power Solutions Private Limited*, the NCLAT emphasized the significance of the resolution applicant elucidating how the interests of all stakeholders are safeguarded. This directive presents a ray of optimism, as it implies that resolution applicants could encounter challenges in justifying a provision of zero payment to OCs.[14]

Employees and workmen too have been classified as OCs under the Code. Though they are positioned better off in the waterfall mechanism, they must share a pie with the secured creditors and are at loss, especially at the time of liquidation. The classification of creditors under the Code is predominantly defined under section 53 wherein the clear distinction between secured and unsecured creditors can be established. But what is intriguing is the fact that in the waterfall mechanism even after paying out the dues of secured creditors, workmen and employees, the next in line liable for payment is unsecured FCs and not unsecured OCs. The other remaining unsecured OCs are sixth in line of distribution at the time of realization and repayment of debts, which clearly depicts that how FCs although unsecured are benefitted from the favoritism being provided in the name of being the lifeline to the company by providing the much-needed working capital to the company.

Liquidation of a large company has a direct bearing on all its vendors and any entity or person associated with it in business or employment terms, but the one who suffers the most during this whole process is the OCs. The treatment of OCs under IBC causes a cascading effect in the whole business ecosystem.

ADVERSITIES CONFRONTED BY THE OPERATIONAL CREDITORS

In the context of CIRP and liquidation, OCs often face challenges and perceived negligence that can affect their interests.

a) Initiation of CIRP

In case of delay in payment, FCs, such as banks and other lending institutions, hold a privileged position under the IBC. They can directly trigger the insolvency process against a debtor. Whereas in case of OCs, there is a slightly different process to follow when faced with payment delays.

[12] The Report of Bankruptcy Law Reforms Committee, *supra note* 8.

[13] M/s. Binani Industries v.Bank of Baroda, Company Appeal (AT) (Insolvency) No. 82 of 2018.

[14] M/s. Hammond Power Solutions Private Limited v. Sanjit Kumar and Ors, Company Appeal (AT) (Ins) No.606 of 2019.

OCs are required to send a demand notice to the CD and wait for a limited time before initiating the insolvency proceedings. This notice essentially serves as a final warning to the debtor, giving them an opportunity to settle the dues within a specified time frame. They need to wait for the stipulated time mentioned in the demand notice for the debtor to respond or make the payment. If the debtor fails to comply within the timeframe, the OC can proceed to initiate insolvency proceedings.

b) Insufficient knowledge and lack of guidance

Insufficient knowledge and dearth of proper guidance can cause considerable challenges if the default amount is nominal and the case gets admitted. There is a possibility of them ending up overspending funds on the procedural part. Also, there is a risk that debt amount may be reduced to the sum admitted by the Interim Resolution Professional (IRP) due to lack of evidence, which would be further reduced at the time of realization under waterfall mechanism.

This is even more disadvantageous for an OC having place of business outside India. The intricate processes of attestation, involvement of foreign notary, and other related processes complicate the situation for them. Consequently, it becomes imperative for OCs to possess a foundational understanding of the insolvency process and receive well-intentioned advice to navigate these intricacies effectively.

However, the increase of the threshold limit to ₹ 1 crore, have brought a noteworthy shift in this landscape. There has been a significant decline in the number of filings in this segment, suggesting a potential alteration in the dynamics of insolvency proceedings for OCs.

c) Limited information flow & inadequate information

OCs often grapple with untimely and limited information about the initiation of insolvency process. In many instances, they are unaware about the public announcements made by the IRP. While it is mandatory for the IRP to inform all creditors, including OCs about the commencement of CIRP, certain challenges arise practically due to unavailability of data and relevant records from the suspended Board of Management.

Such lack of transparency creates significant hurdles for them, impeding their ability to make informed decisions or actively participate in the resolution process. They do not have knowledge about the status of their claims and the overall resolution process, making it difficult for them to strategize effectively or exercise their rights in a meaningful manner.

Further, the scarcity of bandwidth and knowledge of procedural matters hampers access to the legal systems and professional assistance. This compounded lack of information and constrained resources collectively undermines the OC's ability to navigate the insolvency landscape with the required insight and efficacy.

d) Complexity of claims verification

The complexity in the process of the verification of claims is enhanced due to the inherent unsecure nature of trade and the prevalent absence of documentation and maintenance of records with the OCs. OCs often find themselves struggling with the unavailability of supporting evidence at the crucial juncture of claims verification. This insufficiency of substantiating evidence not only hampers the expeditious validation of claims but also gives rise to disputes during and after the verification process.

In essence, the intricate nature of claims verification is a direct consequence of inadequate record-keeping practices among OCs, leading to delays and heightened challenges in the overall insolvency resolution proceedings. Efforts to streamline and improve documentation practices within this context can significantly contribute to expediting the resolution process and mitigating disputes.

e) Adjudication of disputes

The expeditious adjudication of disputes is paramount for ensuring a smooth and seamless insolvency process. Delays in resolving disputes related to claims prolong uncertainties and inflict financial strain upon OCs.

Disputes often arise in the context of insolvency proceedings, particularly concerning the validity or quantum of claims submitted by OCs. The lack of a swift and effective resolution mechanism for these disputes can lead to protracted legal battles, enhancing the financial burden on OCs. In such instances, the prolonged uncertainty and financial strain can impede the effective functioning of OCs, who may find it challenging to plan and manage their finances with the required clarity and it may also hinder their day-to-day affairs.

Timely adjudication of disputes is essential not only for the financial well-being of OCs but also for the overall efficiency of the insolvency resolution process. A streamlined and expeditious dispute resolution mechanism can help relieve financial pressures and contribute to a more effective and equitable resolution for all stakeholders involved. Efforts to enhance the efficiency of dispute resolution mechanisms within insolvency proceedings are therefore crucial for fostering a conducive and fair environment for OCs.

f) Inadequate representation in CoC

The fate of insolvency proceedings is intricately tied to the decisions made by the CoC, a body vested with substantial authority in the CIRP. It plays a decisive role in all the major matters of insolvency ranging from the appointment of the Resolution Professional (RP) to the approval of the resolution plan. The CoC plays a pivotal role and exercises considerable power in the course of the CIRP.

The CoC only consists of the FCs. OCs encounter a significant challenge in finding place for themselves in terms of representation within the committee. If the OCs constitute 10% of the total debts of the company, then only they get a representation in the CoC. Even when the threshold is met and they participate in the meeting, they do not get any voting power.

This absence of voting rights and the limited representation of OCs within the CoC profoundly impacts their ability to shape decisions that are crucial to the resolution process. As a result, decisions made within the CoC may not adequately consider the unique interests and concerns of OCs. This imbalance in representation underlines the need for a more inclusive framework that ensures the active involvement and consideration of all creditors, including OCs, in the decision-making processes of insolvency proceedings. A more equitable representation is vital for ensuring fairness, transparency, and an outcome that takes into account the diverse interests of all stakeholders involved.

g) Limited say in approval of resolution plan

Resolution plans are firstly approved by the CoC before approval by the AA. OCs do not get a say in the same and such plans are frequently dominated by the preferences and priorities of the FCs. The plan is mostly driven by FCs and many a times the terms of the resolution plan entail substantial haircuts for the OCs, reaching as high as 95% or more of their outstanding dues.

According to report, the realizations for OCs has been 2.2% as against that of 22.31% for FCs. The resolution plan, which is largely influenced by the FCs, may prioritize their interests over those of OCs. The significant reduction in the amounts allocated to OCs through these plans further compounds the financial strain already experienced during the insolvency process. In some cases, the recovery for OCs from the resolution phase is so minimal that it fails to provide meaningful relief.

The situation becomes even more challenging in the event of liquidation, where OCs may receive negligible proceeds. The disparity in treatment between FCs and OCs within the resolution and liquidation processes underscores the need for a more balanced and equitable approach. A more inclusive and collaborative formulation of resolution plans is crucial to ensure that the interests of OCs are adequately considered. Although resolution plans are capturing almost the entire going concern surplus, over and above the liquidation value, it does not seem to have good effect on OCs at all.

h) High transaction costs

OCs encompass a diverse range of entities, ranging from government entities and large suppliers to small scale service providers. The insolvency process, however, may not adequately account for the varying degrees of financial vulnerability among OCs. This lack of differentiation can be challenging as they have already lost out the monies leading to erosion of capital and on top of that, they have to go through the legal and administrative expenses. These may disproportionately impact their ability to recover outstanding dues. This burden is especially pronounced for smaller entities within this category. The impact of high transaction costs extends beyond the immediate financial burden and can have lasting consequences, potentially impeding the recovery and sustainability of OCs. Recognizing and addressing the disparities in the financial capacities of OCs within the insolvency process is crucial for promoting a more equitable and supportive framework that facilitates their recovery efforts.

i) Low priority in payment hierarchy

Section 53 of the IBC provides for waterfall mechanism detailing the order and priority of distribution of proceeds from the sale of liquidation assets among the stakeholders. The hierarchical structure is outlined as follows:

1. Cost of liquidation 2. Secured creditors and workmen payments 3. Pending wages of employees 4. Unsecured creditors 5. Dues to the Government and unpaid amount to secured creditors 6. Operational Creditors and unpaid amount to unsecured creditors 7. Preference shareholder and 8. Equity Shareholders or Partners.

It is clear from this order that OCs occupy a position towards the end of the payment queue. Secured creditors and FCs are accorded higher priority, leaving OCs at a disadvantage. The consequence of this lower position in the hierarchy is that, in the event of liquidation, OCs may receive a disproportionately reduced share of the available assets.

JUDICIAL PRONOUNCEMENTS ON DISBURSEMENT AMOUNT TO OPERATIONAL CREDITORS

***Genius Security and Allied Services v. Mr. Shivadutt Bannanje, RP M/s. Fortuna Urbanscape Pvt. Ltd.*- NCLAT Chennai (January 29, 2021) [15]**

The present appeal arises against the approved resolution plan providing Nil amount to the OCs. It was stated that the OCs in the event of liquidation would get Nil amount due to insufficient value and considering which no payment is being offered at the time of resolution of the CD. In the resolution plan the outstanding government dues, taxes admitted as operational debt, Nil payment has been proposed under the plan. The Appellate Authority observed that there is no discrimination in the treatment of the OCs and Nil payment to the OCs is permissible under the provisions of the Code.

***Damodar Valley Corporation v. Dimension Steel Alloys and Ors.*, NCLAT New Delhi (October 8, 2021) [16]**

The appellant in the present matter was one of the OCs whose electricity dues were pending with the CD and an appeal against the order approving the resolution plan of the CD was sought. The primary ground for appeal was that the appellant was offered only meagre of the admitted claim disregarding the principle of equitable treatment of creditors while payment of dues.

[15] M/s. Genius Security and Allied Services v. Mr. Shivadutt Bannanje, Company Appeal (AT) (CH) (Insolvency) No. 110 of 2021.

[16] M/s. Damodar Valley Corporation v. Dimension Steel Alloysand Ors, Company Appeal (AT) (Insolvency)No. 62 of 2022.

Considering that the full payment against the dues were not made by the CD, the electricity connection was not restored. On the said ground, the OC appealed to reject the resolution plan of the CD as only 0.19% of their admitted dues were offered. Appellate Authority in the said matter had made reference to the Government and authorities to look and decide into the equitable treatment of the creditors during the distribution.

***Yogeshwar Garg and Ors. v. Mandeep Gujral RP Jaycon Infrastructure Ltd. and Anr.* – NCLAT New Delhi (August 23, 2023)**[17]

An appeal was filed jointly by the OCs of the CD against the order passed by the Chandigarh Bench of the AA approving the resolution plan in its IA No. 659 of 2023. The said appeal was filed with regard to inconsistent treatment of OCs in the approved resolution plan. The approved resolution plan allotted Nil amount to the fully admitted claims of the OCs, giving them 100% haircut to their claims.

The aforementioned appeal was also dismissed by the Appellate Authority stating that CoC in their commercial wisdom have decided to allocate Nil amount to the other creditors and "*Adjudicating Authority with the limited powers of judicial review available to it, cannot substitute its views with the commercial wisdom of the CoC in rejecting the resolution plan.*"

LITERATURE REVIEW

Puja Kumari (2019),[18] this paper describes how the Code grounded in principles of equality and transparency, has effectively enhanced the efficiency of corporate insolvency resolution. The IBC is a comprehensive and systemic reform, which will give a quantum leap to the functioning of the credit market. NCLT and NCLAT will deal with caseloads. The data from the Insolvency & Bankruptcy Board of India (IBBI) reveals a concerning trend in the three years since the implementation of the Code- the number of bankrupt companies liquidated has far surpassed those with corporate resolutions, nearly four times more. The existing insolvency laws with new stringent laws would take care of the existing defaulters in a time bound manner.

Saransh Jain (2020),[19] this paper states how the Hon'ble courts have failed to understand the plight of the OCs. The Code was introduced with the objective of speedy and timely resolution of the insolvency of the bankrupt businesses, in order to ensure the availability of credit in the economy. However, according to the researcher, the Code has made the OCs an 'Outcast' from their debts. This paper states how the OCs are forced to be bound by the supremacy of the FCs and in case any other mode of recovery is utilized to recover their debt, the IBC imposes a moratorium on such proceedings throwing the OCs into a void.

C. Scott Pryor and Risham Garg (2020),[20] this paper has identified three major problems. *Firstly*, the CoC is made up of FCs leading to inequitable distributions between the classes of

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[17] M/s. Yogeshwar Garg and Ors. v. Mandeep Gujral RP Jaycon Infrastructure Ltd. and Anr, Company Appeal (AT) (Insolvency) No. 1481 of 2023.

[18] Puja Kumari, *Decoding the Insolvency Laws in India*, Vol 22 Issue 22 Think India Journal (Dec. 2019).

[19] Saransh Jain, *Operational Creditors - the "Outcast" of Insolvency and Bankruptcy Code* Vol 3 Issue 4 Int'l J.L. Mgmt. & Human. 77 (2020).

[20] C. Scott Pryor and Dr. Risham Garg, *Differential Treatment among Creditors under India's Insolvency and Bankruptcy Code, 2016: Issues and Solutions* 94 Amer. Bankr. L.J. 123 (2020).

creditors. *Secondly*, the CIRP provisions of the IBC are inconsistent with public policy as they fail to protect vested charges of secured creditors. And *thirdly*, the CIRP provisions and other insolvency resolution regulations fall short of the standards of procedural fairness. To resolve these problems, this paper suggests that the insolvency resolution regulations can be revised to define "net liquidation value" as the value of the assets of the CD less the value of those assets subject to secured claims of holders of registered charges.

Suharsh Sinha (2021), [21] this paper defines how the use of credit has benefited many corporate borrowers for the initial funding, funding for expansion and growth the corporate borrowers have achieved which they would not have been able to, if they relied on own funding. As there is benefit to the one who is getting the credit, on the other hand the person providing the same has risk and the unsecured creditors face higher risk in terms of getting the repayment if the company goes into liquidation as they are only paid with whatever assets are left with the borrower after paying secured creditors. Though in the initial phases of IBC, the secured creditors may have suffered, the legislature has made continuous amendments regarding the incorrect interpretation and protected the rights of secured creditors.

Dhaval Vyas (2021),[22] this paper has identified both internal and external factors for the delay in the implementation of the Code. This could be since the CD does not want to hand over the control to CoC as that would make him dependent and not have a full say in the day-to-day administration. In India, most of the businesses are in the unorganized sectors and there were a lot of systemic and infrastructure bottlenecks which create information absence. Further, the markets and economy may be ill-prepared too. The paper describes that delays may occur at each stage of the resolution process right from the time of application filing, reply, formation of CoC, appointing RP, approval of resolution plan, decision making, sale of assets, and so on.

Prerna Jain Kala (2022),[23] this paper analyses how the Code has been utilized by creditors as a means of recovery, and corporate borrowers have also been led astray by the creditors' recovery strategies out of concern that an insolvency petition will be admitted against the CDs and the repercussions that will follow from this. The paper states that the most recent events and decisions made by the Apex Authority, on the other hand, have had the consequence of putting the OCs in a disadvantageous position. Despite its infancy, the IBC has already succeeded in bringing about a significant change in the Indian banking sector's prevailing culture of borrower impunity.

Avinash Kumar (2023),[24] the Code initially aimed to strengthen OC's positions, but due to legal developments, their chances of payment through the CIRP have worsened. This paper explores the qualifications of OCs, analyses their plight during CIRP and liquidation, and addresses the ongoing debate on their equal treatment compared to FCs. Despite the IBC's

[21] Suharsh Sinha, *Rights of Secured Creditors under Indian Insolvency Law* JGILS Working Paper No. 1 / 2021.

[22] Vyas Dhaval, *Delay under Insolvency and Bankruptcy Code, 2016* (Nov. 11, 2021).

[23] Prerna Jain Kala, *Status Quo of Operational Creditors under IBC – a Judicial Analysis* 5 (3) IJLMH, 2039 - 2045 (2022).

[24] Avinash Kumar, *Position of Operational Creditors: In regard to CIRP and Liquidation* Vol 9 Issue 2 International Journal of Legal Developments & Allied Issues (2023).

goals of balancing stakeholder interests, OCs often face disenfranchisement. Legislative efforts have focused on restricting their rights rather than ensuring fair treatment, requiring a reassessment of the IBC's objectives.

Vidushi Puri (2023),[25] the distinction between FCs and OCs under the IBC is critical and such a situation raises concerns about discrimination rather than differentiation. The article emphasizes on the fact that the Code lacks incentive mechanisms to ensure that FCs don't prioritize their own interests over the overall goal of maximizing recovery for all creditors and despite recent legal resolutions addressing prompt payment and discriminatory practices, the ongoing battle persists. The articles claims that unlike liquidation, there's no clear guidance in the IBC on how to distribute the resolution amount, whether equally, pro-rata, or if OCs should have a say in certain approvals impacting their interests and until these conflicting perspectives are addressed within a clarified legal framework, resolving the priority struggle between FCs and OCs remains a distant dream.

Ananya Singh (2023),[26] this paper defines how OCs are disenfranchised under the Code, and then attempts to lower the same as much as possible through amendments made from time to time by the legislature and the IBBI. OC's rights are voiceless, as at the time of approval of resolution plan or liquidation of the CD, they are paid their dues at last after payment to FCs, they also do not have the right to attend CoC and, OCs many a times do not get any payment from the CD as under IBC, the ratio of CD coming under the umbrella of IBC, resulting in liquidation is much higher than the CD being revived.

RESEARCH QUESTION AND METHODOLOGY

The research question dealt in this paper is - Will the OCs be able to get adequate amount on approval of resolution plan? This study is done to evaluate the ten companies which have undergone CIRP between the years 2019-2023 and realisation of the amount from the resolution plan to OCs and FCs. The research design of this study is descriptive and will assist the decision-maker in determining, evaluating, and selecting the best course of action to take in a given situation. Inconclusive is a causal research design that is used to obtain evidence of cause-and-effect relationships.

The one variable we have taken i.e. percentage of amount received by OCs and FCs on approval of resolution plan compared to their percentage of claims.

DATA ANALYSIS

For this research study, the authors have selected different sectors such as petrol, steel plant, construction, port, pharmacy, tiles and IT. These companies were undergoing insolvency during CIRP period for the financial year 2019-2023.

[25] Vidushi Puri, *Distinction in Treatment of Financial Creditors vs. Operational Creditors under IBC*, IBC Laws (Jan. 9, 2023).

[26] Ananya Singh, *The Operational Creditors under IBC: A Tale of Disenfranchisement*, S&R Associates (Nov. 24, 2023).

Table 1.1 Admitted claims of FCs and OCs

Sl.	Name of Companies	Sector	Financial Creditors Claim Admitted (In ₹)	Operational Creditors Claim Admitted (In ₹)	Total Claim Admitted (In ₹)
1.	JBF Petrochemicals Limited	Petrol	49,151,578,877	7,128,847,407	56,280,426,284
2.	Sona Alloys Private Limited	Steel Plant	18,863,116,428	2,652,117,871	21,515,234,299
3.	Essar Steel India Limited	Steel Plant	494,731,500,000	50,920,600,000	545,652,100,000
4.	Jaypee Infratech Limited	Construction	226,189,500,000	4,643,200,000	230,832,700,000
5.	Karaikal Port Private Limited	Port	29,592,925,467	183,736,114	29,776,661,581
6.	Reliance Naval & Engineering Limited	Shipyard	125,128,400,000	3,709,700,000	128,838,100,000
7.	Vasan Health Care Private Limited	Pharmacy	14,628,170,659	7,607,327,255	22,235,497,914
8.	SQL Star International Limited	IT	21,700,000	91,334,697	113,034,697
9.	Sungracia Tiles Private Limited	Tiles	274,180,308	97,270,434	371,450,742
10.	Mercator Petroleum Limited	Petrol	4,100,800,000	735,094,000	4,835,894,000

The above table specify claim amount admitted by the IRP or the RP at the time of CIRP. The claim amount submitted by the OCs and FCs to the IRP and RP may differ from the claim admitted based on the verification of claims with the books of accounts by the Insolvency Professional (IP). The amount of claim as mentioned in the table above are the final claims as admitted by the IRP and RP.

Table 1.2 Amount provided to FCs and OCs under the resolution plan

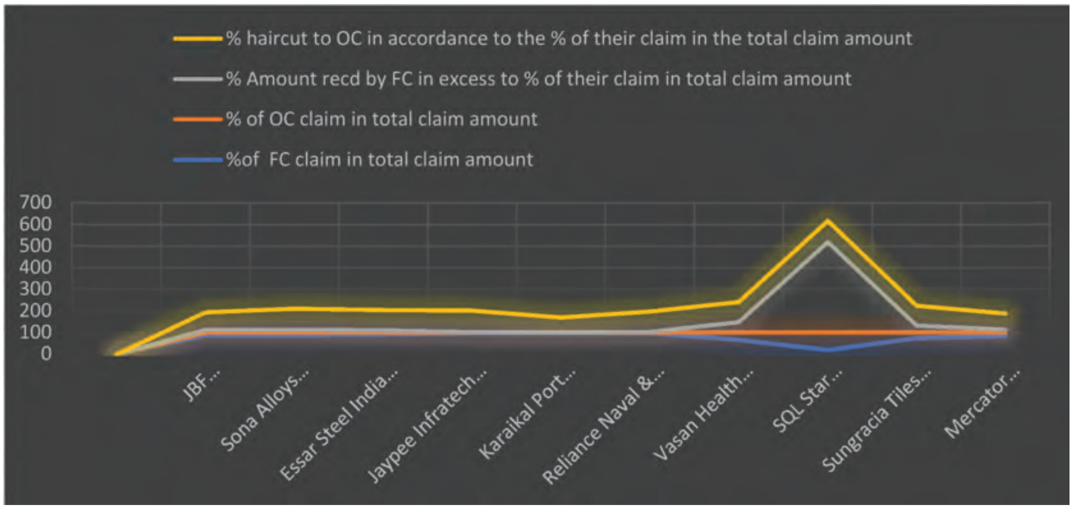
Sl.	Name of Companies	Sector	Amount provided to Financial Creditors under the Resolution Plan (In ₹)	Amount provided to Operational Creditors under the Resolution Plan (In ₹)	Resolution Plan Amount (In ₹)
1.	JBF Petrochemicals Limited	Petrol	20,299,129,387	493,365,642	20,792,495,029
2.	Sona Alloys Private Limited	Steel Plant	5,548,500,000	21,500,000	5,570,000,000
3.	Essar Steel India Limited	Steel Plant	419,877,000,000	2,140,700,000	422,017,700,000
4.	Jaypee Infratech Limited	Construction	173,286,900,000	4,000,000	173,290,900,000
5.	Karaikal Port Private Limited	Port	15,800,000,000	30,653,357	15,830,653,357
6.	Reliance Naval & Engineering Limited	Shipyard	20,400,000,000	30,800,000	20,430,800,000
7.	Vasan Health Care Private Limited	Pharmacy	3,430,000,000	89,300,000	3,519,300,000
8.	SQL Star International Limited	IT	1,000,000	4,970	1,004,970
9.	Sungracia Tiles Private Limited	Tiles	147,356,133	3,223,967	150,580,100
10.	Mercator Petroleum Limited	Petrol	1,348,900,000	54,033,000	1,402,933,000

The above table specifies the amount received by the FCs and the OCs on approval of resolution plan.

Table 1.3 Receipt of amount by FCs in excess to % of their claim in total claim amount and haircut accepted by the OCs in accordance to % of their claim in the total claim amount

Sl.	Name of the Company	% of FC claim in total claim amount	% of OC claim in total claim amount	% Amount received by FC in excess to % of their claim in total claim amount	% haircut accepted by OC as compared to their % claim in the total claim amount
1.	JBF Petrochemicals Limited	87.33	12.67	11.79	81.27
2.	Sona Alloys Private Limited	87.67	12.33	13.62	96.87
3.	Essar Steel India Limited	90.67	9.33	9.73	94.56
4.	Jaypee Infratech Limited	97.99	2.01	2.05	99.89
5.	Karaikal Port Private Limited	99.38	0.62	0.43	68.62
6.	Reliance Naval & Engineering Limited	97.12	2.88	2.81	94.76
7.	Vasan Health Care Private Limited	65.79	34.21	48.15	92.58
8.	SQL Star International Limited	19.20	80.80	418.32	99.39
9.	Sungracia Tiles Private Limited	73.81	26.19	32.58	91.82
10.	Mercator Petroleum Limited	84.80	15.20	13.38	74.66

Chart 1.2 Receipt of amount by FCs in excess to % of their claim in total claim amount and haircut accepted by the OCs in accordance to % of their claim in the total claim amount



The above chart specifies the huge gap between the amount paid to the FCs and the OCs compared to their percentage proportion in the total claim amount. The OCs are facing the huge burnt of haircuts in the CIRP.

CONCLUSION

The introduction of IBC marked a significant departure from the erstwhile frameworks that mostly favored secured creditors and provided control to the debtor and establishes a regime that prioritized the empowerment of the FCs with a key focus on optimal debt reduction and resolution of the company. However, it's high time to recognize the importance of addressing the concerns of the OCs, letting them have some skin in the game. The OC has no fault of its own and has been put into helpless position. The situation of OCs is that of the bleak and abandoned lenders. The OCs have faced many challenges while doing the business either of the bad debts and slow receivables. It is next to impossible to run a commercial unit without having OCs. The current framework is centered around the CoC wherein the interests of these creditors, who are the real brains behind the industrial setup, is often sidelined. OCs tend to find themselves in a vulnerable position in spite of playing a vital role in the functioning of commercial enterprises.

While the Code primarily caters with the needs of the FIs and banks, there is disparity in treatment of the OCs even when their liabilities are gigantic. Even after being the true architects behind the success of the industrial setups, they have been rubbed off the area under the Code. It may be worthwhile for regulatory authorities to revisit and refine the framework, ensuring an equitable and inclusive process that considers the diverse interests of all the stakeholders. As legal and economic landscapes evolve, continuous review and potential amendments to the Code could provide a more comprehensive solution that aligns with the broader goal of fostering a balanced and sustainable insolvency resolution framework for the benefit of all parties involved.

18

LITIGATION FUNDING: MAXIMISING VALUE

Shiv Anant Shanker, Ajanta Gupta and Ansh Gupta

ABSTRACT

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) provides a time bound resolution and liquidation process to avoid any depletion in value of resources and serve the creditors with maximised value. Noteworthy, considerable value of the insolvent entities locked in sundry debts, disputed claims, and assets underlying avoidance transactions remains unattended. The creditors are reluctant to invest their good money in doubtful assets. An insolvent entity barely has any appetite to fund to pursue or initiate legal proceedings. Although the possibility of success and recovery is also very unknown, avoidance trades do have potential to release enormous value. The creditors have now acknowledged that avoidance applications cannot be expected to be completed prior to adoption of a resolution plan due to the complexity, time-consuming, and in-depth fact-finding nature of avoidance transactions. To maximise the return to the creditors, it has been observed that developed jurisdictions allow third-party litigation funding (TPLF) in insolvency. Since litigation funding is relatively new in India, the present paper attempts to study the litigation funding in the context of insolvency in India, as a tool to maximise the returns of the creditors with respect to avoidance transactions and disputed claims.

Keywords: Third party Litigation Funding, Insolvency Litigation Funding, Avoidance Transactions, Contingent Assets, Not Readily Realisable Assets (NRRA), Maximising Value.

INTRODUCTION

The IBC provides a time bound resolution and liquidation process to avoid any depletion in value of resources and serve the creditors with maximised value. Noteworthy, considerable value of the insolvent entities locked in sundry debts, disputed claims, and assets underlying avoidance transactions remains unattended. The creditors are reluctant to invest their good money in doubtful assets. An insolvent entity barely has any appetite to fund to pursue or initiate legal proceedings. Although the possibility of success and recovery is also very unknown, avoidance trades do have potential to release enormous value. The creditors have now acknowledged that avoidance applications cannot be expected to be completed prior to adoption of a resolution plan due to the complexity, time-consuming, and in-depth fact-finding nature of avoidance transactions.

To maximise the return to the creditors, it has been observed that developed jurisdictions allow TPLF in insolvency. The most frequent application of TPLF in the context of insolvency is for avoidance actions, and property/disputed claims maintained by the estate that are generally very expensive to pursue.

RESEARCH OBJECTIVES

To address the foregoing issues, the present paper has been designed to:

- What is TPLF and how it works ?
- Present status of litigation funding in insolvency in India
- How does the insolvency litigation funding process work ? Study of framework for insolvency litigation funding across developed and creditor-in-possession jurisdictions
- Learning and takeaways: TPLF in the context of insolvency in India

WHAT IS THIRD-PARTY LITIGATION FUNDING (TPLF)?

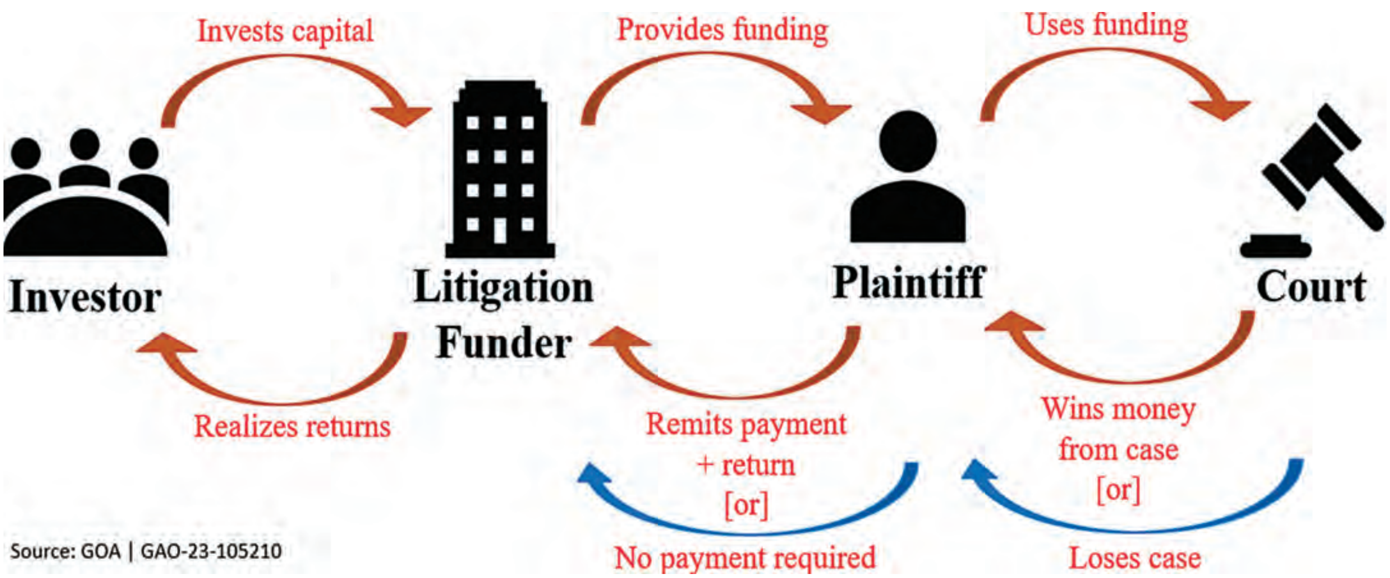
The terms "Third-party Litigation Funding", "Third Party Funding" or "Litigation Financing" are more widely used to refer to Litigation Funding Agreements internationally. TPLF is a system wherein a funder, who agrees to assist the litigant in funding the litigation but is not a party to it. It is the non-recourse financing of a party's litigation expenses by a funder in return for a certain percentage of the money rendered in the case, should it be successful. TPLF may pay for the costs of any kind of dispute resolution procedure, including mediation, arbitration, and regular court action. TPLF makes sure that there are equal opportunities for all parties and that insufficient resources won't jeopardise legal rights. American Bar Association describes this practice "*The funding of litigation activities by entities other than the parties themselves, their counsel, or other entities with a preexisting contractual relationship with one of the parties, such as an indemnitor or a liability insurer.*"

Traditionally, TPLF funders have only made individual case investments; however, there have been claims of an increase in TPLF "portfolio funding", which is said to involve money for several cases across various practice areas involving law firms. TPLF is typically separated into two categories: "commercial litigation financing", which includes cases like antitrust litigation, insolvency litigation, intellectual property actions, and business/corporate disputes;

and “consumer-litigation financing”, which typically entails funding for personal injury claims, divorce actions, and other non-commercial cases.

The TPLF practice originated in Australia in the mid-1990s and is still widely utilised there today.[1] Indeed, almost half of the federal class action lawsuits brought in Australia over the previous six years were funded by third parties, according to recent research.[2] In addition to Australia, TPLF is now a widely accepted practice in a number of other nations, such as the UK, Canada, New Zealand, South Africa and United States. The largest TPF funder in the world has an investment portfolio of approximately US$ 2.4 Billion. The Global Litigation Funding Investment Market was valued at US$ 10,916.3 million in 2018 and is expected to reach US$ 22,373.3 million by 2027 growing at a CAGR of 8.3%.[3] In the global landscape, several established players operate in the litigation finance space, including companies like Apex Litigation Finance, Burford Capital, Omni Bridgeway, and many others.[4]

HOW TPLF WORKS



A party to the suit first seeks a funder who will finance commercial litigation cases as financeable assets. The detailed and comprehensive information about the cases or claims are provided to the litigation funders. The legal staff will begin the cases’ due diligence. After doing a thorough investigation into the litigant’s case, the funder would present the litigant with a financing option that might involve funding a single case or a portfolio of several cases. The funder would take into account a number of factors, such as the potential receivables, the anticipated timeline, the risks involved, and the litigant’s “winnability”. The money thus supplied by the litigation funder are subsequently used to pay for the costs and expenses,

[1] Maya Steinitz, *Third Party Funding of Investment Arbitration,* Boston School of Law, https://scholarship.law.bu.edu/cgi/viewcontent.cgi?article=4444&context=faculty_scholarship.

[2] Jason Geisker and Dirk Luff, *The Third Party Litigation Funding Law Review 6th edition: Australia,* https://www.claimsfunding.com.au/news-and-insights/the-third-party-litigation-funding-law-review-australia/.

[3] https://www.liticap.com/wp-content/uploads/2021/10/LitiCap_Guide-to-TPLF_Final_EPDF.pdf

[4] Joel John, *Global Litigation Funding Investment Market Share Likely to Grow At a CAGR of 9% By 2033,* https://www.custommarketinsights.com/press-releases/global-litigation-funding-investment-market/.

and they are often given for a predetermined period of time. Such financing is generally given on a 'non-recourse basis' referring that the funder would be paid back from the proceeds of success but would not be entitled to any compensation in the event of an unsuccessful litigation. Subject to any agreed-upon timeline between the parties, litigation funding may be granted at any point throughout the proceedings and may continue until the resolution of any outstanding appeals and the implementation of the verdict.

MECHANISM FOR TPLF ARRANGEMENTS

(a) **Contingency agreements:** Contingency Agreements are retainer contracts in which the litigant and their lawyers take upon themselves the entire cost of the legal action (either through their own balance sheets or with help from lenders/ funders) and only get paid for their services if the lawsuit is successful.

i. **Conditional Fee Arrangements (CFAs):** CFAs are agreements whereby a lawyer / litigation funder and client agree that the lawyer will be paid only for their services if the lawsuit is successful. Such kind of agreements may stipulate that the lawyer / litigation funder will receive a percentage boost ("success fee") upon winning the case, up to 100% of the basic fees (typically permitted 25%) to compensate for the expense of the credit they have extended to the client and the potential risk of non -payment.These kinds of agreements are frequently referred to as "no win, no fee" contracts.

ii. **Damages-based agreement (DBA):** This arrangement allows the service provider to be paid a portion of the client's recovery under a damages-based agreement. In damages-based agreement (DBA), the client and the service provider share the risk of litigation. In this kind of arrangement, service provider's fee is determined as a percentage of the compensation (damages) and is not based on an hourly rate; rather, it depends on the outcome of the case. In case of low recovery from the losing party (case is won), the DBA percentage fee from recovered monies can be a sum considerably less than that which would have been payable on a ordinary retainer basis or pursuant to a CFA.

iii. **CFA with After the Event (ATE) insurance:** In order to protect themselves against having to pay the opponent's costs, in the event that they lose the case, parties may also opt to get ATE insurance. ATE policies can occasionally be purchased with "deferred and self-insured" premiums, which means that in the event that the case is lost, the insured party will not be required to pay the premium; rather, the insurance will take care of both the premium and any associated costs.

(b) **Assignment**: An assignment of a legal claim occurs when one party (assignor) transfers its rights in a cause of action (set of facts that give birth to a claim that is actionable in court/ recognised legal wrong that gives rise to a lawsuit) to another party (assignee).[5] Selling/ outright sale or assigning a cause of action is an alternative method for litigation funding.

[5] Black's Law Dictionary 136 (9th ed. 2009) (defining "assignment" as "the transfer of rights or property").

i. **Absolute Assignment:** Under absolute assignment, the assignee - the party to whom the assets are transferred will possess ownership of the assets and all associated rights. All legal rights, remedies, and the ability to terminate the action (by settlement, for example) without the assignor's intervention would be transferred as part of the assignment.

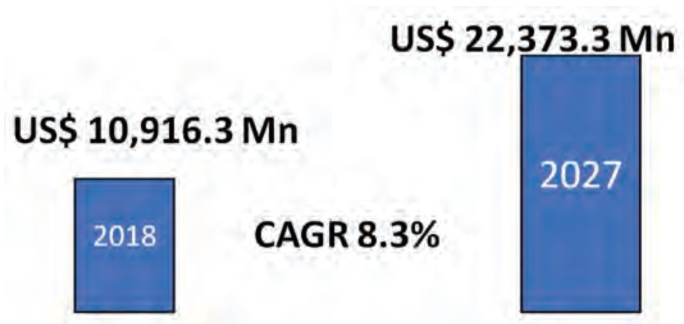
ii. **Assignment with Recompense Facility:** This option enables the assignor to assign the asset at the initial price. As per the terms of the engagement signed to enforce the assignment, assignee and assignor would split any further net discovery, that is, value realised less expenses spent throughout the recovery of the value above the initial price. When choosing an assignment agreement with recompense facility, the assignor must exercise caution in the terms of the agreement and take appropriate safety measures with regard to unsuccessful action such as sharing only in successful recovery and assignee bearing the costs of an unsuccessful action.

TYPICAL STRUCTURE OF LITIGATION FUNDING AGREEMENT

A typical Commercial Claim Funding Agreement[6] would include: background, definitions and interpretation, cooling off period, funding, claims for payments, reimbursable amount and additional sum, appeal of the proceedings, funder's indemnity, representative and conduct of proceedings, commencement and termination, representations and warranties by claimant, confidentiality and disclosures, notices, assignment, conflicts management policy, and amendments to the agreement etc. The schedule of this agreement involves filling in the following details: the claims description, the names of respondents and legal representatives, the investigative work details, the funding amounts for the proceedings and the enforcement work split between legal costs and disbursements, the additional sum specified as a multiple of the reimbursable amount or as a percentage of any resolution amount, and the same treatment for appeals, the amount for indemnity for an order for costs and security for costs, any condition precedents, and conflict disclosure.

TPLF IN THE GLOBAL CONTEXT

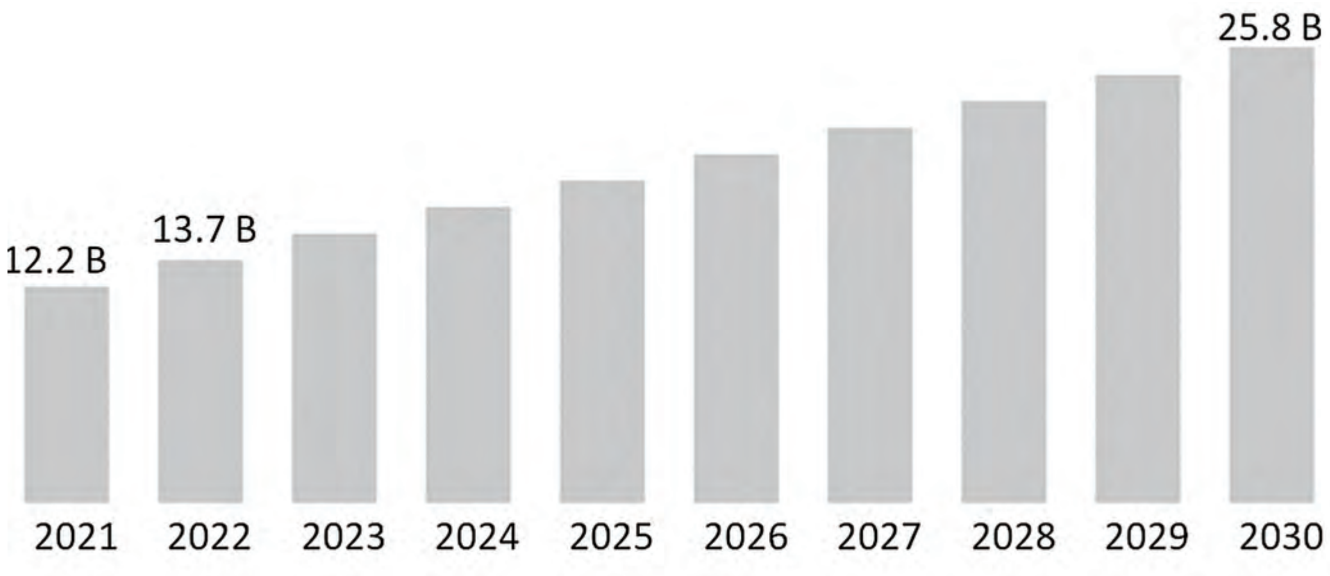
TPLF began in Australia in mid 90s and now matured in developed economies: US, UK, Australia, Singapore, and Hong Kong. The global litigation funding investment market was valued at:



Source: Guide to TPLF in India, Liti Cap

[6] Litigation Funding Agreement, https://www.sec.gov/Archives/edgar/data/925741/000143774920007637/ex_181285.htm.

Global Litigation Funding Investment Market 2021–2030



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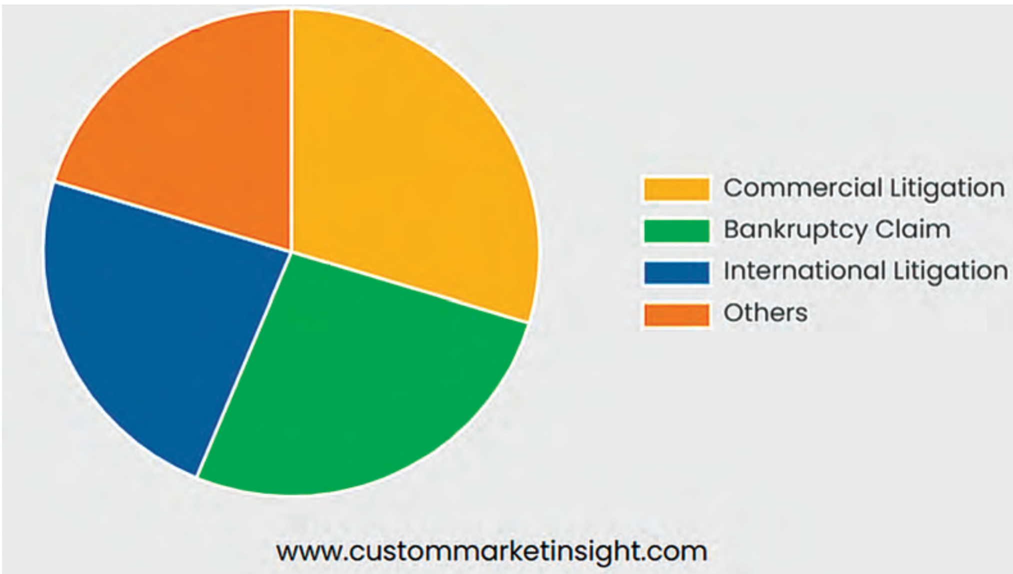
Global Litigation Funding Investment Market 2023–2032



TPL Funders: (a) Globally: Burford Capital LLC, Parabellum Capital, Bentham Capital, Juridica Investments, Woodsford Litigation Funding, Apex Litigation Finance, Omni Bridgeway etc. (b) Indian Start-ups: LitiCap, LegalPay, LegalFund etc.

LEGALITY OF TPLF IN INDIA

In India, litigation funding has been in realm of grey area. That being said, TPLF is not illegal in India. Guidance in this regard can be found in a Privy Council case from 1876, *Ram Coomar Coondoo v. Chunder Canto Mookerjee*. For facilitating access to justice, the court in this case approved TPLF, however it concluded that:

> Their Lordships think it may properly be inferred from the decisions above referred to, and especially those of this tribunal, that a fair agreement to supply funds to carry on a suit in consideration of having a share of the property, if recovered, ought not to be regarded as being, per se, opposed to public policy. Indeed, cases may be easily supposed in which it would be in furtherance of right and justice, and necessary to resist oppression, that a suitor who had a just title to property, and no means except the property itself, should be assisted in this manner.
>
> But agreements of this kind ought to be carefully watched, and when found to be extortionate and unconscionable, so as to be inequitable against the party, or to be made, not with the bona fide object of assisting a claim believed to be just, and of obtaining a reasonable recompense therefor, but for improper objects, as for the purpose of gambling in litigation, or of injuring or oppressing others by abetting and encouraging unrighteous suits, so as to be contrary to public policy, effect ought not to be given to them.

In addition to the fact that the concept of TPF has been acknowledged by Indian courts, the state legislatures of Gujarat, Madhya Pradesh, Andhra Pradesh, Orissa, Tamil Nadu, and Uttar Pradesh have formally recognised TPF through amendments to Order 25; Rule 1 of the Code of Civil Procedure, 1908 (CPC). In 1983, the Bombay High Court further modified Order 25; Rule 2 of the CPC, giving courts the explicit authority to collect litigation expenses by requesting that the third-party financer join the suit and deposit the costs with the court.

Post Hon'ble Supreme Court observation in *Bar Council of India v. AK. Balaji* (2018) that the litigation funding is gaining popularity-

> In India, funding of litigation by advocates is not explicitly prohibited, but a conjoint reading of Rule 18 (fomenting litigation), Rule 20 (contingency fees), Rule 21 (share or interest in an actionable claim) and Rule 22 (participating in bids in execution, etc.) would strongly suggest that advocates in India cannot fund litigation on behalf of their clients. There appears to be no restriction on third parties (non-lawyers) funding the litigation and getting repaid after the outcome of the litigation. In U.S.A., lawyers are permitted to fund the entire litigation and take their fee as a percentage of the proceeds if they win the case. Third Party Litigation Funding/Legal Financing agreements are not prohibited. In the U.K., Section 58B of the Courts and Legal Services Act, 1990 permits litigation funding agreements between legal service providers and litigants or clients, and also permits third party Litigation Funding or Legal Financing agreements, whereby the third party can get a share of the damages or "winnings"

Based on the Privy Council's 1876 ruling and the Supreme Court's observations in *AK Balaji's case*, it can be inferred that TPF agreements are recognised by Indian courts as long as the requirements of the Indian Contract Act, 1872 (ICA) are strictly followed and the third party is not alawyer. As to section 23 of the ICA, the funding should not be found by courts to be "opposed to public policy". Presently, there is no legislature regulating TPLF in India. However, the introduction of not readily realisable assets (NRRA) during liquidation under IBC is a step towards facilitating third party funding for maximisation of wealth for liquidating insolvent entities. But the nuances and uncertainties in assignment of NRRA left the value of such assets miniscule.

NEED FOR LITIGATION FUNDING IN INDIAN INSOLVENCY

(a) **Unrealised/ contingent assets of insolvency estate:** The IBC *inter alia* creates an ecosystem for maximisation of value of assets of a corporate debtor (CD) and balancing of interests of all stakeholders in a time bound manner. It is a duty of the Resolution Professional (RP) or Liquidator, during corporate insolvency resolution process (CIRP) or Liquidation process respectively to make best estimates of the valuation of the CD. The estate of the CD includes fixed and current assets (balance sheet item) and contingent assets (off-balance item). While some of these assets can be swiftly transformed into cash, others may take an extended period of time to realise due to their unique character or exceptional circumstances. These assets include sundry debts, reimbursements from the government and its agencies, disputed assets (such as those in which the legal title is unclear), claims (receivables) from litigation, as well as and assets underneath avoidance transactions. The CD will naturally depend on RP and its creditors to realise the contingent assets. However, when a business declares bankruptcy or enters a formal liquidation process, it may not have any assets that may be sold right once or cash on hand to start or carry out proceedings. Nevertheless, creditors avoid funding to realise these unrealized assets because of the unpredictable nature of court cases and their requirement for capital investments. Thus, potential financial assets in contingency remains unrealised and often seen as treating as nil assets, resulting in reduced value of the CD estate.

(b) **Funding avoidance transactions:** Most jurisdictions specify several procedures to challenge transactions entered into by a CD prior to the commencement of the insolvency proceeding. These procedures, generally known as claw-back actions or avoiding powers, which allow the retrospective avoidance of certain transactions. Thus, the existence of avoiding powers generate several benefits i.e., promote a fair and efficient insolvency system – which treats stakeholders equitably, minimises costs inherent to insolvency and maximises stakeholder's wealth. Further, such provisions address opportunistic, value-destroying behaviour generally faced by debtors who are in the zone of insolvency, ensuring thereby that the creditors as a whole are dealt equitably by allowing payments made or assets transferred under certain transactions to be reverted to the CD or their effect reversed. Thus, the presence of avoidance powers can aid in maximizing the value of the firm, not only *ex post* (i.e., once the CD is in insolvency) but also *ex ante*, as it may restrain market participants to enter into avoidance transactions with an insolvent debtor. Further, avoidance procedures are widely considered to be an important tool for the control of related party transactions under insolvency.

The Bankruptcy Law Reforms Committee (BLRC) which conceptualised the IBC discussed the possibility of identifying and recovering from vulnerable transaction. These are most likely to result from litigation seeking restitution for recognised vulnerable transactions and instances of fraudulent actions by the former entity's directors. However, these are extremely uncertain. The trade-off is between keeping the case open and accruing liquidation costs from Liquidator fees on the one hand, and closing the case, dissolving the entity but retaining the liquidation trust, so that any recoveries made can be deposited into the trust after deducting the Liquidator costs of managing these lawsuits. The Liquidator may request that the adjudicator terminate the case based on estimates of the time to recovery and the potential value of recovery from the vulnerable transactions. The costs that can be levied for recovering from vulnerable transactions will differ in structure. Here, the regulator will set a fee threshold. All expenditures expended above this threshold amount must be recovered from the case filed for the recovery of vulnerable transactions. As with the IRP for low or no asset cases, the regulator will require a Liquidator to provide her services free of charge for a minimum number of cases as part of the registration process. The Liquidator continues to handle cases involving vulnerable transactions. Whatever recovery are recovered are put in the Trust and distributed as dividends, net of legal fees.

The Code attempts to preserve commercial morality by incorporating provisions for avoidance of certain transactions, and penalising suspended directors' misconduct. Accordingly, the RP or the Liquidator is obliged under the Code and the regulations to file applications in respect of avoidance transactions or vulnerable transactions (preferential transactions, undervalued transactions, extortionate transactions, and fraudulent transactions) found by him during corporate insolvency resolution and liquidation processes to the Adjudicating Authority (AA) seeking appropriate relief permissible under the Code.

The AA may pass any or all of the following orders in the application dealing with avoidance transactions:

(a) *Order in case of preferential transaction (Section 44)*

- (i) property transferred to be vested with the CD;
- (ii) proceeds of the sale of property or the money so transferred to be so vested;
- (iii) release or discharge of any security interest created by the CD;
- (iv) pay any sum in respect of benefit received from the CD;
- (v) financial debt or operational debt of a guarantor to be revived or to be a new debt, where any such debt was released or discharged;
- (vi) providing security or charge on any property for the discharge of any financial or operational debt and also the same priority as a security or charge on the property, where security or charge released or discharged while giving priority; and
- (vii) extend to which a person whose property is vested in the CD or on whom financial or operational debt is imposed by order of the AA, to be proved in the CIRP or liquidation process.

(b) *Order in case of undervalued transaction (Section 48)*

- (i) property to be vested with the CD;
- (ii) release or discharge of any security interest created by the CD;
- (iii) pay any sum in respect of benefit received from the CD; and
- (iv) payment of such consideration for the transaction as determined by an independent expert.

(c) *Order in case of transaction defrauding creditors (Section 49)*

(i) restoration of the position as it existed before the undervalued transaction entered into by the CD under section 45(2); and

(ii) protecting the interests of persons who are victims of such undervalued transaction, where such transaction was entered into deliberately for keeping the assets of the CD beyond the reach of any persons entitled to make a claim against it or in order to adversely affect the interests of such persons.

(d) *Order in case of extortionate credit transaction (Section 51)*

(i) restore the position as it existed prior to the transaction;

(ii) set aside the whole or part of the debt created on account of extortionate transaction;

(iii) modify the terms of such transaction;

(iv) payment of amount received by any person to be paid back to the CD; and

(v) relinquish any security interest created as part of the extortionate credit transaction.

(e) *Order in case of fraudulent or wrongful trading (Sections 66 and 67)*

(i) make liable such parties to contribute to assets of the CD; and

(ii) any debt of such person to CD shall rank in priority under section 53 after all other debts.

Based on perusal and study of the orders delivered by AA pertaining to avoidance transactions filed, the following table highlights the *modus operandi* and the awards /relief granted thereto.

Avoidance Transaction	**Modus Operandi**	**Relief granted**
Preferential	1. Repayment of unsecured loan to companies owned/run by promoter family and their relatives	Restore transfer of ₹ 25.84 crore along with 12% interest to CD till the date of realisation.
	2. Repayment of unsecured loan to promoter/ director and shareholders of the CD	Respondents were directed to retore the amount of ₹ 51 lakh to the CD.
	3. Repayment of unsecured loan to related parties and unrelated parties	Respondents were directed to refund amount of ₹ 6.37 crore to the CD which shall be used for the payment of creditors and not to be paid to resolution applicant.

	4. Unexplained advances to related parties	Directors and one wife of director were directed to return the amount of ₹ 61 lakh.
	5. Operational debts settled through sale of land (vacant residential plots) by sale agreement	Set aside the transfer by sale agreement and required the property so transferred to be vested in the CD.
	6. Land of the CD in the name of promoter director	Erstwhile promoter director agreed to transfer the land lying in his name back to CD.
	7. Amount withdrawn during moratorium	Erstwhile director was directed to deposit ₹ 32 lakh along with interest at 12% from date of withdrawal.
	8. Amount realised from sale of assets used for payment of loan to unsecured financial creditors (FCs)(related parties) and the book entry by setting of one receivable from the related party with the liability of another related party	
	9. Assets of the CD was adjusted against the balance of creditors and directors submitted that erroneous entries signed inadvertently in the financial statements by oversight	Directed the directors to make contribution of ₹ 21 lakh within 2 months from date of order.
Under-valued	10. Hefty irregular discounts (even 100%) to operational debtors immediately before the commencement of the CIRP of the CD	Respondents/companies were directed to deposit the amount of ₹ 5.77 crore to CD within 3 months from date of order and same was not paid then recovered from amount equally from suspended board of directors.
Fraudulent	11. Loan in cash to directors ● Expenses paid in cash not recorded, qualified audit report – “Books of Accounts and documents not provided”. ● Transactions not recorded in accounting	Directors of the CD were directed to make contribution of ₹ 1.69 crore to the CD.

	system, mismatch of GST Returns ● Loan and advances written off/adjusted to other parties; ● Sundry debtors written off ● Interest income reversed.	
	12. Directors/Company Secretary not prepared to divulge the information where such amount of ₹ 33 crore disappeared	Directions were issued to SFIO to investigate.
	13. Deviating from the object clause: Like CD engaged in manufacture of food products and beverages and launched a collective investment scheme and collected money ₹ 37 crore from public at large. The investment scheme was stopped abruptly without repayment of the deposit collected from public. Amount was illegally transferred/siphoned off from the CD to related parties and cash withdrawal by ex/suspended director of the CD	Respondents were directed to contribute jointly and severally ₹ 26.87 crore to the CD within 2 months and if failed to pay, then same shall be realised from their personal properties. Applicant was directed to institute criminal prosecution.
	14. ● Entire job sales to related parties resulted in receivables were adjusted to fictitious expenses entries. ● Repayment of loan to directors, loan taken by the CD and diverted to directors (by money and adjusting entries) ● Inflated debtors and incorrect book-debts and stock statements - difference in receivable in audited financial statement and submitted to bank, stock/ inventory written off on account of fire, 10 times of the fire loss assessed by fire insurance survey report. ● Amount involved ₹ 91 crore	Respondents were directed to return the syphoned money and benefits received to the CD. Failure to comply with order will push the Bench to take penal actions under section 70-73 of the IBC.
	15.Amount involved ₹ 13 crore ● CD has made huge amount of loan and advance payment torelated parties which are pending due since long time to the tune of ₹ 6 crore. ● Consulting expenses of ₹ 27 lakh paid through cash without charging GST and TDS deduction. ● CD has diverted its loan fund toacquire land and the same land has been mortgaged to another Bank for loan of ₹ 5 crore	Respondents were directed to return the syphoned money and benefits received to the CD. Failure to comply with order will compel the Bench to take penal actions under section 70-73.

	16. Amount involved ₹ 106.19 crore ● Diversion of funds to related entities/ unrelated parties in the form of interest free loan, personal expenses like purchase of gold, wedding expenses incurred from the account of the CD. ● Misappropriation of assets of CD – vehicles recorded in the B/s of the CD found registered in the name of third parties. ● Unreasonable reduction in value of land in the books of CD and interest on residential properties of directors paid from the account of CD	Directed the suspended directors to deposit the amount of ₹ 106.19 crore with AA within 2 months which shall be used to pay creditors.
	17. ● Manipulation in stock and material consumption to the tune of ₹ 5 crore and sold in cash. ● Misappropriation of funds under related party transactions i.e. to promoter cum ex-director/ son of director of the CD of through suspense account credit ₹ 3 crore ● Doubtful recovery from sundry debtors ₹ 2.2 crore ● Electricity expenses overstated ₹ 21 lakh; ● Diversion of money through excessive remuneration to KMP including their relatives to the tune of ₹1.89 crore ● Excessive charge being abnormal and doubtful expenses to the tune of ₹ 5.9 crore ● Withdrawal of money from CD and bogus entries booked adjusted unsecured loan from directors for ₹ 4 crore; ● Trade payables outstanding and negative cash balance ● Continuous sale and purchase of fixed assets; Miscellaneous balances written off ₹ 1.85 crore ● Concealment of statutory dues ₹ 29 crore ● Adjustments in the books of accounts post initiation of CIRP for ₹ 8 crore ● Fund diverted through non-show of actual sales consideration ₹ 50 lakh ● Amount involved ₹ 29.76 crore	Respondents were directed to contribute ₹ 29.76 crore to the CD within 2 months. Applicant was directed to institute criminal prosecution

It is clear from the above that the Code provides civil remedies in respect of avoidance transactions. While the RP may have filed an application with the AA based on his determination, it may not always be possible for the AA to consider and dispose of the application during the tenure of the CIRP or the liquidation process. The application may remain pending with the AA for disposal, when the corporate insolvency resolution/ liquidation process comes to an end.

Section 26 of the Code clarifies that the filing of an avoidance application by the RP shall not affect the proceedings of the CIRP. Accordingly, avoidance applications can go on concurrently with the CIRP and even after it has ended. They are also said to be independent of it. Achieving a rapid resolution for the CD while maximising asset value is the aim, Section 26 segregates the resolution process and avoidance adjudication. However, in the case of *Tata Steel v. Venus Recruiter*, Single Bench of the Delhi High Court had decided that an avoidance application's validity expires at the end of the CIRP and cannot be reviewed after it is finished. The Insolvency Law Committee[7] discussed the issue raised in *Venus Recruiters* and, taking into account the significance of section 26 of the Code, recommended that proceedings pertaining to Preferential, Undervalued, Fraudulent and Extortionate (PUFE) transactions be treated independently of the CIRP and can continue post CIRP. On June 14, 2022, Regulation 38(2)(d) was added to the CIRP Regulations. Under this regulation, a resolution applicant was required to specify in the resolution plan how the PUFE transaction proceedings would be handled following resolution plan approval as well as how any proceeds from those proceedings would be allocated. The Division Bench of the Delhi High Court ruled that "*the Scheme of IBC makes it clear that Avoidance Applications and CIRP are a separate set of proceeding*" and Avoidance Applications can be continued post completion of CIRP. With regard to beneficiary of avoidance transactions, the court held: "*This is public money, and therefore, the amount that is received if and when transactions are avoided and receive the imprimatur of adjudicating authority must be distributed amongst the committee of creditors in a manner determined by the adjudicating authority*."

Although the dilemma of continuance of avoidance transactions post completion of CIRP has been ironed out, a new jurisprudence by the Hon'ble Supreme Court[8] with regard to impleadment of third party under section 66 of the IBC has limited the scope of remedy and recovery thereto. The SC held that the remedy against third party is not available under section 66 of Code, and in such circumstances, it is for the RP or the successful resolution applicant (SRA) to take such civil remedies against the third party(ies) for recovery of dues payable to CD, and the civil remedies which may be available in law are independent of the aforesaid section (Para 10).

As per IBBI quarterly newsletter for January-March, 2024, claims of more than 3.1 lakh crore of rupees (₹ 3.1 trillion) filed as avoidance applications are pending at various National Company Law Tribunals (NCLTs) under the IBC in India.

[7] In its fifth report, which was released in May 2022.

[8] Gluckrich Capital Pvt. Ltd. vs. The State Of West Bengal & Ors., 19th May 2023.

Details of Avoidance Applications and Disposal

(Amount in ₹ crore)

Sl.	Nature of transactions	Applications Filed		Applications Disposed		
		Number of transactions	Amount involved	Number of transactions	Amount involved	Amount clawed back
1	Preferential	195	29834.26	65	1331.18	38.27
2	Undervalued	36	1810.59	5	362.42	5.77
3	Fraudulent	326	111053.30	58	2924.42	1050.93
4	Extortionate	4	75.65	1	0.09	-
5	Combination	676	228168.47	163	47120.54	5504.23*
	Total	**1237**	**370942.27**	**292**	**51738.65**	**6599.20***

*In the matter of Jaypee Infra, possession of 758 acres out of total 858 acres of land was given back to the CD. The 858 acres of land was earlier valued at ₹ 5500 crore.

The creditors are suffering significantly as a result of the ambiguity and delay in adjudicating avoidance transactions. Stakeholders are unlikely to be encouraged to invest resources in pursuing these measures as a result, especially given how uncertain and time-consuming the outcome seems to be. Currently, in both the CIRP and the liquidation procedures, creditors are only recovering, on average, a small portion of their claims. Avoidance applications can be a valuable tool for creditors to increase collections if they are handled quickly, particularly in cases involving high-value assets.

It is pertinent to note that the views of the Insolvency Law Committee. The Committee noted that difficulties with a lack of funding for such proceedings have also arisen in India. As a result, it examined some of the most common funding methods used around the world. The Committee suggested the various ways of funding the avoidance transactions such as *Debtor's Estate, State support, Funding by creditors and third parties etc*. The Committee suggested that such actions should typically be funded from the debtor's inheritance and the CoC establish a dedicated fund for pursuing litigation, including avoidance actions, against the corporate debtor where such funds are available. With regard to state funding, the Committee recognised that it may not be acceptable to sponsor such lawsuits with public funds in India. Further, in some cases, insolvency practitioners may be able to persuade specific CoC to fund the litigation for such actions, either before or after the resolution plan is finalised. Creditors may also be unwilling to support the litigation if they do not expect a corresponding return, and reaching a financial mechanism that is acceptable to all creditors may be difficult. Furthermore, bankruptcy practitioners approach third parties to fund such litigation. The Committee further noted that the recent Supreme Court decision in *Bar Council of India v. AK Balaji* indicated that there is no legal barrier to third-party lawsuit funding in India. It was stated that funding lawsuits by creditors or third parties is a commercial decision. As a result, the market may be responsible for providing this cash. The Committee addressed how funding for such measures could be entrusted to the market.

NRRA under liquidation process sets a glimpse of the litigation funding under IBC. Section 36(3)(f) provides that the liquidation estate shall comprise any asset or their value recovered through proceedings for avoidance of transactions. Regulation 37A of the Liquidation Process Regulations allows the liquidator to assign or transfer a NRRA - not readily realisable asset (contingent or disputed assets and assets underlying avoidance proceedings) through a transparent method, in consultation with the stakeholders' consultation committee (SCC). The Liquidators have issued notifications about the assignment of NRRA in a number of cases. Few such auction notices are tabulated as under:

Sl.	**Name of the CD under liquidation**	**Issue of Notice Auction**	**Nature of Assets to be Auctioned**
1.	Y M Foodways Private Limited	22.04.2022	NRRA - Underlying proceedings of application IA- 1328/2022 filed under section 25(2) (j) read with section 66 of the IBC, 2016
2.	Growthways Trading Private Limited	30.06.2022	NRRA – (a) Trade Receivables, Long Term Loans & Advances, Short Term Loans & advances, Deferred Tax Assets (b) Application submitted before NCLT Court for Transaction Audit Report U/s 66 of IBC, 2016
3.	Siddhi Vinayak Logistic Limited	23.11.2022	NRRA- (a) Receivables (1098 debtors) amounting to approx. ₹ 66 crore (b) 1344 Vehicles attached by ED (c) Section 66 application filed by Liquidator where the amount involved is ₹ 423.39 crore
4.	Tybros (India) Tours Private Limited	20.03.2023	NRRA- Current Assets - Trade Receivables, Short Term Loans & advances, Other Current Assets. Applications submitted before NCLT Court of Transaction Audit u/s 43 and 66 of IBC, 2016
5.	Cauvery Power Generation Chennai Pvt Ltd	18.04.2023	Assignment/Transfer of NRRA, being applications filed for avoidance transactions before Hon'ble NCLT, Chennai
6.	MKY Construction Private Limited	15.06.2023	Assignment of litigation and contractual rights in outcome, for

			application for avoidance of preferential and undervalued transactions filed before Hon'ble NCLT. Assignment of Rights of following financial assets of the CD such as trade receivables, short term loans and advances
7.	Exclusive Overseas Private Limited	06.07.2023	Assignment of all rights and interests of the CD including the right of litigation, if any in the pending avoidance transactions proceedings before Hon'ble NCLT
8.	Sab Global Entertainment Media Private Limited	12.02.2024	Rights for program content of varied nature expiring around March 2025. Relief / recovery in applications filed pursuant to section 43 & 66 of IBC 2016 (Applications pending for adjudication) - PUFE Transactions

It is observed that while dealing with the issue of when NRRA be transferred to third party under Regulation 37A, Hon'ble NCLT[9] held that the debt can be assigned once the demand has been crystallised, or when the avoidance/PUFE processes have been completed. It is only possible to assign or transfer to a third party the assets that have crystallised in accordance with the order passed in avoidance/PUFE petitions. The issue that arises for consideration is who will fund the litigations expenses to take avoidance application to their logical conclusion.

At the same time, IBBI floated the discussion paper dated 20.10.2023 *inter alia* dealing with Regulation 37A which provides that a liquidator may assign or transfer a not readily realisable asset through a transparent process, in consultation with the SCC in accordance with Regulation 31A, for a consideration to any person, who is eligible to submit a resolution plan for insolvency resolution of the CD. Further, it has been explained that an NRRA may also include assets underlying proceedings for preferential, undervalued, extortionate credit and fraudulent transactions. Dissolution of the CD, while there is a possibility to recover some value which is lying in NRRA, is against the interest of stakeholders. On the other hand, if the dissolution is kept pending for want for realisation of such assets, the liquidation process cost gets accumulated on continuous basis, while the value of the assets keeps on depreciating with time. Presence of substantial NRRA in liquidation estate creates a situation of stalemate. Hence, it might be worthwhile that the Liquidators should be able to assign the proceeds out of avoidance application after due process even before its determination by AA. The discussion proposed that "*A liquidator may assign assets underlying proceedings for preferential, undervalued, extortionate credit and fraudulent transactions referred to in sections 43 to 51 and section 66 of the Code even before the adjudication of such proceedings by the AA*".

[9] Inquest Fintech Pvt. Ltd. vs. Ms. Maya Gupta Liquidator Rain Automotive India Pvt. Ltd. (IA-35/2022, IA-36/2022, IA-57/2022 in Company Petition No. (IB)-1095(ND)/2019), 11 August 2023.

INSOLVENCY PROFESSIONALS AND INSOLVENCY LITIGATION FUNDING

It is the duty of Insolvency Professional (IP) to deal with potential legal action and how to realise the value of a cause of action that could be taken to the advantage of a company's creditors. The IP must be knowledgeable with the case's specifics. The insolvent estate might contain enough money to support a lawsuit (as well as the potential expense). If IP applies appropriate business judgement, evaluate whether they would risk internal resources in the manner intended, and monitor costs to make sure they are reasonable, he may lawfully utilise those funds to take action in such situations. Alternately and far more frequently in an insolvent estate, it can be out of funds. It will be crucial to take into account the various possibilities regardless of whether financing is accessible for the insolvent estate. Before filing a lawsuit or designating a cause of action, the IP may find it prudent to consider the opinions of the creditors and sometimes necessary approval of the Court. The possible options[10] can be do nothing or ask the creditors to fund the action/enter into funding agreement/ assignment to third party.

RECENT EMERGENCE OF THIRDPARTY LITIGATION FUNDING IN THE CONTEXT OF INSOLVENCY ACROSS JURISDICTIONS

Development of insolvency litigation financing in the UK

The 1986 Act was long preceded by the statutory authority to assign bare causes of action in an insolvency environment. In *Seear v. Lawson* (1880) 15 Ch. D. 426, 433, the Court of Appeal examined the reasons why a trustee in bankruptcy would want to assign a claim as "If the trustee gets a right of action, why is he not to realise it? The proper office of the trustee is to realise the property for the sake of distributing the proceeds among the creditors. Why should we hold as a matter of policy that it is necessary for him to sue in his own name? He may have no funds, or he may be disinclined to run the risk of having to pay costs, or he may consider it undesirable to delay the winding up of the bankruptcy until the end of the litigation".

It is proper for a liquidator to assign a cause of action to a party who has the financial means to prosecute such action, as the House of Lords confirmed in *Circuit Systems Ltd. and Anr. v. Zuken-Redac* (U.K.) Ltd. and *Norglen Ltd and Ors. v. Reeds Rains Prudential Ltd and Ors.* (1997):

> The law is traditionally hostile to the assignment of causes of action in return for a share of the proceeds. Such transactions were described as champerty (division of the field) and regarded as illegal and unenforceable. It is unnecessary to examine the reasons: judges said that it would encourage malicious suits, but treating such arrangements as criminal was also, before the introduction of legal aid, an effective way of preventing poor people from obtaining legal redress. The position of liquidators and trustees in bankruptcy is however quite different. The courts have recognised that they often have no assets with which to fund litigation and that in such case the only practical way in which they can turn a cause of action into money is to sell it, either for a fixed sum or a share of the proceeds, to someone who is willing to take proceedings in his own name. In this respect they are of course no different from many other people. But because trustees and

[10] Insolvency Litigation Funding - In the Best Interests of Creditors? By Professor Peter Walton, University of Wolverhampton.

liquidators act on behalf of creditors, the courts have for the past century construed their statutory powers as placing them in a privileged position.

The Small Business, Enterprise and Employment Act, 2015 added a new section 246ZD to the Act on March 26, 2015. Before this change, office holders were allowed to assign causes of action that belonged to the firm, but not personal causes of action that belonged to them. Where the liquidation or administration began on or after October 1, 2015, section 246ZD of the Act permits the liquidators and administrators to assign the rights of action:

246ZD Power to assign

(1) This section applies in the case of a company where— (a)the company enters administration, or (b)the company goes into liquidation; and "the office-holder" means the administrator or the liquidator, as the case may be. (2) The office-holder may assign a right of action (including the proceeds of an action) arising under any of the following— (a)section 213 or 246ZA (fraudulent trading); (b)section 214 or 246ZB (wrongful trading); (c)section 238 (transactions at an undervalue (England and Wales)); (d)section 239 (preferences (England and Wales)); (e)section 242 (gratuitous alienations (Scotland)); (f)section 243 (unfair preferences (Scotland)); (g)section 244 (extortionate credit transactions).

Before 2015, a typical third-party insolvency funder would attempt to take an assignment of any company activities and would provide financial assistance for an office holder action, contingent upon its own evaluation of claims presented to it. A funder will now typically look to take an assignment of any cause of action since it then controls how the action is progressed and whether and when it is settled. This is because changes to the law in 2015 made it possible for office holder actions to be assigned.

Litigation funders are not required to obtain a licence from the Financial Conduct Authority under the Financial Services and Markets Act, 2000. The Voluntary Association of Litigation Funders has a code of conduct that sets minimum financial requirements for its members as well as some guidelines. It doesn't seem like the courts have considered the code of conduct into account. Funders have typically operated on a three-to-one capital commitment when sponsoring an initiative. They might make more money if they accept an assignment. The amount that a funder may get paid or keep from the net revenues of a successful case is not capped. The funder and the office holder will have to negotiate the terms of the funding or assignment. Under a CFA agreement, the amount of money solicitors may claim on their uplifts is limited. Only 100% of the attorney's fee may be claimed as a premium (in addition to their charge). Before signing a retainer agreement with the attorney, the percentage uplift will be discussed and agreed upon.

When it comes to choices, an office holder usually has these options: (i) to run the legal action on a CFA with adverse costs insurance (ATE insurance), in which the CFA permits a 100% increase in attorneys' fees, and ATE premiums often are only due if the lawsuit is successful, (ii) finance the action through the use of a litigation funder being accepted in return for a portion of the profits by the office holder, or (iii) assign the right of action to an outside sponsor. Office holder proceedings could not be allocated prior to 2015, although company insolvency actions might frequently be assigned to a third-party funder. Assignments of both company and office holder actions have been allowed since the option to assign office holder actions was introduced in 2015. Nowadays, the majority of funders would rather accept an assignment of any action with the estate receiving a portion of the net earnings. Shortly after insolvency office holder actions became assignable in 2015, the separate recoverability of the uplift and the ATE premium in insolvency litigation was eliminated in 2016.

A report "P Walton, Insolvency Litigation Funding – in the best interests of creditors? (April 2020)" commissioned by Manolete plc with the support of the Insolvency Practitioners Association and the Institute of Chartered Accountants in England and Wales states that the market for funders became more active as a result of these changes; in 2015, it made up less than 10% of the insolvency litigation market, but now it accounts for about 50% of it. Although there isn't a single list of funders, 60 to 80 would be a fair estimate. According to recent empirical research, the following categories of actions are commonly conducted by insolvency practitioners with the assistance of a third-party funder, and the occurrence of each sort of action is suggested as a percentage: A director's loan nonpayment is 29%; a director's duty violation is 20%; a director breach is 15%; a transaction at an undervalue is 13%; a voidable preference is 9%; an unlawful dividend is 7%; wrongful trading is 4%; and other miscellaneous 3%.

In *Tradition Financial Services Ltd v. Bilta (UK) Ltd and others* [2023] EWCA Civ 112, UK[11] Court of Appeal expanded the scope of provision in the context of fraudulent transactions and held that under section 213 Insolvency Act, 1986, liquidators may bring claims against third parties suspected of being a party to fraud, even if they do not exercise management or control over a company, as long as they are involved in carrying on a fraudulent business. The capacity of the liquidators to recover money for the creditors of dishonest enterprises is strengthened by this ruling, and for the parties accused of dealing with a corporation that was operating fraudulently, they should be aware that they could become the target of claims.

Development of insolvency litigation financing in Australia

Australia recognised the legitimacy of lawsuit funding in a bankruptcy environment in 1996, based on certain principles of insolvency law. The laws governing insolvency in Australia give rise to a wide range of provisions, including the statutory ability of the insolvency practitioner to sell assets, whether acting as a liquidator in the case of corporate insolvency or as a trustee in bankruptcy. Using these clauses as support, the court determined in *Re Movitor Pty Ltd (rec and mgr apptd) (in liq) v. Sims* (reported in 1996) that a Liquidator may contract with a third party to transfer an insolvent company's right of action, signifying that "*the reason why the sale of a bare right of action by a trustee in bankruptcy or a liquidator does not involve maintenance and champerty is that, being a sale under statutory authority, to do that which Parliament has authorised, either expressly or by necessary implication, cannot involve the doing of anything that is unlawful*".

Following *Re Movitor Pty Ltd* (rec and mgr apptd) (in liq), a number of rulings supported this strategy, which in the end led to the widespread adoption of litigation finance with regard to insolvent litigation. The use of lawsuit finance was expanded when the High Court, in *Campbells Cash and Carry Pty Ltd v. Fostif Pty Ltd*, endorsed it by a resounding majority in a situation

[11] Dechert LLP, *UK Court of Appeal indicates that victims of Fraud can target Third parties,* https://www.dechert.com/knowledge/onpoint/2023/3/uk-court-of-appeal-indicates-that-victims-of-fraud-can-target-th.html#:~:text=Under%20section%20213%20Insolvency%20Act,control%20of%20the%20insolvent%20company.

other than insolvency. The use of commercial lawsuit funding in bankruptcy appears to be rather widespread, based on the number of recorded judgements in which court approval is requested for an insolvent litigation funding arrangement. In *Jarbin Pty Ltd v. Clutha Ltd* (2004) NSWSC 28, the Supreme Court observed that:

> It is now well established that a liquidator's power of sale of the property of the company, under section 477(2)(c) Corporations Law, enables him or her to assign all, or part, of a cause of action of the company in return for a consideration, which might be a fixed payment, a share of any net proceeds of the action, or a consideration arrived at in some other way, and such assignment may be made without infringement of the law concerning maintenance and champerty.

A new schedule to the Corporations Act of 2001 called Schedule 2 - Insolvency Practice Schedule (Corporations) (Schedule) was created by the Insolvency Law Reform Act of 2016. Administrators and liquidators, sometimes known as external administrators, were permitted to transfer any lawsuit rights granted to them under the Corporations Act of 2001 on March 1st, 2017. Before the change, personal causes of action including avoidance transactions and allegations of insolvent trade were not assignable, even though causes of action vested in the firm were. Following the incorporation of the Schedule, which stipulates that:

> 100-5 External administrator may assign right to sue under this Act (1) Subject to subsections (2) and (3), an external administrator of a company may assign any right to sue that is conferred on the external administrator by this Act. (2) If the external administrator's action has already begun, the external administrator cannot assign the right to sue unless the external administrator has the approval of the Court. (3) Before assigning any right under subsection (1), the external administrator must give written notice to the creditors of the proposed assignment. (4) If a right is assigned under this section, a reference in this Act to the external administrator in relation to the action is taken to be a reference to the person to whom the right has been assigned.

The Corporations Act 2001 has statutory requirements requiring creditor or court permission for arrangements established by liquidators with terms longer than three months. This has given the court the ability to "approve" litigation-funding agreements. Consequently, there is now a system of "judicial oversight" over lawsuit funding agreements involving insolvent parties. The court's introduction of a set of common law standards or principles that will be taken into account when authorising insolvent lawsuit funding arrangements has helped to fill the "regulatory gap" to some extent. These usually concern things like the likelihood that the proposed lawsuit will succeed, potential oppression, the type and complexity of the claim, the extent to which the liquidator has looked into alternative sources of funding, the amount of the funder's premium, talks with creditors, and the risks associated with the claim.

An examination of how these principles have been used by the court in situations when approval is requested for an insolvent litigation funding agreement seems to show a readiness to genuinely address issues related to the use of litigation financing. This feature may assuage some fears, as will the court's suggestion that it will carefully review the proposed deal rather than just "rubber-stamp" whatever the Liquidator puts before it. The court has made it clear, though, that the standard for approval under section 477(2B) of the Corporations Act 2001 does not entail making a business decision regarding the terms of the agreement; rather, it merely calls for an evaluation of whether the liquidator's decision to enter into the litigation funding agreement was a proper exercise of his or her authority and was not unwise or improper. The Court supervision of lawsuit funders is not included in the scope of judicial engagement in litigation funding; rather, it is limited to the approval of litigation funding agreements. Therefore, the court refrains from acting as a "litigation funding regulator."

With the enactment of legislation stating that these organisations are governed by the financial services regulatory regime, litigation funders have been subject to numerous new official regulatory measures as of July 2020. As a result of these regulatory actions, lawsuit funders had to comply with the provisions of the Corporations Act 2001's Managed Investment Scheme (MIS) regulatory framework by obtaining an Australian Financial Services Licence (AFSL). Proposed reforms include removing the necessity for AFSL, product disclosure, and the Corporations Act 2001's anti-hawking and litigation funding schemes from the MIS regulatory framework. At this point, it seems likely that these modifications will be approved, so litigation funders won't be governed by any official regulations.

Finally, Best Practice Guidelines are provided by the Association of Litigation Funders of Australia (ALFA), which lays out expectations for its members' conduct. The standards' impact is questionable due to two factors: *firstly,* they are not legally required, and *secondly,* it appears that ALFA does not have a large membership base. For instance, among the association's members aren't the two biggest companies in the Australian market, Omni Bridgeway Limited and Litigation Capital Management Ltd. (LCM), who combined account for almost 50% of the revenue share.

The lawsuit funding agreements usually provide that the lawsuit funder will get payment for its out-of-pocket expenses during the proceedings as well as a premium or commission to offset the risk the funder assumed. A multiple of the lawsuit funder's expenses, a percentage of the money recovered, or the higher or lower of any of these sums is how the premium or commission is determined. In addition to the funder's commission, a litigation funding agreement may additionally include a "project management fee" and/or a "settlement administration fee," if applicable. Currently, there isn't a law or rule that specifically caps the fees lawsuit funders may charge. In theory, if the funding premium is deemed "unfair," Australian courts have the authority to invalidate a litigation financing agreement on the grounds of "equitable" contract law criteria such illegality, unconscionability, and public policy.

There are several ways to finance insolvency proceedings, the most obvious being with corporate funds. A genuine barrier, though, can be a lack of money to pursue legal action when a business is in insolvent liquidation. In some cases, additional financing sources for litigation could be taken into consideration. These include conditional cost agreements, the Assetless Administration Fund (AA Fund) (supported by the government), funding provided by creditors in exchange for priority, and funding for commercial litigation. The AA Fund's mission is to assist proceedings in businesses that have little or no assets. The AA Fund offers three different grant categories, each of which follows a set of "Guidelines". These include grants for director banning, asset recovery, and other matters. The kinds of funding that are offered suggest that recovery and enforcement actions are the main priorities. Grant guidelines stress wrongdoing much more. A professional in insolvency may also bargain with the company's creditors to obtain an indemnification for court expenses. Section 564 of the Corporations Act 2001 provides an incentive for creditors to take action, as it grants the court the option to grant certain creditors preference over others with regard to property that is recovered through a successful action. Additionally, the insolvent corporation and the attorney may agree to a "no win-no fee" costs arrangement to financially support the insolvency litigation. In that case, the attorney consents to not bill for his services unless and until a favourable result is achieved. A commercial litigation funder may be approached by an insolvency practitioner alone or in conjunction with a "no win – no fee" expenses agreement as the last resort for providing financial support for insolvent litigation.

LEARNINGS AND KEY TAKEAWAYS

Post consultation with various stakeholders of the IBC ecosystem such as creditors, IPs handling the assignments as RP and Liquidator, advisors and lawyers etc., it has been understood that there is a need to re-evaluate how to deal with the avoidance transactions for maximising the value to the creditors. One on one interviews were conducted, a questionnaire was prepared and feedback from IPs in various meeting organised by IPAs and IBBI were considered. Based on the above, the following learnings and takeaways have emerged to tap the untap potential in various contingent assets through third parties:

(i) Information asymmetry

(a) **Expectations of funders:** Litigation funders need certain information from the IP in order to help them evaluate the claim. These include supporting documentation, a synopsis of the claim, the pleadings, significant documents like letters of demand, correspondence between the parties, and written advice from advocates, an estimate of the costs of the litigation up to a fully contested hearing, and the asset searches that have been conducted for the proposed defendants. Funders expect that the expenses incurred throughout the claim's prosecution are commensurate with its expected recovered value. Litigation funders use these factors when determining whether to finance litigation: responsibility, claim merits, quantum, recoverability, litigation costs, and any unique aspects of the case.

(b) **Assessment of contingent assets:** Depending on the situation, a number of techniques can be used for valuing contested or contingent assets or avoidance claims in insolvency estate. These consist of the probability discount, the standard valuing of future earnings, etc. From the perspective of the debtor, creditor, or parties in interest, determining the value to be assigned to a contingent estate litigation claim and allocating it are crucial decisions.

(c) **Contingents assets and avoidance transactions to be part of information memorandum and availability of records in virtual room:** Amount to be recovered from the disputed claims and avoidance transactions application etc. are also assets of the CD and may fetch value in the resolution plan. IP is responsible for accumulating relevant information from the CD and scrutinising its affairs to trace avoidable transactions or transactions amounting to wrongful or fraudulent trading. Details of avoidance transactions should be part of information memorandum prepared under Regulation 36 of the CIRP Regulations and records should available for third party funders in virtual room for assessment.

Insolvency Professional Agencies (IPAs) and their parent bodies have been trying to standardise the formats for capturing the value lying in the avoidance applications/ assessment of avoidance /audit reports etc. It is pertinent to suggest that a standardised format for capturing the information related to avoidance transactions is issued for the guidance of IPs. Information related to avoidance transactions which can be further utilised by the assignees or litigation funders to ascertain the value(s) that would fructify at a future date.

(d) **Templates for avoidance application:** To prevent uncertainty and delay, the interim resolution professional, RP, Liquidator(s), CoC, and auditors must work on the proofs and evidence with proper documentation. It is necessary to create avoidance application templates that include avoidance transactions within the look-back period along with documentary proofs and evidence. A standardised template would assist the Adjudicating Authority to adjudicate the avoidance transactions and also the Funder to value the assets underlying in avoidance transactions.

(e) **Engagement of insolvency asset tracker agencies**: Insolvency asset tracker agencies utilize forensic accounting techniques to trace assets that may have been transferred or hidden to avoid creditors' claims and conduct thorough investigations by money trails, identifying offshore accounts, and uncovering any attempts to dissipate assets. They analyze various documents, including financial records, transactions, bank statements, contracts, invoices, and communication records to identify any suspicious or irregular transactions. These agencies can be engaged by the RP/liquidator in consultation with the CoC/SCC with no cost contribution and sharing of proceeds, if any.

(ii) Balancing stakeholder interest

(f) **Focussed deliberations with Creditors:** CoC/SCC to make informed decisions regarding theses contingent assets including avoidance transactions. CoC/SCC should seek information and reports on such claims/assets on priority and explore various innovative mechanism to maximise the value of the CD, such as:

a. **Litigation trust:** The litigation trusts are a relatively new creature, they are becoming more common as a category of litigants because their sole purpose is to pursue litigation post conclusion of the insolvency process. These trusts are commonly used when debtors have significant litigation claims against third parties. In these cases, the debtor will bequeath the right to pursue these claims to a newly-formed litigation trust and will typically seed the trust with some amount of initial funding. Interests in the trust will be distributed pro rata to particular creditors groups as per the terms of the approved resolution plan. This process will entitle the creditors to receive their pro rata share of any value that is ultimately obtained through prosecution of these claims.

b. **Lead bank to take control of avoidance transactions:** FC, primarily, any Public Sector Bank having maximum exposure in the CD may take a lead to pursue the avoidance transactions post resolution or dissolution of the CD.

c. **Absolute assignment over any conditional fee agreement**: The RP/Liquidator has to be cautious of the fact that if he continues to pursue the legal action with an arrangement of funds from third party, there will be cost which would be uncertain and further, such legal cost will be paid out of the company's assets as CIRP cost or liquidation cost before any other claims. A cause of action that is transferred altogether, that is, for a predetermined sum, shields the assignor from a third-party costs order and the accompanying obligation to pay the assignee's legal fees. Although it may not result in the best price, the absolute assignment gives the RP/Liquidator the most assurance regarding the amount of the recovery and the costs exposure.

d. **Insolvency and bankruptcy fund:** The Government may operationalize the Insolvency and Bankruptcy Fund and IBBI may use this fund to pursue application for avoidance transaction in some cases such as when Liquidation Process ends and application for avoidance transaction remain pending, CIRP ends by withdrawal under section 12A and where an application is not filed by the IP, or matter is not pursued properly. The distribution of recoveries after dissolution as per waterfall in section 53 of the Code and the excess recoveries and unclaimed amounts to be credited to the Insolvency and Bankruptcy Fund.

(g) **Considerations for assessing litigation funder:** (i) Funder's expertise and experience (ii) Reasonableness of terms negotiated such as fee percentage, amount of funding to be provided (capping etc), extent of Funder's involvement in litigation proceedings, the strength and financial resources of the funder, as well as whether it will be able to sustain the case to the end given its other funding obligations (iii) the funder's track record of success (iv) the funder's compliance with all applicable Laws and procedure (v) Funder's independence and managing conflict of interest

(iii) Maximise value

(h) **Assignment of assets underlying in avoidance transactions as part resolution:** An explicit regulation can assist the RP and CoC to assign during CIRP, proceeds of actions involving unfair preferences, undervalue transactions, extortionate credit transactions, fraudulent transactions or wrongful trading, to third parties in consultation with CoC. This is in line with the provisions of the Liquidation Regulations in India and Omnibus Act in Singapore. This new method of funding may further improve the chances of aforesaid actions being pursued, with the potential reward of providing higher recovery to all the stakeholders in the event the action is successful.

(i) **Section 66 of the Code covers third party:** With time, more and more complicated transactions that fall under the purview of IBC Section 66 are becoming apparent. It is imperative that the provisions of section 66 be understood and constructed harmoniously in light of its goal and purpose. It is not possible to interpret section 66 in a way that would grant third parties total immunity or give the RP or purchasers of avoidance applications unrestricted authority to pursue recoveries from third parties without adhering to the required legal procedures. Given that the word "any other person" is used expressly in section 66, third parties who have committed acts of creditor fraud should be subject to NCLT jurisdiction.

(iv) Capacity building

(j) **Capacity Building of the IP:** If the investigations reveal responsible and actionable activity, they cannot just "play safe" and avoid to take appropriate action. IPs must consider what will serve creditors' interests the most. As a result, IPs typically decide in a way that maximises the financial value for creditors. Only when IPs have a thorough understanding of the various funding possibilities, they will be able to make a well-informed and rational selection. IPs are responsible for making sure that choices about the most effective way to enforce causes of action are well-informed. IPs need to be educated and provided with guidance so that their decisions are, and are seen to be, in the best interests of creditors.

(k) **Awareness programme for CoC to deal with TPLF in contingent assets and avoidance application:** It is crucial to have awareness programs for the CoCs to effectively deal with TPLF in contingent assets and avoidance applications for ensuring informed decision-making and maximizing recovery in insolvency proceedings. The CoC should be educated about the role of TPLF in insolvency proceedings, particularly in dealing with contingent assets and avoidance applications, and to provide them with practical strategies for leveraging TPLF to enhance asset recovery.

(l) **Creation of dedicated benches to deal with avoidance application:** Since avoidance transactions are complex in nature to adjudicate, and require a separate skill set and expertise, it is recommended that the dedicated bench should be created to adjudicate on avoidance transactions along with requisite staff/researchers having qualification of chartered accountants/holder of forensic audit certificates.

(m) **Role of AAs:** The court sanctioned TPLF could potentially increase the company's estate and enhance the recovery for creditors. The role of AA in TPLF arrangements is to thoroughly review the proposed arrangement rather than just "rubber-stamp" to whatever RP/Liquidator has proposed. However, the court does not entail making a commercial judgement regarding the terms of the agreement or assume the role of a "litigation funding regulator", rather it requires assessment of legitimate use of RP/Liquidator authority without any ill-incentives and abuse of process.

(n) **Dedicated RP for avoidance transactions:** It has been mentioned by AA in certain cases that the RP pursuing avoidance application has not been diligent enough to investigate the avoidance transactions. It is recommended that a new RP having an expertise in field of forensic auditing, may be appointed with the sole responsibility to scrutinise and assess all avoidance transactions. Thus, it will ensure that only legitimate avoidance transactions with high probability of recovery have been reported leading to better prospects of recovery and shredding the load of the RP responsible for conducting the CIRP and also of AA by submitting timely and genuine applications.

Litigation funding in India is not a common practice. However, there exist a claim during insolvency which has all the potential to maximise the value of the CD. Litigation funding in the IBC framework can play a pivotal role in facilitating the resolution and liquidation of insolvency cases in a time bound manner by providing the necessary financial support to parties involved in complex legal disputes. Unconventional techniques of dealing with litigation through lateral thinking including settlement, particularly for IBC avoidance transactions, may result in improved avoidance proceedings, so maximising the value of the CD and meeting the objectives of the IBC.

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FROM MORATORIUM TO SECURITY INTEREST: DECODING THE INTRICACIES OF GOVERNMENT DUES IN IBC PROCEEDINGS

Pooja Singla and Romit Nandan Sahai

ABSTRACT

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) revolutionized India's insolvency landscape, offering a streamlined process for resolving financially distressed entities. However, uncertainties surrounding tax dues, assessments, and security interests of tax authorities under the Code have sparked significant debate. Once insolvency proceedings commence, a moratorium halts all actions against the corporate debtor (CD), including those by tax authorities. However, it's unclear whether tax reassessment proceedings can proceed during this period, leading to divergent judicial interpretations. Additionally, the prioritization of tax dues remains contentious, with tax authorities typically treated as operational creditors (OCs), receiving lower repayments in liquidation. To protect their interests, tax authorities have sought security interests in debtor assets, though the legality during the moratorium and distribution processes is uncertain. This paper addresses these issues, emphasizing the need for legislative clarity. It examines the impact of uncertainties on the resolution process and government revenue, proposes a uniform approach to tax assessments during the moratorium, and evaluates the treatment of tax authority security interests in asset distribution, drawing comparisons with international practices. The methodology employed is doctrinal, given the research's nature and scope.

Keywords: Tax assessments, Security Interest, Priority, Moratorium, Government Dues

INTRODUCTION

The IBC has been a watershed moment that has transformed India's insolvency landscape, by offering a streamlined and time-bound mechanism for the resolution and liquidation of financially distressed entities.[1] However, the treatment of tax dues, tax assessments, and security interests of tax authorities under the Code has been a subject of significant debate and concern.

As soon as any insolvency or liquidation proceeding is initiated under the Code, a moratorium kicks in which puts a halt on all proceedings in relation to the CD including those at the instance of the tax authorities. During this period, tax-authorities are barred from initiating or continuing any proceedings against the debtor for the recovery of tax dues and, any recovery, if to be made, must be through the resolution process. However, the Code does not provide clarity on whether reassessment proceedings can be initiated or continued during the moratorium i.e., whether the tax-authorities are precluded from even ascertaining tax liability of a debtor during the moratorium.[2] This ambiguity has led to divergent judicial interpretations, with some courts allowing assessments to proceed, while others holding them in abeyance. The lack of uniformity in approach not only has hampered the efficiency and effectiveness of the resolution process but is all the more worrisome considering that once the resolution or liquidation process is concluded, all prior liabilities of the CD stand extinguished resulting in revenue losses to the government.[3]

Furthermore, the treatment of tax dues concerning priority in repayment remains a contentious issue. Tax authorities are ordinarily considered OCs under the Code, and their claims rank below secured financial creditors (FCs). This means that in case of liquidation, tax authorities may receive a significantly lower proportion of their dues, which impacts the overall government's revenue. To safeguard their interests, tax authorities have sought to assert security interests in the assets of the debtor by way of attachment of properties which to a degree has been acquiesced by the Supreme Court. However, much remains to be said, as to whether the tax authorities can take this recourse during the subsistence of moratorium or not, and whether in the event of distribution under resolution plan or waterfall mechanism, such security interest can be enforced?

This paper attempts to answer the aforesaid questions and underscores the need for a legislative clarity on the treatment of tax dues, assessments, and security interests of tax-authorities under the Code. The paper illustrates the problems that have effaced qua the Code and taxation statutes in India and highlight the impact it has had on the resolution process as-well as the government's revenue. It then attempts to provide a uniform approach to tax assessments during the moratorium, coupled with treatment of security interest of tax authorities in the distribution of assets, and a comparative analysis of provisions dealing

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[1] Aastha Dass, *New Bankruptcy Law to improve ease of doing business,* India Today (Dec. 21, 2023, 6:09 PM),https://www.indiatoday.in/india/story/new-bankruptcy-law-to-improve-ease-of-doing-business-278253-2015-12-21.

[2] Sikha Bansal, *Tax Authorities Left High & Dry,* Vinod Kothari (May 10, 2024, 15:16 PM) https://vinodkothari.com/wp-content/uploads/2019/06/Tax-Authorities-Left-High-Dry.pdf.

[3] KV Kailash Ramanathan, *Recovery of Indirect Taxes and Duties Post Imposition of Moratorium: Resolving the Legal Quagmire,* Centre for Business & Commercial Laws – NLIU (May 10, 2024, 15:16 PM)https://cbcl.nliu.ac.in/insolvency-law/recovery-of-indirect-taxes-and-duties-post-imposition-of-moratorium-resolving-the-legal-quagmire/.

with the same in other jurisdictions. The methodology followed is doctrinal considering the nature and scope of research.

ASSESSMENT OF TAX LIABILITY DURING THE SUBSITENCE OF MORATORIUM

Moratorium under the Code

One of the most significant hallmarks of the Code, is the concept of 'Moratorium'[4] that has been engrafted within section 14[5] which stipulates, that upon commencement of a corporate insolvency resolution process (CIRP), the institution and continuation (emphasis) of any and all proceedings against the CD shall come to a halt during the subsistence of the insolvency resolution process.[6] This prohibition on either pursuing or initiating any legal proceeding against the CD or in respect of its property from the date of commencement of CIRP till its completion is popularly known as the 'Moratorium Period'. It in essence is a 'Stasis' or a 'Strategic Pause'.[7]

Before adverting to the scope and ambit of the prohibition envisaged by the moratorium, it would be apposite to understand the reason behind providing for 'Moratorium' by the Code in the first place and the paramount role played by it in the insolvency resolution process. Ordinarily, whenever a debtor fails to pay its debt or any of its part, the creditor acquires a legal right to move against that debtor by way of legal proceedings to recover that debt which is due. Now, for an instance, the same debtor fails to repay a debt or any of its part to two or more creditors, each of those creditors will in their individual capacity acquire a legal right to individually (emphasis supplied) move against that debtor in their own personal capacity for recovery of the debt that is due to them irrespective of whether the other creditors also choose to move against the defaulting debtor or not; this in legal sense is popularly known as the creditor's '*in personam legal right of recovery*'.[8] In such scenarios, where the debtor has defaulted in respect of multiple creditors, the recovery of debt by each of those creditors effectively boils down to a 'race to the court' amongst the creditors i.e., which creditor is able to initiate proceedings against the debtor the quickest and is able to obtain a relief to recover its amount first.[9] This creates a precarious situation where the creditor who moved first, will be able to make its recovery by apportioning the assts of the debtor till its claim is satisfied, and the other creditors would be left high and dry, having to make do with whatever little assets remain to recover their respective debts. This results in a very lopsided recovery, where the first creditor recovers its entire amount, and the other creditors recover next to nothing, merely because they could not institute the legal proceedings fast enough or because of the complex nature of their debt, the proceedings took longer to conclude.[10] Another

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[4] Stefan Schneider, *Insolvency Moratorium – The worst is yet to come,* Deutsche Bank Research (Aug. 13, 2020), <https://www.dbresearch.com/PROD/RPS_EN-PROD/PROD0000000000511054Insolvency_moratorium:_The_worst_is_yet_to_come.PDF?undefined&realload=wQqRgYLf2ryXK6~VoA96WXh1tPpvJHb9lOp8uuDuKN2lYJTUJDs9cQSpFnR2RbNA>.

[5] IBC, *supra note* 3, § 14.

[6] Shalmoli Ghosh, *Moratorium under the Insolvency and Bankruptcy Code, 2016 and its Impact on Parallel Proceedings,* 2(2) IJLLR, 1, 3-4 (2020).

[7] *Id.*

[8] Omkar Goswami, *The Urgent Need for Fast Bankruptcy,* The Indian Express (Dec. 16, 2023, 7:55 AM), https://indianexpress.com/article/opinion/columns/the-urgent-need-for-fast-bankruptcy/.

[9] Dr. M.S.Sahoo, *Freedom to Exit: The Insolvency & Bankruptcy Code, 2016 builds the third pillar of economic freedom,* Quarterly Newsletter of IBBI for October – December 2016.

[10] William Cooke, *A Compendium System of Bankrupt Laws*, 1 (1778).

downside of this is the '*Cherry-Picking*' effect which means that a creditor who obtains the relief first, will be able to choose which assets of the debtor it wishes to apportion, effectively allowing it to utilize the more viable assets of the debtor, leaving behind the obsolete and less financially viable assets of the debtor for the other creditors, and thus frustrating the recovery of other creditors.[11]

As a countenance, to the above broad implications of individual recoveries by creditors, the concept of 'Insolvency' was introduced, whereby all the creditors rather than pursuing individual recovery proceedings against the same debtor, would instead pursue a single concerted recovery proceeding popularly known as 'Insolvency Proceeding' against the debtor, and all the returns from the apportionment of the debtor's assets are pooled together in a common-joint stock known as the debtor's estate which is then equally distributed amongst the creditors in a fair and equal manner. Thus, in essence insolvency is the process of resolving outstanding due debts of a debtor through a single concerted legal process, whereby each creditor gets a fair and equal return to the other similarly situated creditors. This concerted resolution and recovery is known as *'proceedings in rem'* and is the linchpin that fundamentally sets-apart the insolvency process from other ordinary legal proceedings.[12]

The concept of 'Moratorium' is a by-product of this insolvency process and is a necessary creation in order to enable and facilitate a concerted recovery over individual piecemeal recoveries[13] and to prevent mischievous creditors from frustrating the insolvency process by pursuing their own recovery proceedings.[14] It does so in two distinct ways; *firstly*; by putting an embargo over the courts, tribunals and other forums from proceeding further with any litigation pertaining to the CD or any of its asset that by efflux of time has become the subject matter of insolvency. *Secondly*; by putting an end to all such pending as-well as prospective claims and legal proceedings as of the date of insolvency, by extinguishing the rights of the creditors therein except for the rights accrued to them from the insolvency proceedings, which it does so in conjunction with the successful approval and implementation of the insolvency resolution plan.[15]

In other words, the moratorium ensures that whatever proceedings that have already been instituted as well as those that may arise from a cause of action prior to initiation of insolvency are no longer actionable in any court of law or legal forum till the pendency of insolvency thereby ensuring that; as long as the insolvency proceedings are in effect, no sly or mischievous creditor can sideline the insolvency to pursue individual recovery at the cost of the other creditors as well as the CD itself i.e., it helps prevent the death of the CD by a 'thousand-cuts'.[16] Alongside the 'stay' of pending and prospective proceedings, the moratorium also

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[11] Ministry of Corporate Affairs, *Report of the Expert Committee on Company Law: Restructuring & Liquidation (2009),* http://www.mca.gov.in/MinistryV2/restructuring+and+liquidation.html.

[12] Indus Biotech Private Limited v. Kotak India Venture (Offshore) Fund (formerly Kotak India Venture Limited) & Ors, C.A. No. 1070 of 2021.

[13] Chris Umfreville, *A Review of the Corporate Insolvency Framework: A new moratorium to help business rescue?,* Company Law Newsletter, 385 (2016).

[14] Ashish Makhija, Insolvency and Bankruptcy Code of India, Lexis Nexis (2018).

[15] Sir Dinshaw Fardunji Mulla, Mulla: The Law of Insolvency in India, (6th ed.Lexis Nexis 2017).

[16] Prof. John D. Ayer, Michael Bernstein et. al., *Chapter 11 – "101" An Overview of the Automatic Stay,* 22(10) Am. Bankr. L.J.,1 (2004).

ensures or rather encourages all existing and potential creditors of the CD to participate in the insolvency proceedings by providing for the 'extinguishment' or discharge of such proceedings and claims upon conclusion of the insolvency by virtue of the 'Clean-Slate' theory, thereby ensuring that maximum number of lenders actually go through the insolvency and recover their debt.[17]

Thus, it is very apparent, that the moratorium plays a vital role in ensuring three folds; (i) that the viable assets of the CD remain intact, and it continues to remain a going concern, (ii) that any insolvency proceeding takes place in a fair and equitable manner that is not detrimental to any one creditor in respect of the other and (iii) to ensure that all stakeholders and creditors of the debtors actually participate in the insolvency proceeding. If insolvency proceeding won't be fair, then there would be no sanctity to the so called 'concerted' recovery, the recoveries of the creditors would be purely dependent upon luck in securing a relief from the court first (as delineated above) as a result of which, creditors will have no confidence or faith over the insolvency regime for their recoveries, which in turn would make them reluctant in lending funds as they would think twice before any loan is extended due to their apprehension of inconsistent and inadequate recoveries from this 'luck' based recovery regime,[18] which itself would spell disaster for the lending and credit macroeconomics of the country. If the assets of the CD are not kept intact, then its financial viability would plummet, it won't be able to remain a going-concern for much long spelling a certain death for the CD,[19] and in such scenario even if the insolvency takes place in a fair and equitable manner, if the CD itself is not financially viable, no potential buyer would be inclined to participate in the resolution process and acquire it, thus rendering the entire insolvency process meaningless.[20] If the creditors are not encouraged to participate vociferously in the insolvency proceeding, there will be a vacuum in decision making, as during the insolvency all key business decisions and viability of resolution plan are explored and taken by the creditors of the CD, more particularly the committee of creditors, if the creditors itself would not take a keen interest in the resolution of the CD then also the insolvency proceedings would be meaningless.

Thus, moratorium is not just here to stay, but is a quintessential component of any insolvency regime, without which no effective insolvency proceeding or recovery can hope to move forward.

Ambit of prohibition under the moratorium

With it sufficiently established that moratorium is a necessary aspect to any insolvency proceedings that effectively puts a stop or a bar on existing & prospective legal proceedings with respect to the CD and or its assets, the question that arises is what proceedings are prohibited? In other words what process would fall within the domain 'proceedings barred under section 14' or *simpliciter* what is the scope of prohibition envisaged under the concept of moratorium under section 14?

[17] Vatsal Khullar, *Report Summary Bankruptcy Law Reforms Committee,* PRS India Legislative Research (Dec. 21, 2023), https://www.prsindia.org/sites/default/files/bill_files/Report_Summary_-_BLRC_0.pdf.

[18] Christopher J. Cowton, *Putting Creditors in their Rightful Place – Corporate Governance & Business Ethics,* 102 Journal of Business Ethics 21, 27 (2011).

[19] Douglas G. Baird, *An Overview of the Law & Economics of Financially Distressed Firms,* Coase-Sandor Institute for Law & Economics, Working Paper No. 43 (1997).

[20] Vanessa Finch, Corporate Insolvency Law: Perspectives and Principles, 4 (2nd ed. Cambridge University Press 2009).

To put the problem in a better perspective and more in tune with the context of the present paper; if a company escaped tax liability of say ₹ 1 crore in FY-2023-24 and CIRP is initiated against a company in 2024 by virtue of which it goes into insolvency, does this now mean that because of the bar of moratorium under section 14, the tax authorities are precluded from initiating and pursuing assessment proceedings against the CD? Does the bar under section 14 mean that once insolvency proceedings are initiated, no assessment proceedings can continue against the CD and only that quantum of tax liability can be recovered which have already been assessed prior to the insolvency proceedings?

To understand the precarity of the confusion surrounding tax assessment proceedings that have led to the problems being addressed in the present paper, it would be fruitful to understand the nature of tax proceedings. Without mincing any words, tax proceedings as they exist today on statutes more particularly the Income Tax Act, 1961 (Income Tax Act) and the Central Goods and Services Tax Act, 2017 are indeed recovery proceedings in as much as they are proceedings in which outstanding tax liabilities of the CD are satisfied by and against the assets of the CD. The entire process of tax recovery begins with the assessment of income of the CD on the basis of the past returns filed by it in order to determine the extent of tax liability escaped by it. Until, the assessment is complete, no liability is incurred by the CD. Once the liability is assessed, a demand notice is issued to the CD seeking its response to the liability, and when no good response is elicited so as to dispute the liability, the liability is confirmed (subject to confirmation of CIT & ITAT and then the liability specified in the demand notice becomes due payable and subject to recovery proceedings as specified under the Income Tax Act.

Thus, for any attempt towards ascertaining whether the assessment proceedings ordinarily undertaken under the Income Tax Act would fall foul of the moratorium under section 14 so as to be prohibited, the width and scope of the prohibition would have to be understood first, so as to see what all proceedings and process actually fall within it. Section 14 of the Code *simpliciter* begins with the word 'Moratorium' and the said provision is being reproduced below: -

14. Moratorium. –

(1) Subject to provisions of sub-sections (2) and (3), on the insolvency commencement date, the Adjudicating Authority shall by order declare moratorium for prohibiting all of the following, namely:—

(a) the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgment, decree or order in any court of law, tribunal, arbitration panel or other authority;

(b) transferring, encumbering, alienating or disposing of by the corporate debtor any of its assets or any legal right or beneficial interest therein;

(c) any action to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property including any action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (54 of 2002);

(d) the recovery of any property by an owner or lessor where such property is occupied by or in the possession of the corporate debtor.

Explanation.—For the purposes of this sub-section, it is hereby clarified that notwithstanding anything contained in any other law for the time being in force, a license, permit, registration, quota, concession, clearances or a similar grant or right given by the Central Government, State Government, local authority, sectoral regulator or any other authority constituted under any other law for the time being in force, shall not be suspended or terminated on the grounds of insolvency, subject to the condition that there is no default in payment of current dues arising for the use or continuation of the license, permit, registration, quota, concession, clearances or a similar grant or right during the moratorium period;

(2) The supply of essential goods or services to the corporate debtor as may be specified shall not be terminated or suspended or interrupted during moratorium period.

(2A) Where the interim resolution professional or resolution professional, as the case may be, considers the supply of goods or services critical to protect and preserve the value of the corporate debtor and manage the operations of such corporate debtor as a going concern, then the supply of such goods or services shall not be terminated, suspended or interrupted during the period of moratorium, except where such corporate debtor has not paid dues arising from such supply during the moratorium period or in such circumstances as may be specified;

(3) The provisions of sub-section (1) shall not apply to—

(a) such transactions, agreements or other arrangements as may be notified by the Central Government in consultation with any financial sector regulator or any other authority;]

(b) a surety in a contract of guarantee to a corporate debtor.

(4) The order of moratorium shall have effect from the date of such order till the completion of the corporate insolvency resolution process:

Provided that where at any time during the corporate insolvency resolution process period, if the Adjudicating Authority approves the resolution plan under sub-section (1) of section 31 or passes an order for liquidation of corporate debtor under section 33, the moratorium shall cease to have effect from the date of such approval or liquidation order, as the case may be.

The word 'moratorium' itself is derived from the Latin word '*moror*' which means to delay or hinder. The Black's Law Dictionary defines moratorium as "*Delay in performing an obligation or taking an action legally authorized or simply agreed to be temporary*".[21] On a bare perusal it would seem to suggest that moratorium *simpliciter* means delaying any legally authorized proceedings for a temporary period and as such till insolvency is continuing no legal

[21] Henry Campbell Black, Black's Law Dictionary 938 (14th ed. 1968).

proceeding even if authorized can even take inception. However, a close reading of the meaning more importantly the words *'delay'* and '*performing an obligation*' would reveal and connote the true meaning of moratorium. The word '*delay*' has been used in reference to the expressions '*performing an obligation'* or '*taking an action legally authorized*' which means that moratorium only is to delay the performance or any action pertaining to an obligation and has nothing to do with determining any obligation, in fact the usage of *'obligation'* suggests the existence of an obligation in the first place. Thus, moratorium itself contemplates determination of obligation, and only restricts the acting onto that obligation.[22] Going by this meaning it would appear that tax assessment proceedings which are effectively determination of tax liability will not fall within the scope of prohibition of moratorium, and it would only be the legal action taken to recover that liability which would fall within the scope of prohibition under moratorium.

In fact, section 14 rather than using vague language, beautifully delineates its scope of prohibition more particularly the proceedings which would be barred through four distinct illustrations found within section 14 sub-section (1) which for sake of convenience pertain to "transfer", "enforcement", "recovery" and "institution/ continuation". The first three clearly show that the proceedings that deal with either transfer, recovery or enforcement are "performance or action to an obligation", thus these in no way impair the assessment of tax liabilities. As regards "institution / continuation" of proceedings is regarded, it only takes into account proceedings which are against the CD. Assessment Proceedings while on the threshold appear to be proceedings *ipso facto* against the CD, however, on a closer look would reveal that they have nothing to do with the CD, we say this because, when the tax liability is still being assessed, the company irrespective of whether it is in insolvency or not, is not privy or is unaware that assessment proceedings are being carried out, it only after the assessment proceedings are concluded and a demand notice is issued that the CD who otherwise would be in insolvency becomes aware of the assessment proceedings (which have since been concluded) and the liability so determined.[23]

Thus, assessment or reckoning of tax liability is not subject to the bar under section 14, it is only the subsequent steps of issuing a demand notice and undertaking recovery proceedings that are prohibited under section 14.

In *Platino Classic Motors India Pvt. Ltd. v. Dy. Commissioner of Central Tax & Ors.*[24] the Kerela High Court while explaining the scope of prohibition under section 14 of the Code held that there is no bar for finalization of the assessment proceedings and its adjudication, and that the prohibition or moratorium is only for the recovery of tax dues. The relevant observations read as under: -

> 5. From perusal of Section 14 of the IBC and several Judgments of the other High Courts as well as the Supreme Court, it is well settled that Section 14 of the IBC does not create a bar

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[22] IBC Laws, *All about moratorium under section 14 of the insolvency and All about moratorium under section 14 of the insolvency and bankruptcy code, 2016 including judicial announcements,* Yale School Of Management Resource Library, (May 10, 2024, 15:16 PM), https://elischolar.library.yale.edu/cgi/viewcontent.cgi?article=2552&context=ypfs-documents2.

[23] Ishaan Chopra, *The Insolvency and Bankruptcy Code, 2016: Impact of Moratorium on Pre-Existing Contractual Arrangements and Exceptions to Statutory Moratorium,* 5(2) RGNUL Fin. & Mercantile L. Rev.,80 (2018).

[24] WP(C)No. 7997 of 2023.

> for finalisation of the assessment and adjudication proceedings in respect of the taxes. On the resolution once the reference has been admitted, there is moratorium for recovery of the tax dues but, there is no bar for finalisation of the assessment and adjudication proceedings. [...]

In *Murli Industries Ltd. v. Assistant Commissioner of Income Tax*[25] a similar view was taken wherein, the Bombay High Court held that the bar under section 14 does not operate on assessment proceedings, however, any assessment proceeding must be undertaken as soon as the Public Announcement is made and the liability so determined must be raised as a claim before the last date of filing of claims. The relevant observation read as under: -

> 21. The point is, once the public announcement is made under the IBC by the Resolution Professional calling upon all concerned, including the statutory bodies, to raise claim, it would be expected from all the stakeholders to diligently raise their claim. The Income Tax authorities in that sense, ought to have been diligent to verify the previous years' assessment of the Corporate Debtor as permissible under the law and to raise the claim in the prescribed form within time before the Resolution Professional.

Thus, there is unanimity amongst judicial decisions that initiation of assessment proceedings during insolvency is not prohibited by the moratorium, what is prohibited is the recovery process under the Income Tax Act. Furthermore, any assessment proceeding must be undertaken when the public announcement is made and must be concluded before the last date inviting claims from creditors of the CD.

In fact, recourse may be taken to the *pari-materia* provisions contained in the Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) which was the predecessor to the Insolvency Bankruptcy Code, 2016 as we know it. Similar to moratorium under the Code, for all the foregoing reasons discussed earlier, the SICA too provided for a stasis on liabilities of company undergoing rehabilitation under the Act, this was incorporated in section 22 of the Act which provided for the "suspension of legal proceedings".

The provision provided that whenever any inquiry for rehabilitation of a company was pending or any scheme for rehabilitation of a company or its implementation was pending, legal proceedings for winding up or execution or distress to the properties of the company shall be suspended. For the prohibition under section 22 of SICA to kick in, the aforesaid twin conditions must be fulfilled[26] i.e., *first,* the process of rehabilitation must be ongoing; this may be either an inquiry or reference or preparation of scheme or its implementation[27] and that *secondly,* the nature of proceedings sought to be suspended must be coercive in nature in respect of the properties of the sick company.[28] Section 22's prohibition cannot be stretched to blanketly and mechanically apply to all proceedings, and that regard must be had to the reason why such prohibition has been provided and the purpose that is sought to be served by suspending

[25] WP No. 2948 of 2021.

[26] Maharashtra Tubes Ltd. v. State Industrial & Investment Corpn. of Maharashtra Ltd., (1993) 2 SCC 144.

[27] *Id.,* para 10.

[28] *Id.*, para 11.

such proceedings.[29] The scope and object of section 22 SICA is to ensure that during the examination, finalisation and implementation of the scheme, there should be no impediment caused to the smooth execution of the scheme of revival of the sick industrial company.[30] A mere demand or saddling of liability cannot be construed to cause any impediment in rehabilitation and would fall outside the scope of section 22 SICA.[31]

This more or less has been the consistent position of law, and now it is no longer *res-integra* that provisions for suspending legal proceedings such as section 22 are only ameliorative in nature, intended to facilitate the object of rehabilitation and resolution of a company by ensuring the smoot formulation and implementation of scheme.[32] As recent as April, 2024, the Supreme Court in *FCIL & Ors. v. M/s Coromandal Sacks Pvt. Ltd.*[33] has reiterated that the prohibition or suspension of proceedings that was envisaged under section 22 of SICA will only apply where there is either an admitted liability or where the proceeding is of such nature that it may cause distress or devaluation of the assets of the company under rehabilitation.[34]

Clean slate theory

In the event the assessment proceedings are not concluded within the stipulated time or worst are sought to be initiated after the insolvency proceeding is over, can the same be done? In *M/s EMC Ltd. v. State of Rajasthan,*[35] the said questions were examined by the Rajasthan High Court wherein it was held that any liability which existed prior to the insolvency proceeding but did not form part of the resolution plan would stand extinguished once the resolution plan is approved and the insolvency proceedings stands concluded. The relevant observations are reproduced below: -

> Law is well-settled that with the finalization of insolvency resolution plan and the approval thereof by the NCLT, all dues of creditors, Corporate, Statutory and others stand extinguished and no demand can be raised for the period prior to the specified date.

Similar view was taken by NCLT, New Delhi in *Uttam Strips Ltd. v. Assistant Commissioner of Income Tax*[36] which held that assessment orders pertaining to period prior to CIRP which were not part of the resolution plan are unsustainable in law once the resolution plan is approved and new management has taken over by virtue of the 'Clean-Slate' Theory. The relevant observations are reproduced below: -

> 23. In view of the aforesaid settled position of law, in our considered view, the Assessment Orders, as referred to in the three I.A.s, passed by the Income Tax Department, which pertain

[29] Raheja Universal Limited v. NRC Limited and Others, (2012) 4 SCC 148, para 48.
[30] *Id.,* para 58 and para 61.
[31] *Id.,* para 57.
[32] Goyal MG Gases Pvt. Ltd. v. SBQ Steels Ltd, 2016 SCC OnLine Del 5100 para 25. See also, Saketh India Limited v. W. Diamond India Ltd., 2010 SCC OnLine Del 1786, para 5 andpara 6. See also, LML Ltd. v. Sunil Mittal, 2013 SCC OnLine Del 1766, para16. M/s Haryana Steel & Alloys Ltd. v. M/s Transport Corporation of India, (2012) SCC OnLine Del 2140, para 11. See also, Kusum Products Ltd. v. Hitkari Industries Ltd. 2014 SCC OnLine Del 4926, para 3 and 4.
[33] 2024 INSC 348.
[34] *Id.,* para 97.
[35] CWP (DB) 6048 of 2020.
[36] IA No. 2395-97/ND/2020 in C.P.(IB)137(ND)/2018.

to the period prior to initiation of the CIR process of the Corporate Debtor, which is now led by the New Management on approval of the Resolution Plan, are unsustainable in law and without jurisdiction.

Thus, from above and countless other judicial decisions it has been consistently held that once the insolvency proceeding is concluded any tax liability pertaining to a period prior to insolvency can neither be assessed nor recovered post approval of the resolution plan due to the 'Clean-Slate' Theory. Does this mean that such pending liability is simply forgone and can never be recovered? The answer to that is both an uncertain yes and no. While it is trite that as per the existing law, those liabilities can never be recovered from the new management of the CD and by its extension the CD itself, the tax authorities still are not rendered powerless, and they have a remnant from the days of Company Law Board and Court monitored Liquidation which is section 179 of the Income Tax Act[37] which reads as under:

179. Liability of directors of private company in liquidation.—

(1) Notwithstanding anything contained in the Companies Act, 1956 (1 of 1956), where any tax due from a private company in respect of any income of any previous year or from any other company in respect of any income of any previous year during which such other company was a private company] cannot be recovered, then, every person who was a director of the private company at any time during the relevant previous year shall be jointly and severally liable for the payment of such tax unless he proves that the non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the company.

(2) Where a private company is converted into a public company and the tax assessed in respect of any income of any previous year during which such company was a private company cannot be recovered, then, nothing contained in sub-section (1) shall apply to any person who was a director of such private company in relation to any tax due in respect of any income of such private company assessable for any assessment year commencing before the 1st day of April, 1962.

Explanation.—For the purposes of this section, the expression "tax due" includes penalty, interest or any other sum payable under the Act.

Section 179 in essence allows the Tax Authority to recover any tax dues pertaining to a company from its erstwhile promoters and directors in the event the recovery is not possible from the company itself.[38] The said provision was utilized back when companies were wound up under the Companies Act, 2013 and were no longer existing, in such cases the recovery was then made from its managers and directors, while there is dearth of any judicial decision on this aspect, there seem to be no logical or legal prohibition for the tax authorities to utilize this provision for making their recoveries in the event the insolvency of the CD is concluded.

[37] The Income Tax Act, 1961, No. 43, Acts of Parliament, 1961, § 179.

[38] CA Govind Agarwal, *Liability of Directors of Private Companies under Section 179 of the Income Tax Act, 1961,* ICSI – Student Company Secretary (Feb. 2022), https://www.icsi.edu/media/webmodules/1100320222_LIABILITY_OF_DIRECTORS.pdf.

SECURITY INTEREST OF GOVERNMENT DUES

Why were Government Dues ranked lower?

In the dynamic landscape of insolvency and bankruptcy proceedings in India, a critical facet that demands meticulous examination is the treatment of government dues within the ambit of these procedures. Government dues comprising taxes, fees, and other financial obligations owed to the state, hold a unique position in insolvency cases. In India, the IBC ranks government dues at a lower priority as compared to secured creditors as per the order of priority given under section 53 of the Code. The rationale behind the ranking of government dues under IBC can be traced back to the Reports of the BLRC which formulated the Code. The Interim Report of the BLRC suggested that –

> allowing crown debt (whether state or central) to prevail over the security interest of secured creditors is problematic for several reasons- (i) it leads to uncertainty for secured creditors regarding the sums that would be payable to them in the event of a company's insolvency; (ii) it may slow or otherwise complicate the exercise of out-of-court enforcement rights by secured creditors and increase costs; (iii) the cost of credit for the debtor company may increase as secured creditors may ultimately pass on the risks arising from these to the debtor through higher interest rates; and (iv) it may reduce the attractiveness of certain kinds of security interests that would otherwise generate positive externalities, as where they encourage monitoring ex ante.

The BLRC pointed out that when a company goes bankrupt, the money it owes to the government isn't a major concern compared to the total government income. On the other hand, if the company doesn't pay back other businesses, especially public sector banks, it could have serious consequences. It might even push those businesses into bankruptcy, causing broader economic problems.[39]

In its conclusive report, the Committee suggested that, in the liquidation distribution waterfall, the claims of the Central and State Government should be prioritized below those of unsecured and secured FCs. This recommendation aimed at fostering the accessibility of credit and stimulate the growth of a market for unsecured financing. The Committee believed that such prioritization would enhance the availability of funding, lower capital costs, encourage entrepreneurship, and ultimately contribute to accelerated economic growth in the long term. The proposed insolvency regime is anticipated to bring about efficiency improvements, leading to increased value capture, resulting in additional benefits for both the economy and the exchequer.[40]

The Insolvency Law Committee in its Report of 2020 expressed similar views and noted that 'waterfall mechanism' is aimed at promoting a collective liquidation process to encourage the secured creditors to relinquish their security interest(s), for the benefit of all the stakeholder and value maximisation of the assets of the debtor.[41]

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[39] Interim Report of the Bankruptcy Law Reforms Committee, https://ibbi.gov.in/uploads/resources/57420f272e1515f0c9c137f1a6423d78.pdf (last visited Dec.7, 2023).

[40] Report of the Bankruptcy Law Reforms Committee, November, 2015, https://ibbi.gov.in/uploads/resources/BLRCReportVol1_04112015.pdf (last visited Dec.7, 2023).

[41] Report of the Insolvency Law Committee, February, 2020, https://ibbi.gov.in/uploads/resources/c6cb71c9f69f66858830630da08e45b4.pdf (last visited Dec.7, 2023).

Provisions under the IBC

The preamble to the Code very clearly spelled out its objective and aims by specifying the Code being: -

> 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 and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto.

The third objective of "*alteration in the order of priority of payment of Government dues*" as envisaged in the Preamble to the Code was achieved by laying down a clear waterfall mechanism under section 53 of the Code.

Section 53 of the Code provides as under:

(1) Notwithstanding anything to the contrary contained in any law enacted by the Parliament or any State Legislature for the time being in force, the proceeds from the sale of the liquidation assets shall be distributed in the following order of priority and within such period and in such manner as may be specified, namely: -

(a) the insolvency resolution process costs and the liquidation costs paid in full;

(b) the following debts which shall rank equally between and among the following:

(i) workmen's dues for the period of twenty-four months preceding the liquidation commencement date; and

(ii) debts owed to a secured creditor in the event such secured creditor has relinquished security in the manner set out in section 52;

(c) wages and any unpaid dues owed to employees other than workmen for the period of twelve months preceding the liquidation commencement date;

(d) financial debts owed to unsecured creditors;

(e) the following dues shall rank equally between and among the following: -

(i) any amount due to the Central Government and the State Government including the amount to be received on account of the Consolidated Fund of India and the Consolidated Fund of a State, if any, in respect of the whole or any part of the period of two years preceding the liquidation commencement date;

(ii) debts owed to a secured creditor for any amount unpaid following the enforcement of security interest;

(f) any remaining debts and dues;

(g) preference shareholders, if any; and

(h) equity shareholders or partners, as the case may be.

(2) Any contractual arrangements between recipients under sub-section (1) with equal ranking, if disrupting the order of priority under that sub-section shall be disregarded by the liquidator….

Hence the intention of the legislature is clear as regards ranking of government dues below secured and unsecured creditors. The data released by IBBI also substantiates this, as against the recovery of 34% for FCs, the recovery to OCs is a meagre 10.85% in the cases resolved under the Code as on September 30, 2023. This includes the recovery for trade creditors and government dues. Further, in cases closed as result of liquidation, the recovery with respect to government dues plus amount unpaid following enforcement of security interest is 0.65% only.[42]

Legal jurisprudence and conflicts

Although section 53 of IBC primarily addresses the priority of distributing proceeds from the sale of liquidation assets in the liquidation process, its provisions are equally pertinent during the CIRP, especially concerning payment to the creditors in the resolution plan. In the liquidation process, a secured creditor can choose to either relinquish or realize its security interest under section 52(1). The decision to realize the security interest determines the ranking of the said secured creditor, regarding unpaid dues, under the 'waterfall mechanism' outlined in section 53. Notably, section 53(1)(e) places government dues on par with the dues owed to secured creditors for any unpaid amount following the enforcement of security interest under section 52(1)(b).

Several court judgments have upheld the supremacy of the Code over tax legislations and the precedence of secured creditor dues over tax dues. In the recent case of *Sundaresh Bhatt v. Central Board of Indirect Taxes and Customs*,[43] the Supreme Court held that the Code has an overriding effect on the Customs Act. In *PCIT v. Monnet Ispat and Energy Ltd.*,[44] the Supreme Court held that income-tax dues, being in the nature of crown debts, do not take precedence over secured creditors, who are private persons. However, a few other judgments created a controversy as regards preference of government dues under IBC.

In the case of *Union of India v. Vijaykumar V Iyer*,[45] a crucial issue revolved around whether dues under the Department of Telecom (DoT) spectrum license qualify as an operational debt. The Court affirmed this, recognizing the Central Government as an OC. However, it clarified that Spectrum Trading Guidelines couldn't be replaced during CIRP and the licensor's dues couldn't be settled under a resolution plan provision. The court emphasized that spectrum use requires payment of dues, which cannot be swept away by initiation of CIRP. Hence, the NCLAT established a distinct class of creditors for DoT, granting specific powers not available to other OCs and created confusion about the waterfall priority established under the Code.

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[42] Data sourced from website of the Insolvency and Bankruptcy Board of India, https://ibbi.gov.in/en/claims/cd-summary.

[43] Civil Appeal No. 7667 of 2021.

[44] Petition(s) for Special Leave to Appeal (C) No(s). 6483/2018.

[45] Company Appeal (AT) (Insolvency) No. 733 of 2020.

In *BSE Limited v. Asahi Infrastructure & Projects Limited,*[46] the NCLAT affirmed the AA's order striking the appellant's CIRP application for failing to pay the listing fee. This judgment excluded the listing fee from the purview of operational debt and refused it the protection which is afforded to an operational debt in the event of default.

Can the government dues be treated as secured creditors?

Though section 53 of the Code establishes a clear priority for payment of dues in the event of liquidation, however, an interesting question arises on the treatment and priority of the government dues in the event a 'charge' is created over the asset(s) of the CD, by way of operation of law or statute.

> Section 3 of the Code provides as under: -
>
> (30) "secured creditor" means a creditor in favour of whom security interest is created;
>
> (31) "security interest" means right, title or interest or a claim to property, created in favour of, or provided for a secured creditor by a transaction which secures payment or performance of an obligation and includes mortgage, charge, hypothecation, assignment and encumbrance or any other agreement or arrangement securing payment or performance of any obligation of any person:
>
> Provided that security interest shall not include a performance guarantee;
>
> ……
>
> (33) "transaction" includes a agreement or arrangement in writing for the transfer of assets, or funds, goods or services, from or to the corporate debtor;

The Code necessitates the creation of a security interest in favour of the creditor so as to grant him the status of a secured creditor. Such security interest has to be created by way of a transaction which means an agreement or arrangement in writing. Recently, the Ministry of Corporate Affairs (MCA) issued a discussion paper[47] regarding the classification of the government's statutory dues under the IBC. According to the MCA, the government's statutory dues can be recognized as secured creditors' dues only if there is a documented transaction that designates them as such under the IBC provisions. Consequently, the automatic classification of the government's statutory dues as secured creditors is not guaranteed.

Rainbow Papers Ltd.

In the matter of *State Tax Officer v. Rainbow Papers Ltd.*,[48] the Supreme Court examined whether government dues, secured by a 'charge' under the Gujarat Value Added Tax Act, would be accorded equal priority with other secured creditors under section 53 of the IBC. The Court held that government dues could be treated as 'secured debt', making the government a secured creditor. The court held that section 48 of the GVAT Act did not conflict with section

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[46] Company Appeal (AT) (Insolvency) No. 346 of 2019.

[47] MCA Notice - Invitation of comments from the public on changes being considered to the Insolvencyand Bankruptcy Code, 2016, https://ibbi.gov.in/uploads/whatsnew/7f55e29ae9c0023184a3895f849cd2ef.pdf (last visited Dec.20, 2023).

[48] Civil Appeal No. 1661 of 2020.

53 or other IBC provisions, affirming that government dues rank equally with debts owed to secured creditors. However, the Court also emphasized its applicability to the specific circumstances of the case alone.

The ruling in *Rainbow Papers*, equating state-level tax authorities with secured creditors, stirred concerns among experts who argue it may disrupt the established hierarchy of claims, affecting insolvency resolutions and unsettling FCs' expectations. This led to filing of review petitions in the case. However, the Supreme Court rejected a set of five review petitions challenging the Apex court's unanimous decision in the *Rainbow Papers* case. The court asserted that the grounds for seeking a review were not satisfied. With the Supreme Court's dismissal of the review petitions, though on the technical grounds, the legal stance articulated in the *Rainbow Papers* case remains unchanged. Experts note that this means tax authorities eager to recover tax dues will retain the same rights as secured creditors under the IBC waterfall mechanism.

Paschimanchal Vidyut Vitran Nigam Ltd.

In the *Paschimanchal Vidyut Vitran Nigam Ltd.*[49] (PVVNL) case, the Supreme Court examined the priority of dues of an OC with a first charge on the assets of a CD, as per Clause 4.3(f)(iv) of the Uttar Pradesh Electricity Supply Code, 2005. The Court affirmed that section 238 of the IBC prevails over the Electricity Act, 2003, and noted that a 'charge' could arise from statutory provisions or regulations. Consequently, the Court deemed PVVNL a 'secured creditor' as a charge was established on the CD's assets via Clause 4.3(f)(iv) and the agreement between the parties. Despite this, the Court, considering the functions and private participation in PVVNL, clarified that dues payable to PVVNL did not qualify as 'government dues' under section 53(1)(e) of the IBC. The Court further asserted that dues intended for the Treasury, such as taxes and tariffs falling under Article 265 of the Constitution, constitute 'government dues'.

The Apex Court went a step further and examined the question of the order of priority of secured 'government dues' vis-à-vis the order of priority under section 53. The Apex Court while analysing the judgment passed in *Rainbow Papers* (supra), observed that the GVAT Act, no doubt creates a charge in respect of amount due and payable, however, section 53 creates a separate and distinct treatment of amounts payable to secured creditor on the one hand, and dues payable to the government on the other, thereby clearly signifying the Parliament's intention to treat the government dues differently from the dues of secured creditors. Thus, the 'government dues', whether secured or unsecured, would be covered under section 53(1)(e) of the Code, being a distinct and separate class.

International perspectives

(a) **UNCITRAL Model:** UNCITRAL's Legislative Guide on Insolvency Law noted that priority given to government tax claims, often justified for reasons like protecting public revenue, can have various implications. While it may encourage reorganization by incentivizing tax authorities to postpone tax collection, it can also hinder uniform enforcement of

[49] Civil Appeal Nos. 7976 of 2019.

tax laws and potentially serve as a form of state subsidy. Granting priority to these claims might discourage diligent monitoring and debt collection practices by tax authorities, which could otherwise help prevent insolvency and asset depletion. The delicate balance between protecting public funds and maintaining the effectiveness of insolvency regimes requires careful consideration of these competing factors.[50]

(b) **Australia:** In Australia, the Corporations Act outlines the order for distributing proceeds from a company's asset realization. The hierarchy includes covering insolvency administration costs, fulfilling employees' entitlements up to a fixed amount, addressing unsecured creditors equally, and allocating funds to shareholders based on the money paid on their shares. Secured creditors retain control of their assets unless they surrender security, with the proceeds initially applied to their debt. If the secured creditor doesn't surrender security, their debt recovery is limited to the realization proceeds and, if insufficient, the shortfall is treated as an unsecured debt, shared equally.

A secured debt is linked to specific property, such as a mortgage on a house, a car loan for a vehicle, or hire purchase agreements for items like furniture or electronics. In the context of a debt agreement, a secured creditor can be the holder of a Personal Property Securities Act 2009 security interest or a person with a mortgage, charge, or lien on the debtor's property. Whether a debt is secured or unsecured depends on the contract at the time of debt initiation. Security interests are typically perfected by registration on the Personal Property Securities Register, but some may not be registered yet remain perfected under the Personal Property Securities Act 2009. Certain debts, such as water supply charges, rates/land charges in specific locations, and certain taxation debts, are deemed secured by law under certain circumstances.

(c) **Canada:** Liens on personal and real property can arise statutorily, particularly in federal and provincial statutes aimed at enhancing the collection of specific claims from debtors, such as Crown claims for taxes and employee source deductions. The Bankruptcy and Insolvency Act (BIA) outlines a priority scheme for paying claims against a bankrupt, giving precedence over provincial legislation. The hierarchy includes claims of property owners, 'super-priority' claims favouring the Crown, secured creditor claims, preferred creditor claims, and general unsecured claims.

Formal insolvency proceedings like those under the BIA or the Companies' Creditors Arrangement Act (CCAA) establish special priorities over Crown deemed statutory trusts only during insolvency proceedings. Bankruptcy and proposal proceedings collapse most statutory deemed trusts, except for those under the Income Tax Act, Canada Pension Plan, Employment Insurance Act, and others expressly surviving. Crown claims become unsecured, but exceptions include registered claims and those with Enhanced Requirements to Pay (ERTPs). For GST/HST deemed trust claims, there is no special priority in bankruptcy, proposal, or CCAA proceedings unless an ERTP exists, or Crown registration occurred before the insolvency. In receiverships, GST/HST deemed trust claims and other Crown deemed trust claims retain super-priority.

[50] Management of Proceedings, UNCITRAL's Legislative Guide on Insolvency Law (2004), Part two (V), para 74.

(d) **England:** The current order of distribution in insolvency proceedings, outlined in the Insolvency Act 1986 and the 2016 Rules, prioritizes payments to secured creditors, insolvency practitioners' fees, preferential unsecured creditors, prescribed part creditors, secured creditors with a floating charge, non-preferential unsecured creditors, and shareholders or individuals.

Since the Enterprise Act 2002, tax claims were treated as ordinary unsecured debts. However, a legislative change with effect from December 1, 2020 has elevated certain tax debts to secondary preferential status, ranking after employees' preferential claims but before claims of floating charge holders. This includes VAT, Pay as you earn (PAYE for Income Tax), Employee National Insurance Contributions (NICs), Construction Industry Scheme Deductions, and student loan repayments. Other taxes, such as Corporation Tax and Employer NICs, are still unsecured.

(e) **United States:** The Bankruptcy Code organizes claims rather than creditors due to potential multiple obligations or division of a single claim into secured and unsecured components. The Code generally respects priorities as outlined in Article 9. After satisfying secured claims, the Code prioritizes certain unsecured claims, including domestic support obligations, administrative expenses, specified taxes, and employment-related obligations. Strict adherence to these priorities is required, with higher priority claims satisfied before lower priority ones. The Court cannot alter or create sub-priorities, and pre-petition contractual subordination provisions are upheld. While Chapter 7 and Chapter 11 cases follow these priorities, creditors in a Chapter 11 plan may agree to different treatment, subject to limitations.

CONCLUDING REMARKS AND WAY FORWARD

By imposing a strategic pause on legal proceedings against the CD during the insolvency resolution process, the Moratorium serves as a mechanism to prevent the chaos of individual creditor pursuits and fosters a fair and concerted recovery through insolvency proceedings. The analysis of the intricate relationship between Moratorium and the assessment of tax liabilities during insolvency demonstrates that while the Moratorium bars the recovery process, it does not hinder the assessment of tax liabilities. Assessment proceedings can proceed during the insolvency, and the prohibition only comes into play when recovery actions are initiated post-assessment. The international comparisons also highlight that the Moratorium primarily focuses on staying enforcement actions and does not preclude the determination or assessment of tax liabilities.

Furthermore, the Clean-Slate theory ensures that once the insolvency process concludes, the extinguishment of liabilities includes those arising from tax assessments. However, the tax authorities may resort to section 179 of the Income Tax Act which empowers to seek recovery of outstanding tax liabilities linked to a company from its former promoters and directors if reclaiming these dues directly from the company proves unattainable. Although the absence of specific judicial rulings on this matter exists, there appears to be no inherent legal or logical barrier preventing tax authorities from invoking this provision for recoveries.

On the other hand, the deemed security interests created by way of operation of law pose a challenge for secured creditors as they represent invisible priority claims. Unlike other claims, these deemed trusts do not require registration to establish priority, making it difficult for lenders to ascertain their existence or quantify the claim amount when extending credit or pursuing collections. In examining the treatment of statutory liens in the context of government dues under the IBC in India, it becomes evident that international jurisdictions have taken proactive measures by expressly addressing such matters within their statutory frameworks. Many countries have recognized the significance of providing clarity on the treatment of security interests created by operation of law, as exemplified in their legal statutes. These provisions help establish a robust legal foundation, offering guidance on the priority, enforcement, and realization of statutory liens in insolvency proceedings.

In light of this international precedent, it becomes imperative for India to consider a similar approach. Addressing the treatment of security interests created by operation of law could further enhance the clarity and efficiency of the insolvency resolution process. Introducing specific provisions within the IBC that explicitly outline the treatment, priority, and enforcement mechanisms for statutory liens related to government dues would not only align India with international best practices but also contribute to the development of a more comprehensive and globally competitive insolvency framework.

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A STUDY ON THE UNTAPPED POTENTIAL OF PRE-INSOLVENCY RESOLUTION PROCEDURES

Archana Sharma and Anchita Sood

ABSTRACT

The Insolvency and Bankruptcy Code, 2016 (IBC/Code) has transformed the approach to business failures in India. Over its seven-year existence, dynamic policy interventions have kept pace with evolving stakeholder needs, inducing behavioral changes among debtors and acting as a deterrent to defaults. One of the latest novel experiments was the introduction of Pre-Pack Insolvency Resolution Process (PPIRP) to provide a swift and cost-effective resolution framework for micro, small, and medium enterprises (MSMEs). As one of the Pre-Insolvency Resolution Procedures (PIRPs),it offers a faster, more flexible and transparent framework that is succeeded by formal insolvency procedures, building stakeholder confidence and avoiding conflicts. The PPIRP framework aims to balance the debtor-in-possession and creditor-in-control model. Despite its potential benefits, PPIRP faces challenges, including limited adoption and creditor apprehensions. This comprehensive study explores the PPIRP framework, its usage, and outcomes within India's insolvency landscape, while also examining similar frameworks in international jurisdictions. The study emphasizes the need to leverage PPIRP to expedite resolutions, reduce costs, and safeguard stakeholder interests, while also evaluating its relevance and effectiveness in various scenarios, and suggesting the use of alternative frameworks where appropriate. In conclusion, the study provides policy recommendations for the government, regulators, and other stakeholders to maximize the potential of PPIRP.

Keywords: Pre-insolvency resolution procedures, Pre-packaged insolvency resolution process, Hybrid insolvency process, MSME, Out-of-court restructuring, Informal procedures, Creditor-led resolution approach, Fast track insolvency resolution mechanism.

INTRODUCTION

The IBC has been a game-changing modern reform. It has brought about a paradigm shift in how business failures and defaults are addressed between the debtors and creditors. With over seven years in existence, the IBC has witnessed several dynamic policy interventions to keep pace with the emerging jurisprudence and evolving stakeholder expectations.

The insolvency resolution process serves as a means of maximising value of assets of the corporate debtors (CDs) and realisation to the creditors who have extended money to various entities or individuals. In India, the initiation of the resolution process typically follows the fulfilment of the “default” criteria, starting with the submission of an application by an eligible stakeholder. The stakeholder initiating the process could be a financial creditor (FC), operational creditor (OC) or the corporate applicant itself.

The Code establishes a moratorium period wherein parties can attempt to address corporate distress without facing recovery or enforcement actions. In cases of corporate insolvency, creditors evaluate the feasibility of the CD and aim to revitalize it through a resolution plan. An effective resolution plan benefits both debtors and creditors by maximizing the value of the distressed company’s assets.

However, achieving such resolutions can be challenging in certain situations due to the conflicting objectives of both parties. The Code bifurcates and separates the interests of the firm from that of its promoters / management with primary focus to ensure revival and continuation of the firm by protecting it from its own management and from a death by liquidation.[1] With the operationalisation of the Code, the entrenched managements are no longer allowed to continue in management if they cannot pay their debts.[2]

Despite the challenges, the Code provides a structured framework to facilitate the resolution process and strike a balance between the interests of creditors and the distressed corporate entity. The objectives of the Code have been underpinned by Hon’ble Courts in various judgements. The objective of the Code is time bound reorganisation and insolvency resolution of firms for maximisation of value of assets of the firm in distress to promote entrepreneurship and availability of credit and balance the interests of all its stakeholders. The first order objective of the Code is resolution. The second order objective is maximisation of value of assets of the firm and the third order objective is promoting entrepreneurship, availability of credit and balancing the interests of stakeholders. This order of objectives is sacrosanct.[3]

IBC as a dynamic economic legislation

The IBC harnessed a new insolvency regime that is proactive, incentive compliant, market led, and time bound. The Government has undertaken series of interventions with the experience gained and maturity of the ecosystem. It is also relevant to note that an economic law is essentially empiric. It evolves continuously through experimentation. [4] The Code is no exception. The Code has so far witnessed six legislative interventions, which demonstrate

[1] Supreme Court (2019), Swiss Ribbons Pvt. Ltd. & Anr. vs. Union of India & Ors., 4 SCC 17.

[2] Judgement dated 31st August, 2017 of the Supreme Court in the matter of M/s. Innoventive Industries Ltd. vs. ICICI Bank & Anr.

[3] Judgement dated 14th November, 2018 of the NCLAT in the matter of Binani Industries Limited vs. Bank of Baroda & Anr.

the keenness of the Government to continuously improve resolution framework. Each of these amendments have strengthened the processes in sync with the emerging market realities and reinforced the objectives of the Code.

The Amendment paving way for Pre-Packaged Insolvency Resolution Process

As regards the sixth and latest amendment to the Code regarding PPIRP, the Bankruptcy Law Reforms Committee (BLRC) had noted that until the Indian market for insolvency practitioners becomes sufficiently developed and sophisticated, it may not be advisable to allow pre-pack sales without the involvement of the court or the National Company Law Tribunal (NCLT). However, such sales could be allowed as part of an NCLT supervised scheme of arrangement and operationalised through rules at an appropriate stage after wider consultation with the stakeholders.[5] Usually, pre-pack is a natural step in the evolution of insolvency regimes.[6]

In the Indian context, in April 2021, the IBC underwent a significant amendment, introducing the PPIRP.[7] These amendments, encapsulated in Chapter IIIA of the Code, are widely regarded as one of the most pivotal changes in the history of insolvency legislation. The amendments aimed to provide an efficient alternative insolvency resolution framework for corporate persons classified as MSMEs under the Code, for ensuring quicker, cost-effective and value maximising outcomes for all the stakeholders, in a manner which is least disruptive to the continuity of MSME businesses, and which preserves jobs.[8]

Notably, the PPIRP was extended to include MSMEs, recognizing the severe impact of the COVID-19 pandemic on this sector, recognized as vital to societal welfare and economic stability. A survey conducted by the National Small Industries Corporation Ltd. revealed that about 9% of MSMEs had to cease operations due to the pandemic. The initiative for the said amendment was based on a trust model and to honour the honest MSME owners by trying to ensure that the resolution happens, and the company remains with them.[9]

It's important to note that the inclusion of businesses within the MSME category is contingent upon meeting specific conditions outlined in the Micro, Small, and Medium Enterprises Development Act, 2006 (MSMED Act, 2006). This Act provides an overall structure for promoting and developing MSMEs and increasing their competitiveness, which are defined as under:

(a) **Micro Enterprises:** Enterprises with an annual turnover of less than ₹ 5 crore and an investment in plant and machinery or facilities of less than one crore rupees.

(b) **Small Enterprises:** Enterprises with an annual turnover of less than ₹ 50 crore and an investment in plant and machinery or facilities of less than ten crore rupees.

(c) **Medium Enterprises**: Enterprises with an annual revenue of less than ₹ 250 crore and a plant and machinery or equipment expenditure of less than fifty crore rupees.

[4] Supreme Court (2019), Swiss Ribbons Pvt. Ltd. & Anr. vs. Union of India & Ors., 4 SCC 17.

[5] The Interim Report of the Bankruptcy Law Reforms Committee, February 2015.

[6] M. P. Ram Mohan and Vishakha Raj, *Pre-packs in the Indian Insolvency Regime,* IIMA Working Paper No. 2020-08-03 (2020).

[7] The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021, 4th April 2021.

[8] *President promulgates Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021*, (Apr. 7, 2021), https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1710161.

[9] *Id.*

The rationale behind incorporating MSMEs into the PPIRP framework is rooted in the need to offer a swift and cost-effective mechanism for the revival of these enterprises. The adverse effects of the pandemic have highlighted the vulnerability of MSMEs, making their inclusion in the PPIRP a strategic move to facilitate their resolution and contribute to overall economic resilience.

The MSMEs in India have been playing a crucial role by providing large employment opportunities at comparatively lower capital cost than large industries as well as through industrialization of rural & backward areas, *inter alia,* reducing regional imbalances, assuring more equitable distribution of national income and wealth.[10] India has approximately 6.3 crore MSMEs. Micro sector with 630.52 lakh estimated enterprises accounts for more than 99% of total estimated number of MSMEs. Small sector with 3.31 lakh and medium sector with 0.05 lakh estimated MSMEs accounted for 0.52% and 0.01% of total estimated MSMEs, respectively.[11]

OBJECTIVE OF STUDY

This paper delves into the uncharted territory of PIRPs within the unique framework of the Indian insolvency landscape. One of the notable PIRP framework implemented in the Indian landscape is the PPIRP. The study elaborates and analyses the framework of PPIRP in the IBC, their use by stakeholders and outcomes delivered so far. A comparative analysis has been done for the processes of PPIRP and corporate insolvency resolution process (CIRP) to understand the key benefits that PPIRP are offering to MSMEs.

By addressing critical issues within India's corporate insolvency framework and proposing tailored policy recommendations, this study aims to contribute to the ongoing discourse regarding the robust use of PIRPs as an alternative to the IBC. In conclusion, the study aims to provide a roadmap for unlocking the full potential of PPIRP, facilitating more effective corporate restructuring, and promoting sustainable economic growth in India.

CONCEPT OF PRE-PACKAGED INSOLVENCY RESOLUTION

PPIRPs are generally hybrid processes that combine the advantages of informal procedures which are often economical and swift without involving complex procedural requirements and offering certain features of formal insolvency processes.[12] Pre-packaged bankruptcy proceedings first emerged in United States to avoid the relative costs and complicated negotiation processes involved in an ordinary bankruptcy proceeding filed under Chapter 11 of the US Bankruptcy Code.[13]

PPIRP entails a pre-arranged strategy for resolving insolvency issues between a financially distressed company and its creditors. This mechanism facilitates negotiations between debtors and creditors to reach an agreement on the resolution plan before formally initiating the insolvency process as outlined in the Code. The pre-packaged approach aims to streamline the resolution process by mitigating uncertainty and minimizing delays, given that the plan

[10] Ministry of Micro, Small and Medium Enterprises, *Annual Report 2022-2023* 31.
[11] *Id.* at 32.
[12] Bo Xie, Comparative Insolvency Law: The Pre-pack Approach in Corporate Rescue 28 (Edward Elgar Publishing 2016).
[13] *Id.*

is established in advance. Pre-pack has emerged as an innovative corporate rescue method that incorporates the virtues of both informal (out-of-court) and formal (judicial) insolvency proceedings.[14]

Under the PPIRP, a small or medium-sized business that owes money can begin a process by creating a plan to solve its debt issues, with the help of a Resolution Professional (RP). This plan is then presented to the creditors for their approval. If the majority of the creditors agree to the plan, it is then submitted to the Adjudicating Authority (AA)/ NCLT for final approval.

One of the core features of pre-insolvency proceedings is the remediation of the deteriorating financial condition of the debtor before it commits default or can be placed into formal insolvency process.

Insights into the modern MSME insolvency practices[15]

Globally, insolvency processes are often deemed unsuitable for struggling MSMEs due to their complexity, length, and inflexibility. MSMEs face hurdles in accessing credit and lack expertise for prolonged statutory procedures, further hindered by financial constraints to support intricate insolvency proceedings. Consequently, creditors hesitate to participate in such proceedings, preferring alternatives like recovery actions.

Amid a surge in MSME insolvencies driven by the COVID-19 pandemic, there's a global push for tailored insolvency frameworks. Reports from international bodies highlight the mismatch between formal insolvency procedures and MSME needs, prompting reforms in countries like Singapore and Australia.

In the Indian insolvency resolution framework, the Government took further steps post the COVID-19 pandemic to provide a structured framework to harness behavioral change brought in by the Code. This led to the introduction of the PPIRP framework which can be explored by select entities before proceeding to the detailed procedures outlined in the IBC.

LEGAL AND REGULATORY FRAMEWORK OF PPIRP IN INDIA

The Report of the Sub-Committee on PPIRP noted that the introduction of the pre-pack insolvency scheme represents an evolution of the Indian insolvency regime. In the aftermath of the COVID-19, the Pre-pack Committee stated that it was the 'right time to introduce pre-packs in India' as there was a likelihood of an increase in insolvency cases.[16]

The aim of PPIRP is a speedy and more cost-effective resolution, with lesser disruption to business than the CIRP.[17] To achieve these goals, the pre-pack framework in India consciously shifted away from many procedures and practices as seen in a CIRP while trying to maintain the core features of the Code.[18]

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[14] *supra note* 12

[15] Ministry of Corporate Affairs, *Report of the Insolvency Law Committee on Pre-packaged Insolvency Resolution Process*, 23 (July 2021).

[16] Ministry of Corporate Affairs, *Report of the Sub-Committee of the Insolvency Law Committee* on *Pre-packaged Insolvency Resolution Process* 31 (October 2020).

[17] *Id.* at 32.

[18] M. P. Ram Mohan and Sriram Prasad, *Lessons From Pre-Packaged Insolvency Cases In India: A Long Road Ahead,* IBBI Annual Publication 2023 176.

Eligibility for PPIRP under the IBC

1. **Corporate Debtors**: A CD classified as a micro, small, or medium enterprise under section 7(1) of the MSMED Act, 2006, is eligible to initiate the PIRP.[19]

2. **Default Condition**: Section 54A(2) outlines the conditions for a CD to be eligible for PIRP. It includes cases where a CD commits a default specified in section 4, subject to several conditions.

   An application for initiating PPIRP may be made in respect of a CD, who commits a default referred to in section 4, subject to the following conditions, that[20]—

   (a) it has not undergone pre-packaged insolvency resolution process or completed corporate insolvency resolution process during the period of three years preceding the initiation date;

   (b) it is not undergoing a corporate insolvency resolution process;

   (c) no order requiring it to be liquidated is passed under section 33;

   d) it is eligible to submit a resolution plan under section 29A;

   (e) the financial creditors of the corporate debtor, not being its related parties, representing such number and in such manner as may be specified, have proposed the name of the insolvency professional to be appointed as resolution professional for conducting the pre-packaged insolvency resolution process of the corporate debtor, and the financial creditors of the corporate debtor, not being its related parties, representing not less than sixty-six per cent. in value of the financial debt due to such creditors, have approved such proposal in such form as may be specified:

   Provided that where a corporate debtor does not have any financial creditors, not being its related parties, the proposal and approval under this clause shall be provided by such persons as may be specified;

   (f) the majority of the directors or partners of the corporate debtor, as the case may be, have made a declaration, in such form as may be specified, stating, inter alia, that—

   (i) the corporate debtor shall file an application for initiating pre-packaged insolvency resolution process within a definite time period not exceeding ninety days;

   (i) the pre-packaged insolvency resolution process is not being initiated to defraud any person; and

   (ii) the name of the insolvency professional proposed and approved to be appointed as RP under clause (e)

[19] Section 54A(1), The Insolvency and Bankruptcy Code, 2016 (Amended 12-08-2021).
[20] Section 54A (2), The Insolvency and Bankruptcy Code, 2016 (Amended 12-08-2021).

(g) the members of the corporate debtor have passed a special resolution, or at least three-fourth of the total number of partners, as the case may be, of the corporate debtor have passed a resolution, approving the filing of an application for initiating pre-packaged insolvency resolution process.

(3) the corporate debtor shall obtain an approval from its financial creditors, not being its related parties, representing not less than sixty-six per cent. in value of the financial debt due to such creditors, for the filing of an application for initiating pre-packaged insolvency resolution process, in such form as may be specified:

Provided that where a corporate debtor does not have any financial creditors, not being its related parties, the approval under this sub-section shall be provided by such persons as may be specified.

(4) prior to seeking approval from financial creditors under sub-section (3), the corporate debtor shall provide such financial creditors with —

(a) the declaration referred to in clause (f) of sub-section (2);

(b) the special resolution or resolution referred to in clause (g) of sub-section (2);

(c) a base resolution plan which conforms to the requirements referred to in section 54K, and such other conditions as may be specified; and

(d) such other information and documents as may be specified.

Process of PPIRP under the IBC

1. **Initiation**: A corporate applicant meeting the requirements of section 54A may file an application with the AA to initiate PIRP.[21]
2. **Application Filing**: The application, must be submitted in the prescribed form, containing necessary particulars, and accompanied by the prescribed fee.[22]
3. **Furnishing Documents**: The corporate applicant is required to provide declarations, resolutions, name and consent of RP, and approvals from FCs along with the application.[23]
4. **AA's Decision**: The AA shall admit or reject the application within fourteen days of receipt. In case of rejection, the applicant is provided an opportunity to rectify any defects within seven days from the date of receipt of notice.[24]
5. **Commencement**: Upon admission, the PIRP begins from the date specified by the AA.
6. **Completion Timeline**: The PIRP must be completed within one hundred and twenty days from the commencement date.[25] Section 54D(2) requires the RP to submit

[21] Section 54C(1), The Insolvency and Bankruptcy Code, 2016 (Amended 12-08-2021).
[22] Section 54C(2), The Insolvency and Bankruptcy Code, 2016 (Amended 12-08-2021).
[23] Section 54C(3), The Insolvency and Bankruptcy Code, 2016 (Amended 12-08-2021).
[24] Section 54C(4), The Insolvency and Bankruptcy Code, 2016 (Amended 12-08-2021).
[25] Section 54D(1), The Insolvency and Bankruptcy Code, 2016 (Amended 12-08-2021).

resolution plan, as approved by committee of creditors (CoC), to AA within ninety days from the commencement date.

7. **Termination**: If no resolution plan is approved within the specified time, the RP shall file an application for termination of the process with the AA.[26]

COMPARATIVE ANALYSIS: POTENTIAL OF PPIRP VS. CIRP

To gain insights into the factors influencing the under utilization of PPIRPs, it's imperative to grasp the core aspects of corporate insolvency resolution within the framework of IBC. Within the IBC framework, the insolvency processes for corporates primarily consist of the CIRP and the PPIRP.

The introduction of the PPIRP, currently applicable to MSMEs, necessitates a thorough understanding of its significant divergences from the CIRP and PPIRP under the IBC.

Comparison between CIRP and PPIRP [27]

Sl.	Criteria	CIRP	PPIRP
1	Eligibility	All companies and LLP	Companies classified as MSME
2	Minimum amount of Default	1 Crore Rupees	10 Lakh Rupees
3	Application for Initiation	FC, OC and CD himself	CD, authorized person of CD, Person in control of financial affairs of the CD
4	Timeline	180 Days + 90 Days (overall 330 days)	120 Days (No Extension)
5	Interim Resolution Professional (IRP)	IRP will get appointed on the Insolvency Commencement Date (ICD)	No Such Concept under this Process
6	RP	RP will get appointed on the 1st CoC meeting held on 30th day of ICD	RP will get appointed on the Pre-Packaged Insolvency Commencement Date (PICD)
7	Base Resolution Plan (Sec 5(2A))	No Such Concept under this Process	It will be submitted by the Corporate Debtor to FCs before PICD
8	Moratorium & Public Announcement	Applicable U/s 14 & 15 of IBC	Applicable U/s 54E of IBC
9	Constitution of CoC	23rd Day from the ICD	7th Day from the PICD

[26] Section 54D(3), The Insolvency and Bankruptcy Code, 2016 (Amended 12-08-2021).

[27] CA S Sidharth, *Unlocking Success: The Untapped Potential of PPIRP for MSMEs,* Taxmann (Feb. 11, 2022), https://www.taxmann.com/research/ibc/top-story/105010000000023664/unlocking-success-the-untapped-potential-of-ppirp-for-msmes-experts-opinion.

10	First Meeting of CoC	To be held within 7 days of Constitution of CoC	To be held within 7 days of Constitution of CoC
11	Preliminary Information Memorandum (Sec 5(23A))	No Such Concept under this Process	It will be submitted by Corporate Debtor within two days of PICD to RP
12	Management of the CD	Vested with the IRP on ICD and subsequently transmitted to RP (Sec 17)	Vested with the old management and RP shall monitor it (Sec 54F(2)(d))
13	Initiation of CIRP (Sec 54O)	Not Applicable	CoC at any time may decide upon for initiation of CIRP with voting not less than 66%
14	Resolution Plan	Equal Opportunity to All	First Opportunity to Promoters
15	Termination	Results in Liquidation	Only in case of 54J order – Liquidation Other case – Management continues CD

One key difference lies in the approach to formulating resolution plans. In PPIRP, the resolution plan is discussed and agreed upon by the involved parties before approaching the competent authority for final approval. This stands in contrast to the formal bidding process mandated under CIRP. By allowing for prior consensus, PPIRP streamline the approval process, potentially reducing delays and associated costs.

Moreover, the empowerment of the CD to initiate proceedings under PPIRP once informal agreement on a resolution plan is reached is a departure from the CIRP, where the initiation is not solely in the hands of the debtor. This shift in initiation rights fosters a more collaborative and efficient resolution process, as it enables proactive engagement by the debtor in addressing insolvency issues.

Another critical advantage of PPIRP is the provision for a shorter timeline for the disposal of proceedings, with a maximum period of 120 days, compared to the 270-day threshold under CIRP. This compressed timeline can lead to faster resolution outcomes, reducing the overall economic impact of insolvency proceedings and providing stakeholders with quicker clarity on the future of the distressed entity. This accelerated process has the potential to expedite insolvency resolutions, thereby reducing economic costs and safeguarding the interests of stakeholders.

In a survey conducted by the researchers, stakeholders were asked –

"From your perspective, what are the main benefits of using PPIRPs compared to traditional insolvency resolution processes?"

"Do you believe that PPIRP is a better resolution mechanism than the corporate insolvency resolution process? Please explain your viewpoint."

The limited responses that the authors received suggest that while PPIRP offer various advantages such as efficiency, business continuity, and reduced uncertainty, challenges related to FC agreement, claim verification, and stakeholder responsibilities must be addressed to fully leverage the potential of PPIRP as insolvency resolution mechanisms. Additionally, the perceived superiority of PPIRP over the CIRP depends on factors such as the viability of the business and stakeholder co-operation.

UNDERSTANDING PPIRP BENEFITS

The PPIRP was heralded as a trust-based resolution model for the MSMEs by providing an efficient alternative insolvency resolution framework for timely, efficient & cost-effective resolution of distress. The introduction of this model aimed at ensuring positive signal to debt market, employment preservation, ease of doing business and preservation of enterprise capital. The other expected impact and benefits of the amendment included lesser burden on AA, assured continuity of business operations for CD, less process costs & maximum assets realization for FCs and assurance of continued business relation with CD and rights protection for OC.[28] These have been discussed in detail in ensuing paragraphs.

The PPIRP presents a range of advantages for distressed companies and stakeholders involved in the restructuring process. One of the primary benefits of PPIRP is its ability to expedite the resolution process. By negotiating a resolution plan before formal insolvency proceedings commence, PPIRP significantly reduces the time required to complete the restructuring, enabling a faster return to financial stability.

Moreover, PPIRP helps in preserving the value of the distressed company by maintaining key contracts, customer relationships, and asset integrity. This preservation of value not only safeguards the interests of creditors but also enhances the prospects for the company's future viability.

In addition to speed and value preservation, PPIRP offers cost efficiencies. With fewer legal and administrative hurdles compared to traditional insolvency processes, the overall expenses incurred by stakeholders are minimized. Furthermore, PPIRP minimizes disruption to the company's day-to-day operations, providing greater stability for employees, suppliers, and customers during the restructuring phase.

Another key advantage of PPIRP is the level of control it affords to the debtor. By allowing the company to negotiate and agree upon a resolution plan before insolvency proceedings begin, PPIRP empowers the debtor to retain control over the restructuring process. This control can be instrumental in ensuring that the interests of all stakeholders are considered and that the transition post-restructuring is as smooth as possible.

Moreover, PPIRP can enhance credit or confidence. The structured framework provided by PPIRP, along with the pre-negotiated resolution plan, can instil greater confidence in creditors, leading to higher acceptance rates and smoother implementation of the restructuring plan.

Overall, PPIRP offers a more efficient, flexible, and controlled approach to resolving insolvency issues, benefiting distressed companies, creditors, employees, and other stakeholders alike.

[28] Ministry of Micro, Small and Medium Enterprises, *supra note* 10.

ASSESSING THE EFFECTIVENESS OF PPIRP

The PPIRP was introduced in 2021 specifically targeting MSMEs in India, aiming to provide a streamlined mechanism for their revival and resolution. However, its effectiveness has been limited, with only ten applications admitted since its inception. Out of these, one case was withdrawn, while the resolution plans for five cases have been approved, leaving four cases ongoing as of March 2024.[29]

Sl.	CD	Date of Admission	NCLT Bench	Present Status
1.	GCCL Infrastructure & Projects Ltd.	14.09.2021	Ahmedabad	Plan Approved
2.	Loonland Developers Pvt Ltd.	29.11.2021	Principal Bench, New Delhi	Withdrawn
3.	Enn Tee International Limited	10.10.2022	Principal Bench, New Delhi	Plan Approved
4.	Amrit India Limited	28.11.2022	Principal Bench, New Delhi	Plan Approved
5.	Sudal Industries Limited	20.04.2023	Mumbai	Plan Approved
6.	Shree Rajasthan Syntex Limited	19.04.2023	Jaipur	Plan Approved
7.	Mudraa Lifespaces Private Limited	06.12.2023	Mumbai	Ongoing
8.	Kethos Tiles Private Limited	04.01.2024	Ahmedabad	Ongoing
9.	Shreemati Fashions Private Limited	05.01.2024	Kolkata	Ongoing
10.	Kratos Energy & Infrastructure Limited	01.02.2024	Mumbai	Ongoing

In a survey conducted by the researchers, stakeholders were asked –

"How would you assess the effectiveness of PPIRP as a mechanism for resolving insolvency? Please explain your viewpoint."

The analysis of responses reveals a spectrum of perspectives on the effectiveness of PPIRP in resolving insolvency. While some respondents view PPIRP positively i.e. PPIRP is a very effective tool for resolving insolvency smoothly, akin to a semi-formalised OTS (One-Time Settlement) proposal and emphasize its benefits in facilitating smooth resolution and business continuity, others identify challenges such as dependency on FC's consent and the importance of stakeholders' conduct and honesty.

[29] Insolvency and Bankruptcy Board of India, *Quarterly Newsletter for January-March 2024.*

These responses suggest that the effectiveness of the process depends on the conduct and honesty of the involved parties. This viewpoint acknowledges the role of stakeholders' behavior and integrity in determining the success of the process. It implies that the success of PPIRP is contingent upon the ethical conduct and collaborative efforts of all parties involved.

Additionally, there is recognition of the current ineffectiveness of PPIRP but also optimism regarding its potential for improvement.

These diverse viewpoints underscore the complexity and multifaceted nature of pre-insolvency resolution mechanisms like PPIRP. Effective implementation requires addressing various challenges, including stakeholder co-operation, regulatory frameworks, and ethical considerations. Further research and analysis may be necessary to evaluate the practical implications of these perspectives and inform potential reforms or improvements to enhance the effectiveness of PPIRP in resolving insolvency.

It is pertinent to note that every legislation, particularly in economic matters is essentially empiric and it is based on experimentation or what one may call trial and error method and therefore it cannot provide for all possible situations or anticipate all possible abuses.[30] In such instances, what becomes crucial is the evaluation and assessment of the legislation's implementation. Upon identifying issues, appropriate interventions may be undertaken to address bottlenecks or strengthen the legislation. Judicial intervention becomes particularly pertinent in these circumstances. Additionally, governmental bodies and regulators should play a role in enhancing effectiveness.

COMPARATIVE GLOBAL JURISDICTIONAL PERSPECTIVE: PRE-PACK FRAMEWORKS

The primary objective of most pre-pack arrangements is to streamline and expedite the insolvency process, which tends to be expensive and protracted. Apart from direct costs like professional fees, financial distress often incurs significant indirect costs such as damage to reputation, bargaining power, goodwill, employees, lenders, and suppliers. These cumulative costs can erode the going concern value of otherwise viable companies facing financial difficulties. Pre-packs, by reducing both the financial burden and duration of insolvency proceedings, often facilitate the survival of such businesses and maximize returns to creditors.

However, the implementation of pre-packs varies across jurisdictions, with distinctions among pre-negotiated reorganizations, pre-packaged reorganizations, and pre-packaged sales. Pre-negotiated reorganizations involve debtor-creditor negotiations before formal insolvency procedures, thus cutting down on procedural time and costs. In contrast, pre-packaged reorganizations involve formal solicitation of creditor approval before commencing insolvency proceedings, enabling swift court confirmation. The US typically employs this model, which has inspired similar practices in Singapore. On the other hand, pre-packaged sales, common in the UK, involve negotiation and completion of business or asset sales before the initiation of insolvency proceedings, often rescuing the business promptly.

[30] *supra note* 3.

Despite the common terminology, nuances in pre-pack arrangements are evident across jurisdictions. While the US and Singapore use “pre-pack” to denote pre-packaged reorganizations, the UK applies it to pre-arranged sales in insolvency. Moreover, regulatory frameworks and eligibility criteria for pre-packs vary globally. While India reserves pre-packs for MSMEs, countries like Singapore, the UK, and the US have no such restrictions. Furthermore, international disparities exist in the regulation of pre-packs, with the UK and the US relying on court guidelines rather than legislative regulations, while India and Singapore regulate pre-packs within their respective insolvency laws.

In India, PPIRP is designed for the MSMEs. However, in most of the jurisdictions that allow pre-packs, pre-pack as a restructuring mechanism can be used by any company. Studies conducted in the UK suggest that pre-packs are commonly favored by MSMEs. These enterprises typically possess relatively modest asset values, have been established within the last 5 to 15 years before entering administration, maintain secured debts below £250,000, and unsecured debts under £500,000. Thus, in the UK, the data suggests that pre-packs are predominantly utilized by small, relatively young businesses.[31]

United Kingdom

Initially, pre-pack insolvency procedures were not formally incorporated into the UK legislation. Instead, they evolved as a market practice, receiving implicit endorsement from the courts. However, the emergence of this new framework transformed into a tactical approach for selling financially distressed firms without creditor consultation. Notably, pre-pack insolvency shifts the control paradigm from a creditor-in-possession regime to a debtor-in-possession regime. This shift raised concerns, which were deliberated to be address through certain voluntary measures to be taken by the companies before going for a pre-pack like:

(a) Establishment of a pre-pack pool comprising seasoned business professionals to offer their assessment of the proposed pre-pack sale.

(b) Providing comprehensive information to creditors during pre-pack sales.

United States of America

In US, three forms of pre-packs available under the US Bankruptcy Code viz, pre-plan sales, pre-packaged bankruptcy proceedings and pre-arranged bankruptcy proceedings. Pre-planned sales bear similarity to pre-pack sales in the UK. In this context, the ‘bankruptcy trustee’, acting as an administrator, is vested with the authority to sell significant assets of the CD upon its initiation of the reorganization process. A pre-packaged insolvency proceeding involves the CD reaching an agreement with key creditors, securing their approval on the arrangement, and subsequently submitting a Chapter 11 petition. Conversely, in pre-arranged insolvency proceedings, the CD negotiates an agreement with creditors but refrains from disseminating the plan or soliciting votes prior to filing the Chapter 11 petition.

[31] Singapore Management University School of Law, *The Rise of Pre-Packs as a Restructuring Tool: Theory, Evidence and Policy*, Research Paper No. 15/2021.

Singapore

The pre-pack process requires more judicial powers and intervention. The court holds significant discretion regarding compromises and arrangements. It may approve a proposed compromise without necessitating a creditors' meeting, provided the court deems that such a meeting would likely have resulted in creditor agreement. This framework is reinforced by the Insolvency, Restructuring and Dissolution (Amendment) Act, 2020, which aims to further diminish the role of creditors in the process.

EXPLORING POTENTIAL BEST PRACTICESIN PPIRP FRAMEWORK

In a survey conducted by the researchers, stakeholders were asked –

Are there any best practices from other jurisdictions that you think could be adapted to improve the effectiveness of PPIRP?

The responses provided in the survey suggestions for potential best practices that could be adapted to improve the effectiveness of the PPIRP.

(a) **Designated benches in NCLT for PPIRP matters:** This suggestion proposes the establishment of specialized benches within the NCLT dedicated to handling PPIRP cases. Specialized benches can offer expertise and efficiency in handling complex insolvency matters, including PPIRP. By allocating specific resources and personnel to PPIRP cases, it can streamline the process and ensure consistent application of relevant laws and regulations.

(b) **Admission of PPIRP based on erosion of net worth:** Another suggestion is to admit companies into the PPIRP process based on the erosion of their net worth. This criterion could provide a clear and objective threshold for determining eligibility for PPIRP, streamlining the admission process. By focusing on companies experiencing significant financial distress, it targets those most in need of efficient insolvency resolution mechanisms like PPIRP.

(c) **Adaptation of Income Tax Assessment process and procedure:** The third suggestion proposes adopting aspects of the income tax assessment process and procedure to enhance the effectiveness of PPIRP. While specific details are not provided, this suggestion may imply leveraging certain features of the income tax assessment process, such as standardized procedures, timelines, or documentation requirements, to improve the efficiency and transparency of PPIRP proceedings.

(d) **Customization of laws based on grassroots experience and needs:** The final response emphasizes the importance of tailoring insolvency laws and mechanisms like PPIRP to address the unique needs and experiences of stakeholders, particularly in the context of MSMEs. This viewpoint underscores the significance of considering practical realities and feedback from stakeholders when designing and implementing insolvency frameworks.

The suggestions offer unique opportunities for improving the efficiency, transparency, and accessibility of PPIRP. However, their effectiveness would depend on various factors, including regulatory frameworks, institutional capacity, stakeholder engagement, and alignment with broader policy objectives.

NAVIGATING CHALLENGES AND LIMITATIONS IN IMPLEMENTING PPIRPS

In a survey conducted by the researchers, stakeholders were asked –

"What obstacles have you faced when implementing PPIRPs in practice? or What challenges do you perceive in the implementation of PPIRP?"

Based on the responses provided, it's evident that the implementation of PPIRPs faces several significant challenges:

1. **Difficulty in obtaining consent from FC:** One of the most prominent obstacles is the reluctance or hesitance of FCs, such as bankers, to provide consent for the resolution plan. They may be apprehensive about making early decisions and could lack vision or effective decision-making processes. This reluctance creates a significant hurdle in the successful implementation of PPIRP.

2. **Unsettled, disputed, and fraudulent claims:** Another challenge highlighted is the presence of unsettled, disputed, or fraudulent claims within the resolution process. These types of claims can complicate the resolution process, potentially leading to delays or disputes that hinder successful implementation.

3. **Lack of experience or willingness to engage in PPIRPs:** Some respondents mentioned that they have not yet engaged in PPIRPs due to various reasons, such as lack of interest or willingness from bankers or FCs. This could indicate a broader issue of resistance or unfamiliarity with the PPIRP framework among stakeholders involved in insolvency resolution.

4. **Risk aversion and preference for authority over responsibility:** There appears to be a sentiment among stakeholders, particularly bankers or FCs, of preferring authority over responsibility. This suggests a reluctance to take on the risks associated with approving PPIRPs, which could stem from a conservative approach to decision-making or concerns about potential liabilities.

5. **Challenges with promoter declarations:** Some respondents mentioned difficulties with obtaining declarations from promoters, which are likely required as part of the PPIRP process. This could be due to concerns about the accuracy or validity of the information provided, potentially hindering the smooth progression of the resolution process.

Overall, these challenges highlight the complexity and multifaceted nature of implementing PPIRPs in practice. The Insolvency Law Committee also noted that since the concept of debtor-in-possession is a new introduction to the scheme of the Code, there will be a need to take flexible measures to set new standards of conduct for the management and owners of the CD to uphold the object and purpose of the Code, and to avoid any abuse of process.[32] While any

[32] *supra note* 18, at 70.

such review in this direction is yet to be undertaken, it is imperative that addressing the obstacles would likely require collaboration among various stakeholders, including regulators, financial institutions, insolvency professionals (IPs), and corporate entities, to develop strategies and frameworks that facilitate smoother and more efficient resolution processes.

In a survey conducted by the researchers, stakeholders were asked –

“Have you noticed any specific reasons for the limited adoption of PPIRP?”

The responses underscore the various challenges and barriers that contribute to the limited adoption of PPIRPs that may be summarized as-

(a) **Delay in decision-making by bankers/FCs:** One key reason is the perceived lack of willpower or delay in decision-making among bankers and FCs. This hesitation could stem from concerns about risk, uncertainty, or a general reluctance to engage in new or untested processes.

(b) **Difficulty in convincing FCs:** Additionally, the challenge of convincing FCs to participate in PPIRPs emerges as a significant obstacle, indicating a need for greater education and transparency to build trust and confidence in the efficacy of PPIRPs compared to traditional resolution mechanisms.

(c) **Challenges in arranging funds from promoters:** Furthermore, the delay in arranging funds from promoters highlights a practical barrier to implementing PPIRPs, underscoring the importance of adequate financial resources for the success of these processes.

(d) **Time required for assessing the situation:** The need for time to accurately assess the situation before proceeding with a PPIRP suggests a requirement for more thorough due diligence processes to ensure the viability and feasibility of such resolutions.

(e) **Risk aversion and preference for authority over responsibility:** The resistance among stakeholders to take on the risk of approval for admission into the PPIRP process underscores broader issues of risk aversion and a preference for authority over responsibility.

Addressing these challenges would likely necessitate collaborative efforts among stakeholders, including regulators, financial institutions, IPs, and corporate entities, to promote greater acceptance and utilization of the PPIRP framework.

UNCOVERING THE ROOTS OF RESISTANCE TO PPIRPS

The data indicates that there has been limited adoption of the PPIRP. The reluctance in utilizing PPIRP is evident from the survey responses, suggesting that its adoption may require some time and successful outcomes in current cases to encourage more applications.

The subdued response to PPIRP could stem from various factors which could be bifurcated as debtor related, creditor related or institutional infrastructure related.

One of the reasons might be that the promoters of defaulting MSMEs may not be comfortable with initiating PPIRP due to the intense scrutiny of the company's affairs and the delegation of certain powers to the RP.[33]

Additionally, the FCs may exhibit hesitancy in approving PPIRP due to the perception that taking a haircut is typically a last resort in the CIRP, whereas in PPIRP, it's voluntary. Consequently, operating officials at FCs might fear potential scrutiny of such decisions by various authorities at a later date.[34] The scarcity of PPIRP cases may also stem from the reluctance of lower-level bankers to make decisions regarding the approval of PPIRPs and instead delegate this responsibility. In this context, obtaining approval from banks has proven to be the most challenging aspect of PPIRP. However, there are understandable reasons for the banks' hesitance, as they must ensure the authenticity of losses before consenting to a PPIRP. Similar issue was observed in the CIRP cases also and intervention of the Indian Banks Association and the Reserve Bank of India (RBI) was required.

Moreover, the absence of a robust adjudicating infrastructure has contributed to delays in resolving cases.[35] The financial projections and the acceptance of any foundational resolution plan are contingent upon the current outlook, which may evolve once the critical time frame elapses. Delays in PPIRPs could result in reduced prospects for approval of the initial base resolution plan submitted during the PPIRP application. Consequently, the CD might be discouraged from initiating a PPIRP if the proposed base resolution plan would have limited potential for approval—an advantage that PPIRP typically offers over CIRP.

Bankers would typically prefer the CIRP due to its competitive edge, opting to first attempt to sustain the company rather than directly pursuing a PPIRP.

The progress and outcome of the PPIRP cases initiated so far could also disincentivise the use of PPIRP.

GLOBAL PERSPECTIVES: ADDRESSING ISSUES AND CHALLENGES

Primary risks involved in a pre-pack

Recognizing the indispensable role of MSMEs in driving economic vitality and social well-being, there is a growing imperative to address their unique challenges in insolvency proceedings. As integral cogs in the economic machinery, MSMEs contribute significantly to job creation, innovation, and regional development. Hence, crafting specialized insolvency frameworks tailored to their needs isn't just an economic necessity but also a means of safeguarding community resilience and advancing sustainable development objectives.

Furthermore, by instituting simplified and accessible insolvency mechanisms, policymakers can foster an environment conducive to entrepreneurial endeavors and risk-taking—an essential ingredient for nurturing a dynamic and resilient economy. These frameworks empower MSMEs to navigate financial turbulence more adeptly, thereby fostering innovation, attracting investment, and facilitating business expansion. Moreover, by facilitating smoother

[33] IIIPI, *The Resolution Professional,* Vol. 3.2, 7 (April 2023).

[34] *Id.*

[35] *Id.*

resolutions to financial crises, such reforms can help safeguard valuable assets, curb job losses, and mitigate the broader economic repercussions of MSME insolvencies.

In summary, the establishment of specialized insolvency mechanisms tailored to MSMEs represents a proactive stride towards nurturing inclusive economic growth and fortifying societal resilience. By equipping MSMEs with the necessary support and resources to weather financial storms, policymakers can unleash their full potential as drivers of economic prosperity and catalysts for positive societal change.

REFINING THE FUTURE: DISCOVERING POSSIBILITY OF ENHANCING ADOPTION OF PPIRP

Deciphering key data points: Unveiling the untapped potential

As of 31st March 2024, a total of 7567 CIRPs have been initiated. It is noteworthy to mention that approximately 75% of these cases have reached closure through various means such as appeal, review, settlement, withdrawal under section 12A, approval of resolution plans, or commencement of liquidation. Notably, among these initiated processes, a mere 6% have been initiated by the CDs themselves, highlighting a tepid trend in stakeholder-driven initiations.

This data reflects a vivid picture of the transformative impact of the Code. It's evident that the Code has spurred behavioral shifts among debtors and creditors, prompting early resolutions even before the formal application stage. The Code has catalyzed proactive measures at different pre and post admission stages i.e., when default is imminent or on receipt of notice for repayment but before filing an application or after filing application but before its admission or after admission of application. A staggering 28,818 applications for CIRP initiation, involving CDs with underlying defaults totaling ₹ 10.22 lakh crore were withdrawn before admission.[36]

This dual outcome signifies two crucial points. Firstly, there might be a discernible reluctance among CDs to opt for the formal insolvency resolution process, potentially attributable to various factors. Secondly, a substantial number of cases have been rescued prior to entering the formal insolvency resolution framework.

This data is indicative of the inherent preference for proactive, semi-formal frameworks to resolve financial distress, indicating a nuanced approach to insolvency resolution beyond the CIRPs.

There are several factors which can aid in enhancing the adoption of PPIRP as discussed in the ensuing paragraphs.

Promoting a shift in perspective

Even if MSME has only one or two lenders, they should be willing to consider the restructuring proposals put forth by their promoters and agree upon the base resolution plans submitted by them. While the legal process can be lengthy, it is crucial for lenders to actively participate in order to establish authority, order, and direction in implementing these plans effectively.

[36] *supra note* 31.

Many MSMEs encounter short-term financial challenges, which can often be overcome with some time for recovery and minor adjustments accepted by creditors. Therefore, it is imperative for larger creditors to be open to accepting such adjustments in order to enable MSMEs to continue their operations uninterrupted, thus contributing to the broader economic well-being.

Preserving the operational continuity of the entity

In contrast to large corporations, MSMEs operate on a smaller scale, where intricate operational details are often known only to the company's promoter. Unlike in larger firms, where such responsibilities may be delegated to managers, MSME promoters typically remain intricately involved in day-to-day operations to ensure the entity's smooth functioning. Consequently, transferring management duties to the RP isn't always practical or feasible for maintaining the entity's operational continuity.

It is essential for creditors to grasp this distinction. While the PPIRP allows for the company's operations to continue under the promoter's stewardship, creditors should not hesitate to pursue this option. They are best positioned to manage such entities as going concerns effectively, leveraging their intimate knowledge of the business dynamics.

Reviewing connected persons

In contrast to the CIRP, the PPIRP allows the promoter or related individual to propose a base resolution plan, which undergoes evaluation by FCs prior to initiation. Unlike CIRP, where connected individuals are barred from presenting resolution plans under section 29A of the Code.

However, creditors have raised concerns regarding this procedural divergence, fearing potential complications down the line. It's crucial to reassess this viewpoint, particularly for MSMEs, as there is arguably no better management for a company than its promoter or related individuals. This is because the intricacies involved are often limited to them, and an external management team may lack the depth of insight required to maintain the company's operational continuity.

Hence, unless there are suspicions of fraud or illegal activities related to the CD, the base resolution plan proposed by the promoter or related individuals should be afforded equal consideration to plans put forward by external parties.

Facilitating the awareness amongst MSMEs

Many businesses categorized as MSMEs fall under the jurisdiction of the Ministry of Micro, Small & Medium Enterprises. The Ministry is dedicated to fostering the growth and advancement of MSMEs. Many initiatives have been undertaken by the competent authorities to spread awareness amongst the stakeholders with the aim of providing struggling MSMEs with a means to restructure their debt and resolve financial challenges. It's crucial for the stakeholders to understand that the PPIRP process is designed to aid companies in overcoming financial hurdles, rather than stripping ownership from their promoters.

Further, once the understanding develops, PPIRP should be extended to other corporates beyond MSMEs which will again require more awareness drives to be conducted for wider adoption and exploration. As part of the survey, stakeholders were asked:

"What role do you believe Government and Regulator should play in supporting the implementation and effectiveness of PPIRP?"

The responses provided valuable insights into various areas where intervention and support are deemed necessary. Suggestions include –

- The importance of easing government policies related to providing loans to promoters, suggesting that reduced bureaucratic hurdles and relaxed eligibility criteria could facilitate access to financing and thereby bolster the success of PPIRP.
- Some responses advocated for tax benefits as a means to incentivize participation and investment in the resolution process, recognizing the potential role of fiscal policies in promoting stakeholder engagement.
- Additionally, suggestions were made for the government to encourage lending through mechanisms like credit guarantee corporations, particularly to cover working capital issues of reviving companies, indicating a proactive approach to addressing liquidity concerns.
- Furthermore, there was an emphasis on empowering RPs and addressing potential abuse within the process, underscoring the need for regulatory support and effective governance structures.

These responses collectively highlight the multifaceted role of the government and regulators in fostering a conducive environment and clearly reflects a recognition of the need for regulatory support, financial incentives, and effective governance structures to facilitate the successful resolution of insolvency cases through mechanisms like PPIRP.

PROPOSED REFORMS BY THE GOVERNMENT

In India, the Government sought public comments on the possibility of expanding the applicability of PPIRP to apply to a broader range of CDs as observed for similar frameworks in other jurisdictions.

In the draft consultation, it proposed that section 54A be amended to provide that the framework shall apply to prescribed categories of CDs in addition to the MSMEs. Further, the following modifications and relaxations to the procedures stipulated under Chapter IIIA of Part II of the Code have been proposed: -

a) Involvement of range of FCs in PPIRP who will be required to approve its initiation at the pre-commencement stage by confirming the proposed RP under section 54A(2)(e). Thus, to facilitate quicker and more efficient decision-making at this stage, the sixty-six per cent threshold for unrelated FCs may be lowered to fifty-one per cent. Similarly, under section 54A(3), the sixty-six per cent threshold for unrelated FCs may be replaced by an enabling provision for the sectoral regulator to specify the appropriate threshold, not being less than fifty-one per cent of the unrelated FCs, for approving the filing of an application.

b) In practice, it is observed that the MSME CDs face challenges in furnishing a declaration regarding avoidance transactions or improper trading under section 54C(3)(c). Such transactions or trading may not be easy to identify as it is often not the nature of the transaction or trading but the zone of insolvency, which renders transactions or trading suspect. Further, in the case of larger companies too, this may be a cumbersome requirement. Such a requirement should not discourage *bona fide* CDs from utilising the PPIRP for insolvency resolution. Accordingly, it is being considered to omit clause (c) of sub-section (3) of section 54C. The possibility of abuse of this relaxation is mitigated by the CoC's power to terminate the PPIRP or direct the initiation of separate proceedings where it is made aware of such transactions or trading. Notably, during the CIRP, where an application is filed by the CD, such declaration is not required to be furnished before and after the commencement of the process.[37]

It is evident that the Government is intending to explore measures to enhance the effectiveness of PPIRPs. The authors suggest that further research and analysis may be necessary to evaluate the feasibility and potential impact of implementing these suggestions and to identify additional measures that could enhance the role of government and regulators in supporting PPIRP implementation.

In recent times, the Government is also exploring new framework for pre-insolvency resolution procedures or 'out-of-court' initiated Creditor-led Resolution Process (CLRP) as an alternative fast-track resolution process. An expert committee submitted its report on 24th May, 2023 wherein it recommended key legislative amendments related to the fast-track corporate insolvency process. The table below provides a comparative overview of the CIRP, PPIRP and the proposed CLRP, highlighting their key features and procedural differences:[38]

Features	**CIRP**	**PPIRP**	**Proposed CLRP**
Timeline	180 days + 90 days (overall 330 days)	120 days	150 days + 45 days
CDs	Default of min. amount of ₹ 1 Crore.	MSME and Default of at least ₹ 10 lakh.	CDs with asset sizes as notified by the Central Government and default of at least ₹ 1 Crore.
Initiation	• Application by FC, OC or CD before AA. • Process commences upon order of AA admitting application.	• CD convenes meetings of unrelated FCs. • Creditors representing not less than 66% in value of debt approve filing of application for initiation of PPIRP.	• On default, SCBs or other notified class of FCs comprising at least 51% of financial debt (in value) may initiate CLRP after a 30 days' notice to CD. • Process is formally commenced from date of filing of application of intimation of appointment of

[37] Ministry of Corporate Affairs, *Invitation of comments from the public on changes being considered to the Insolvency and Bankruptcy Code, 2016*, Notice, 18th January 2023, 7, https://www.mca.gov.in/content/dam/mca/pdf/IBC-2016-20230118.pdf.

[38] Insolvency and Bankruptcy Board of India, *Report of the Expert Committee on a Creditor-led Resolution Approach* (May 2023).

		• Application by CD before AA. • Process commences upon order of AA admitting application.	RP before the AA and the Board. • No application for initiation of process seeking orders.
Manage-ment of CD	RP-in-possession with creditor-in-control	Debtor-in-possession with creditor-in-control	Party in Control of CD (the CD's management itself or a creditor/s who may have come in possession/ control prior to initiation of CLRP)
Moratorium	Moratorium effective from the date of AA's order until CIRP completion.	• Limited scope of moratorium. • Effective from the date of AA's order until process completion.	Limited scope of moratorium. Section 14(1) and 14(3) comes into effect from date of application for moratorium filed by RP.
Resolution Plan	RP invites plans and plan that is approved by CoC will be presented before the AA.	• CD presents a base resolution plan. • If the same is not accepted by CoC, alternate plans are invited. The best alternate plan is selected through a mandatory challenge mechanism.	• Public invitation of plans by IP. • These are deliberated by CoC and best one is selected through a mandatory challenge mechanism.
Avoidance Transact-ions	RP to examine avoidance transactions.	RP to examine avoidance transactions and on their existence, process to terminate.	RP to file application if he / she discovers avoidance transactions during the process.
Participa-tion of Promoters	IM to be prepared by RP.	• CD to prepare preliminary IM. • RP to finalise the IM. • CD convenes the meeting of unrelated FCs. • CD prepares the Base Resolution Plan.	• RP to prepare the IM based on the information for IM provided by management. • Incentive for CD to participate in processif initiation at early stage. • Credible threat of initiation of CIRP for non-cooperation.

Should Pre-Pack be explored in all cases?

While pre-pack arrangements can be valuable for preserving businesses and jobs, it's important to recognize that they may not always be the ideal solution for every case. Firstly, not all businesses are worth saving, and an effective insolvency system should prioritize the reorganization of only viable businesses. Secondly, viable businesses have various restructuring options available, including out of court restructuring, hybrid procedures, and formal reorganization processes, in addition to pre-packs.

While pre-packs can be advantageous in many scenarios, there's no one-size-fits-all solution. The most suitable restructuring approach depends on several factors such as the company's size, creditor support, financial condition, and the characteristics and costs of reorganization procedures. Additionally, the specific market and institutional features of a country, including its restructuring landscape, also influence the choice of the most appropriate restructuring tool. These factors are crucial in determining whether and how pre-packs should be regulated in a particular jurisdiction.

CONCLUSION

The PPIRP framework was devised to offer an alternative mechanism for proactively resolving the financial distress of MSMEs, considering their distinct business nature and simpler corporate structures. Despite the limited uptake of the PPIRP framework, there is a recognized need for reforms or enhancements to bolster its efficacy. While other alternative fast track and out-of-court mechanisms like the proposed CLRA framework are under consideration, bolstering the PPIRP in the interim could promote its broader adoption.

Effective implementation of the PPIRP necessitates concerted efforts to advocate its benefits to relevant stakeholders, strengthen the institutional infrastructure and engage the key stakeholders. While acknowledging that PPIRP may not suit all distressed firms, it presents a valuable option for those seeking prompt and cost-efficient resolutions under the Code. Expanding the PPIRP framework to encompass a wider range of companies could accelerate the resolution of MSMEs, offering both economic benefits and flexibility.

Based on experience of the resolved cases, it is imperative to address the inherent complexities and unforeseen delays to enhance the PPIRP's functionality. Further research and analysis are warranted to explore strategies for overcoming identified challenges and maximizing the practical effectiveness of PPIRP.

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EXPLORING THE SYNERGY BETWEEN ESG PRINCIPLES AND CORPORATE RESTRUCTURING: LESSONS FROM GLOBAL JURISDICTIONS AND A ROAD MAP FOR INDIA

Anchal Raj and Diksha Sarma

ABSTRACT

The integration of Environmental, Social, and Governance (ESG) principles into corporate restructuring is a topic of utmost relevance and significance, given the increasing emphasis on sustainability, social responsibility, and ethical governance in the business world. This research paper advocates for a purposive integration of ESG principles within the insolvency process under the IBC in India. Through targeted reforms, stakeholder engagement, and capacity-building initiatives, India's insolvency framework can evolve into a catalyst for sustainable development, resilience, and inclusive growth. This paper embarks on a journey of doctrinal research to investigate the intersection of ESG principles and corporate restructuring. It seeks to provide a comprehensive understanding of how ESG factors can be integrated into the restructuring processes of corporations, further offering suggestions for the Indian context. It examines the experiences and best practices of leading global economies, and the authors have offered suggestions that can be adapted and applied in the Indian context. It encompasses legal, regulatory, and market-based strategies for aligning ESG principles with corporate restructuring process in India.

Keywords: Corporate Restructuring, ESG, Global, India, Roadmap, Reform, Regulatory, Stakeholder, Integration

INTRODUCTION

"Sustainability is no longer about doing less harm. It's about doing more good."

- Jochen Zeitz

In the contemporary corporate landscape, the fusion of ESG principles with restructuring initiatives has emerged as a pivotal strategy for fostering sustainable growth, enhancing stakeholder trust, and mitigating systemic risks. Against the backdrop of evolving regulatory frameworks and heightened societal expectations, businesses worldwide are recognizing the imperative to integrate ESG considerations into their strategic decision-making processes.

Against the backdrop of escalating environmental degradation, widening social inequalities, and escalating corporate governance lapses, the integration of ESG principles within the insolvency process assumes paramount significance. By aligning financial objectives with environmental sustainability, social responsibility, and governance best practices, stakeholders can foster sustainable recovery, mitigate reputational risks, and produce long-term value creation.

This paper seeks to delineate the general principles underpinning the integration of ESG considerations within corporate restructuring, drawing upon international best practices from diverse jurisdictions. By examining global trends, regulatory imperatives, and keeping in mind the industry requirements, we aim to distil actionable insights for stakeholders navigating the intricate and dynamic nexus between ESG and restructuring.

Enactment of the Insolvency and Bankruptcy Code, 2016 (IBC/Code) in India marked a watershed moment in India's corporate governance landscape, heralding a paradigm shift towards a time-bound, creditor-driven resolution mechanism. Within this framework, lies a unique opportunity to infuse ESG principles into the fabric of corporate restructuring, thereby elevating the discourse beyond mere financial exigencies to encompass broader societal and environmental imperatives. This paper advocates for a purposive integration of ESG principles within the insolvency process under the IBC in India. Through procedural integration reforms, stakeholder engagement, and capacity-building initiatives, India's insolvency framework can evolve into a catalyst for sustainable development, resilience, and inclusive growth.

In essence, this paper endeavours to bridge the gap between theoretical discourse and practical application, offering suggestions for stakeholders to navigate the complexities of ESG integration within the context of corporate restructuring. By embracing a holistic approach that transcends traditional metrics of financial performance, stakeholders can unlock synergies, mitigate risks, and chart a course towards sustainable recovery and value creation in the wake of financial distress.

WHAT IS ESG AND WHAT ARE ESG PRINCIPLES?

ESG criteria has emerged as one of the central considerations for investors and corporations alike, transcending conventional financial metrics to encompass a broader principle of ethics and sustainability. While often approached from a pragmatic standpoint, the essence of ESG can also be explored through esoteric lenses, delving into its deeper philosophical underpinnings and implications.

To draw a metaphor, imagine ESG as a triumvirate, symbolizing the interconnectedness of humanity, the environment, and the juridical structures forming part of our society. Each of the following constituent of the triumvirate resonates with symbolic significance, offering insights into the broader tapestry of existence:

a) **Environmental consciousness:** The 'E' in ESG encapsulates our relationship with the natural world, representing our stewardship of the Earth and its ecosystems. It calls upon us to recognize the intrinsic value of nature beyond its utilitarian function as a resource. Through ecological mindfulness, we acknowledge our interconnectedness with all living beings, fostering harmony and balance within the web of life.

b) **Social harmony:** The 'S' in ESG reflects the intricate fabric of human society, embodying principles of equity, diversity, and social justice. It calls upon us to cultivate empathy and compassion, recognizing the inherent dignity and worth of every individual. By nurturing inclusive communities and empowering marginalized voices, we strive towards an equitable and harmonious world, where every individual can find solace and belonging.

c) **Governance wisdom:** The 'G' in ESG encompasses the structures and systems that govern our collective endeavours, embodying principles of transparency, accountability, and ethical leadership. It invites us to reflect on the nature of power and authority, fostering governance models guided by wisdom and integrity. Resilient institutions are cultivated by upholding principles of fairness and justice, that serve the common good, transcending narrow interests in the pursuit of enduring prosperity.

In essence, ESG transcends mere financial metrics, serving as a compass guiding humanity towards a more sustainable and compassionate future. It beckons us to embrace a holistic vision of prosperity, where the well-being of people, planet, and principles converge in harmony. Through oversight and collective action, we embark on a transformative journey towards a world where prosperity is measured not only in material wealth but also by the vitality of our converging ecosystems.

The theoretical underpinnings of ESG stem from various disciplines and schools of thought, each contributing to the conceptual framework that underlies the integration of ESG factors into business practices and investment decision-making. Following are some theoretical perspectives:

a) **Sustainable development:** Arising from the field of environmental economics and development studies, the concept of sustainable development emphasizes meeting the needs of the present without compromising the ability of future generations to meet their own needs.[1] It underscores the interconnectedness of economic, social, and environmental dimensions, aligning closely with the holistic approach of ESG.

b) **Stakeholder theory:** Rooted in management and organizational studies, stakeholder theory posits that organizations have a responsibility to consider the interests of all

[1]Report of World Commission on Environment and Development: Our Common Future, 1987

stakeholders, not just shareholders, in decision-making processes. ESG integration reflects a stakeholder-oriented approach by acknowledging the impact of business activities on various stakeholders, including employees, customers, communities, and the environment.

c) **Corporate social responsibility (CSR):** CSR theories advocate for businesses to go beyond profit maximization and take voluntary actions to address social and environmental concerns. ESG practices align closely with CSR principles by encouraging companies to adopt responsible business practices, contribute to societal well-being, and mitigate negative externalities associated with their operations.

d) **Agency theory:** Agency theory, commonly applied in corporate governance studies, examines the relationship between principals (e.g., shareholders) and agents (e.g., corporate executives) within organizations. ESG factors are viewed as mechanisms for aligning the interests of shareholders and management, promoting transparency, accountability, and long-term value creation.

e) **Triple bottom line (TBL):** The TBL framework expands the traditional notion of corporate performance evaluation beyond financial metrics to include social and environmental dimensions. ESG principles reflect the triple bottom line approach by emphasizing the importance of economic prosperity, social equity, and environmental stewardship in organizational decision-making.

f) **Resource-based view (RBV):** Originating from strategic management theory, the RBV suggests that competitive advantage stems from the strategic utilization of unique resources and capabilities. ESG factors are considered strategic assets that can enhance organizational resilience, reputation, and long-term competitiveness, thereby creating sustainable value for stakeholders.

g) **Ethical theories:** Ethical theories, such as utilitarianism, deontology, and virtue ethics, provide philosophical foundations for ethical decision-making and behaviour within organizations. ESG integration reflects ethical considerations by promoting responsible conduct, integrity, and adherence to ethical principles in business practices.

Overall, the theoretical underpinnings of ESG reflect a convergence of interdisciplinary perspectives, emphasizing the interconnectedness of economic, social, and environmental dimensions in organizational performance and decision-making. ESG principles provide a comprehensive framework for fostering sustainability, accountability, and responsible business conduct in today’s global economy.

WHAT IS CORPORATE RESTRUCTURING AND ITS VARIOUS TYPES?

Restructuring can have various definitions and can take various forms depending on the specific goals and circumstances of the organization. A few common forms it takes are as follows:

a) **Corporate restructuring:** In the business world, restructuring often refers to significant changes made to the organizational structure, operations, or finances of a company.

This could involve mergers, acquisitions, divestitures, layoffs, changes in management, or alterations in the company's debt structure.

b) **Financial restructuring:** Financial restructuring typically involves changes made to a company's capital structure, such as refinancing debt, negotiating with creditors, selling off assets to raise capital or issuing new equity to improve financial stability or address liquidity issues.

c) **Operational restructuring:** Operational restructuring focuses on improving the efficiency and effectiveness of a company's operations. This could involve streamlining processes, reorganizing departments, adopting new technology, or outsourcing certain functions.

d) **Debt restructuring:** Debt restructuring involves renegotiating the terms of a company's debt obligations with its creditors to alleviate financial strain. This may include extending repayment periods, reducing interest rates, or converting debt into equity.

e) **Organizational restructuring:** Organizational restructuring refers to changes made to the structure, roles, and responsibilities within a company. This could involve downsizing certain departments, creating new divisions, or redistributing resources to better align with strategic goals. Organizational restructuring may also be imagined as restructuring of a group of entities under a parent corporation or web of interrelated entities.

f) **Market restructuring:** Market restructuring occurs when there are significant changes in the competitive landscape or market dynamics within an industry. This could involve shifts in consumer preferences, technological advancements, regulatory changes, or the entrance of new competitors, prompting companies to adapt their strategies and operations accordingly.

g) **Strategic restructuring:** Strategic restructuring focuses on realigning the overall direction and focus of the organization. It may involve entering new markets, divesting from non-core businesses, pursuing mergers or acquisitions, or repositioning the company's brand and product offerings.

h) **Crisis restructuring:** Crisis restructuring occurs in response to severe financial distress or operational challenges facing a company. It may involve drastic measures such as bankruptcy filings, asset sales, workforce reductions, or other emergency actions to stabilize the organization.

i) **Mergers and Acquisitions (M&A):** Mergers and acquisitions involve combining two or more companies to achieve strategic objectives such as expanding market share, diversifying product offerings, or gaining access to new technologies or markets. M&A activities often result in significant restructuring of the combined entity.

Overall, restructuring encompasses a broad range of activities aimed at improving the performance, efficiency, and competitiveness of organizations in response to internal or external challenges and opportunities.

THE INTERACTION OF ESG WITH CORPORATE RESTRUCTURING

The intersection of ESG principles with restructuring initiatives is increasingly becoming a focal point for businesses, investors, and stakeholders. Here's how ESG considerations intersect with restructuring efforts:

a) **Environmental considerations in restructuring:** In the context of restructuring, companies may evaluate their environmental impact and consider sustainability initiatives as part of their operational restructuring. This could involve adopting eco-friendly practices, reducing carbon emissions, minimizing waste generation, or transitioning to renewable energy sources.

Restructuring efforts may also include divesting from environmentally harmful activities or industries and reallocating resources towards more sustainable and responsible business practices.

b) **Social implications of restructuring:** Social considerations are crucial during restructuring processes, especially concerning workforce management and community impact. Companies undergoing restructuring may prioritize fair treatment of employees, ensuring job security, providing retraining opportunities, and offering support during transitions.

Additionally, companies may engage with local communities and stakeholders to address social concerns and mitigate any adverse impacts resulting from restructuring activities.

c) **Governance practices in restructuring:** Governance aspects are fundamental to effective restructuring processes, encompassing transparency, accountability, and ethical decision-making. Companies undergoing restructuring may focus on enhancing governance structures, strengthening board oversight, and ensuring alignment with shareholder interests.

Implementing robust governance practices during restructuring can help mitigate risks, enhance stakeholder trust, and foster long-term sustainability.

The synergy between ESG principles and restructuring initiatives lies in their shared objectives of promoting long-term sustainability, resilience, and value creation for stakeholders. Following are some points which highlight the synergy between ESG and restructuring:

a) **Alignment with long-term value creation:** Both ESG principles and restructuring initiatives emphasize the importance of creating sustainable long-term value for stakeholders. By integrating ESG considerations into restructuring plans, organizations can enhance their resilience, mitigate risks, and position themselves for sustainable growth and competitiveness over time.

b) **Enhanced risk management:** ESG factors offer valuable insights into potential risks and opportunities facing organizations. By considering environmental, social, and governance risks and opportunities during restructuring, companies can identify and address material risks, enhance risk management practices, and minimize the potential for adverse impacts on stakeholders and the environment.

c) **Improved operational efficiency:** Restructuring initiatives often involve streamlining processes, optimizing resource allocation, and enhancing operational efficiency. Integrating ESG principles into restructuring efforts can further optimize resource utilization, reduce environmental footprint, and enhance operational resilience. For example, investments in energy efficiency, renewable energy, or waste reduction initiatives can yield cost savings and environmental benefits.

d) **Stakeholder engagement and trust:** Effective stakeholder engagement is a core component of both ESG practices and restructuring efforts. By engaging with stakeholders and addressing their concerns transparently and proactively, organizations can build trust, foster positive relationships, and enhance their reputation. Stakeholder engagement can also provide valuable insights and feedback that inform restructuring decisions and ensure alignment with stakeholder expectations.

e) **Access to capital and market opportunities:** Integrating ESG considerations into restructuring initiatives can enhance access to capital and market opportunities. Investors, lenders, and customers increasingly consider ESG factors when making investment decisions, selecting business partners, or purchasing products and services. Companies that demonstrate strong ESG performance and commitment to sustainability are better positioned to attract investment, access new markets, and differentiate themselves from competitors.

f) **Enhanced corporate governance:** Effective corporate governance is a fundamental aspect of both ESG practices and restructuring efforts. By strengthening governance structures, promoting transparency, and enhancing board oversight, organizations can improve decision-making processes, mitigate conflicts of interest, and enhance accountability to shareholders and other stakeholders. Strong governance practices also support the implementation of restructuring initiatives and ensure alignment with strategic objectives.

To summarise, the synergy between ESG principles and restructuring initiatives reflects a holistic approach to value creation, risk management, and stakeholder engagement. By integrating ESG considerations into restructuring efforts, organizations can enhance their resilience, competitiveness, and long-term sustainability while creating value for all stakeholders.

ESG REPORTING

ESG reporting refers to the process of disclosing Environmental, Social, and Governance performance data and related information by companies, organizations, and entities. ESG reporting allows stakeholders, including investors, customers, employees, regulators, and communities, to assess the organization’s sustainability practices, social impact, and governance structures.

The environmental factors typically include a company’s impact on the natural environment, such as its carbon emissions, energy consumption, water usage, waste generation, and efforts to mitigate environmental risks. ESG reports may detail initiatives related to environmental sustainability, climate change mitigation, renewable energy adoption, and resource conservation.

The social factors encompass the company's relationships with its employees, customers, suppliers, and communities. ESG reporting often includes information on labour practices, employee diversity and inclusion, health and safety standards, human rights policies, community engagement initiatives, and philanthropic activities. Companies may also disclose data on employee turnover rates, workforce demographics, employee satisfaction, and diversity metrics.

The governance factor focuses on a company's leadership, decision-making processes, and adherence to ethical and legal standards. ESG reports may provide information on board composition, executive compensation practices, shareholder rights, regulatory compliance, anti-corruption measures, and risk management frameworks. Transparency, accountability, and integrity are key aspects of governance reporting.

There are various reporting standards and frameworks which guide ESG reporting practices, providing guidelines and metrics for disclosing relevant information in a consistent and comparable manner. Common ESG reporting frameworks include the Global Reporting Initiative, the Sustainability Accounting Standards Board, the Task Force on Climate-related Financial Disclosures, and the United Nations Sustainable Development Goals.

For effective ESG reporting engagement with stakeholders is required to identify material ESG issues, gather feedback, and address concerns. Companies may conduct stakeholder consultations, surveys, and meetings to understand stakeholder expectations and incorporate their perspectives into ESG reporting.

Also, integration of ESG reporting with financial reporting enhances transparency and provides investors with a comprehensive view of the organization's performance and long-term value creation potential. Companies may include ESG disclosures in their annual reports, sustainability reports, CSR reports, and other communications to investors and stakeholders.

Overall, ESG reporting plays a critical role in promoting corporate transparency, accountability, and sustainability, enabling stakeholders to make informed decisions and drive positive change towards a more sustainable and responsible business environment.

ROLE OF LAW MAKER AND REGULATOR IN PROMOTION AND INCORPORATION OF ESG

The role of legislators in aligning broader ESG principles with legislation is paramount in shaping regulatory frameworks, promoting sustainable development, and advancing societal well-being. The legislature plays the following role in this alignment:

a) **Legislative oversight and development:** Legislature holds the authority to enact, amend, and repeal legislation related to environmental protection, social welfare, corporate governance, and other ESG-related issues through the legislative processes including draft laws, debate policy proposals, and vote on bills that reflect ESG principles and address emerging sustainability challenges.

b) **Policy formulation and prioritization:** Legislature plays a central role in formulating and prioritizing policies that promote environmental sustainability, social equity, and ethical governance practices. Legislature may introduce resolutions, motions, and inquiries to raise awareness, initiate public discourse, and advocate for policies that advance ESG goals and address pressing societal concerns.

c) **Oversight and accountability:** Legislature exercises oversight and accountability over government agencies, regulatory bodies, and private sector entities to ensure compliance with ESG-related laws, regulations, and standards. Legislating committees, such as environmental committees, social welfare committees, and corporate governance committees, monitor the implementation of ESG policies, scrutinize government actions, and hold decision-makers accountable for their performance and outcomes.

d) **Budgetary and resource allocation:** Legislature approves budgets, allocates resources, and authorizes expenditures for ESG-related programs, initiatives, and regulatory enforcement activities. Through the budgetary process, legislature allocate funding for environmental protection, social services, sustainable infrastructure projects, and capacity-building efforts aimed at promoting responsible business conduct and enhancing governance practices.

e) **Stakeholder engagement and representation:** Legislature serves as a forum for stakeholder engagement, representation, and advocacy on ESG issues. Legislatures represent diverse constituencies, including environmental advocates, social justice organizations, labour unions, indigenous communities, and business associations, and advocate for policies that reflect the interests and concerns of these stakeholders.

f) **International cooperation and treaty ratification:** Legislature ratifies international treaties, agreements, and conventions related to environmental conservation, human rights, labour standards, and corporate governance. By ratifying international agreements, legislature commits to upholding ESG principles, fostering global cooperation, and addressing trans boundary challenges that require coordinated action at the national and international levels.

g) **Public education and awareness**: Legislature plays a role in raising public awareness, promoting education, and fostering civic engagement on ESG issues. Through public hearings, town hall meetings, and legislative debates, legislature engage with constituents, disseminate information, and encourage public participation in policy-making processes related to sustainability, social justice, and responsible governance.

To sum up, legislature plays a multifaceted role in aligning broader ESG principles with legislation by enacting laws, formulating policies, exercising oversight, allocating resources, engaging stakeholders, ratifying international agreements, and fostering public awareness. By integrating ESG considerations into legislative frameworks and governance practices, legislators contribute to building a more sustainable, equitable, and resilient society that prioritizes the well-being of people, planet, and prosperity.

In addition to the legislature, regulators in an economy play a crucial role in aligning ESG principles with corporate insolvency and restructuring processes. Their role encompasses various aspects aimed at promoting transparency, accountability, and sustainability in the resolution of distressed companies. Following are some key roles that a regulator plays:

a) **Setting regulatory frameworks:** Regulators establish the legal and regulatory frameworks governing corporate insolvency and restructuring processes. They formulate regulations, and guidelines that incorporate ESG considerations into insolvency proceedings, ensuring that environmental, social, and governance factors are taken into account during the resolution process.

b) **Promoting stakeholder engagement:** Regulators encourage stakeholder engagement and participation in corporate insolvency and restructuring processes. They may require resolution applicants to engage with creditors, shareholders, employees, suppliers, customers, and other stakeholders to gather input, address concerns, and foster consensus on resolution plans that align with ESG principles.

c) **Monitoring compliance:** Regulators monitor compliance with regulatory requirements and ESG standards throughout the insolvency and restructuring process. They may conduct audits, inspections, and reviews to ensure that resolution applicants and Insolvency Professionals adhere to legal and ethical standards, including environmental regulations, labour laws, and corporate governance norms.

d) **Encouraging disclosure and transparency:** Regulators promote transparency and disclosure in corporate insolvency and restructuring proceedings. They may require resolution applicants to disclose relevant information, including ESG-related risks, opportunities, and impacts, to stakeholders and regulatory authorities. Transparency fosters trust, facilitates informed decision-making, and enhances accountability throughout the resolution process.

e) **Facilitating ESG integration:** Regulators facilitate the integration of ESG principles into corporate insolvency and restructuring processes by providing guidance, support, and incentives to resolution applicants and stakeholders. They may develop frameworks, methodologies, and best practices for assessing ESG risks and opportunities, evaluating the sustainability of resolution plans, and measuring the social and environmental impact of restructuring initiatives.

f) **Enforcing regulatory compliance:** Regulators enforce regulatory compliance and address non-compliance with ESG standards and legal requirements in corporate insolvency and restructuring proceedings. They may impose sanctions, penalties, or corrective measures on parties that violate regulatory norms or engage in unethical or unsustainable practices during the resolution process.

g) **Promoting innovation and best practices:** Regulators promote innovation and best practices in corporate insolvency and restructuring by encouraging the adoption of ESG-focused approaches, tools, and strategies. They may collaborate with industry stakeholders, academic institutions, and professional associations to develop and disseminate knowledge, resources, and training programs that advance the integration of ESG principles into restructuring practices.

To sum up, regulators play a proactive role in aligning ESG principles with corporate insolvency and restructuring processes, ensuring that resolution outcomes are sustainable, equitable, and aligned with the broader goals of economic, environmental, and social well-being. Their efforts contribute to building a regulatory environment that fosters responsible business conduct, promotes stakeholder value creation, and supports the transition to a more sustainable and inclusive economy.

WHAT ARE THE ESG PRACTICES AROUND THE GLOBE WITH RESPECT TO RESTRUCTURING?

United Kingdom

In the UK, we do not find a standalone legislation that encompasses the principles of ESG, rather here are multiple legislations and regulations spread across the entire gamut of domestic laws, to deal with ESG related principles. Further, the UK has a commitment towards various international obligations to place the country in a better position in terms of ESG factors. For instance, under the Climate Change Act of UK, the Government of UK has committed itself towards reduction in the emission of greenhouse gases to net zero by 2050.[2] The Financial Conduct Authority published a consultation paper on Sustainable Disclosure Requirements (SDR) in an attempt to codify the discussion paper released by it on 19th July 2021. Some of the proposals mentioned in the outcome document released consequent to the consultation paper included are proposal against green washing resorted to by firms, detailed sustainability disclosures at both product and entity level etc.[3]

The English insolvency law provides a statutory order of priority for certain unsecured liabilities, such as unpaid wages and certain taxes, but does not afford a specific priority to health and safety-related liabilities. Health and safety-related liabilities may be treated as unsecured claims unless the claimant has been granted a valid security interest in the assets of the insolvent company, in which case the secured interest would rank in priority. The treatment of health and safety-related liabilities may be smoother in cases of pre-packaged administration, where the business and assets are sold as a package. In the UK, restructuring also involves releasing liabilities owed by a guarantor of the principal debtor who is proposing a scheme or a restructuring plan. If these guarantee liabilities are not released, it could hinder the implementation of the debtor company's restructuring. This is because the guarantor would have a cross-claim against the debtor company if a creditor demands payment under the guarantee at a later stage. However, there will be no release of such liabilities in case of preferential, undervalued, malfeasance, wrongful trading or fraudulent transactions.[4]

When it comes to environmental liabilities of companies in the UK, there can be degrees of regulation based on factors such as stakeholders in the company, geographic area in which it is operating, activities that the company undertakes etc. For instance, if we look at the

[2] Climate Change Committee, https://www.theccc.org.uk/what-is-climate-change/a-legal-duty-to-act/ (last visited Feb. 15,2024).

[3] KPMG,https://kpmg.com/xx/en/home/insights/2022/10/uk-sustainability-disclosure-requirements.html (last visited Feb. 15,2024).

[4] Andrew Probert (et al), *ESG in Restructuring,* INSOL International, 422, 422-428(2023).

aviation industry, it runs a heavier risk of emissions and therefore the sector will be regulated by the obligations under the UK Emissions Trading Scheme.[5]

In the case of *Celtic Extraction*[6] an insolvent business had huge amounts of waste and under the terms of the license issued by Environment Agency of England (EA), the business was mandated to take certain measures to manage the waste. The insolvency practitioner sought to disclaim the said license as an onerous property, however, the EA objected to the same by relying on the principle of 'Polluter Pays'. When the said case went to the Court of Appeal, the Court stated that since the polluter cannot pay, hence the said principle wouldn't apply to the insolvent company.

However, if we look at the Scottish cases, then a different approach is being followed by the Courts there. A leading case is that of *Doonin Plant Limited* wherein, the company was issued a notice under the Environmental Protection Act for illegally depositing waste followed by another notice which was sent to the company when it had already entered into liquidation. The insolvency practitioner stated that the amount that was to be used to clear the waste was much more than the funds available with the company for distribution to creditors. In this particular case it was stated that the said remediation will rank higher than the dues to be available to the creditors.[7]

The ESG finance market, with green bonds and loans as its cornerstone, has witnessed significant growth. The International Capital Market Association's (ICMA) Green Bond Principles (GBP) defines green bonds as financial instruments where the proceeds exclusively fund or refinance eligible green projects. These projects must align with the four core components outlined in the GBP. The said four components are as follows: *First*, the proceeds from the finance will be used for green projects that promote pollution prevention, clean energy etc. *Second*, determine the decision-making process to fix the eligibility of green projects, the criteria for assessing environmental benefits etc. and the environmental impact they expect the projects to produce. *Third*, net proceeds from the said projects will be moved to a different portfolio. Fourth, the companies have the duty to make available the data on where the proceeds from such funding is used and report the same via newsletters, websites etc.

Green bonds and loans represent the largest segment of ESG finance market and are instrumental in funding sustainable projects. The ICMA and the Loan Market Association issue and regularly update voluntary guidelines for green bonds and loans. Proceeds from such green bonds or loans, or an equivalent amount, are dedicated to financing or refinancing eligible "green projects". These projects aim to advance environmentally sustainable initiatives such as infrastructure for clean energy, pollution prevention, acquiring low carbon transport solutions, and climate change adaptation.[8]

Two other kinds of bonds which are widely popular in the UK are social bonds and sustainability linked bonds. While the social bonds are used to finance a social project like affordable

[5] *Id.*
[6] *Re* Celtic Extraction Ltd. In Liquidation, [1999] EWCA Crim J0714-2.
[7] Tom Gillet, *Environmental Protection on Insolvency: Where Does the Balance Lie?*, Lexology (Feb. 15, 2024, 8:30 PM), https://www.lexology.com/commentary/environment-climate-change/united-kingdom/steptoe-johnson-llp/environmental-protection-on-insolvency-where-does-the-balance-lie.
[8] Andrew, *supra note* 4.

housing, food security, employment generation etc, sustainability bonds are used to finance both green and social projects.[9]

The outcome of a potential restructuring depends on the terms of the relevant bond or loan agreement, which overs obligations related to green finance principles. Breaching these obligations could lead to higher financing costs and loss of access to other ESG-related financing options. While default events are unlikely, it is considered essential to conform to this. In the regulatory sphere in the UK, apart from the SDR as discussed above, there is the Prudential Regulation Authority's Supervisory Statement (SS) SS3/19 issued in April 2019 on managing climate-related financial risk wherein certain expectations have been set for the firms, regarding climate risk in areas of governance arrangements, disclosure, stress testing etc.[10]

Switzerland

In Switzerland, there is no specific restrictions as to the debts that can be restructured. However, environmental liabilities do not have precedence over other kinds of debts as they do not fall under the statutorily prescribed categories of preferential debts that receive priority in bankruptcy liquidation. The rights and interests of the creditors take precedence over the interests of employees and their claims are privileged only to a certain extent. If under a restructuring plan, the directors are receiving any share or options then the same needs to be disclosed to the creditors to determine their commercial interests. Further, according to Article 732 et seq of the Code of Obligation (CO) and the Stock Exchange Listing Rules, the companies listed on the Swiss Exchange are mandated to disclose the remuneration of the Board of Directors and Key Management Personnel. Further, there is not only the requirement to disclose such remuneration, they are also mandated to take approval of the General Assembly regarding such remuneration. If a listed company deviates from the provisions of the Corporate Governance Directive issued by Swiss Exchange, it must provide an explanation for the variance. In Switzerland, labour authorities, unions, and employee advocacy groups generally don't have direct involvement in court-led restructurings, unlike out-of-court processes. However, companies must grant these entities the right to be heard before initiating mass layoffs to avoid potential damages claims. This requirement applies to both court-led and out-of-court restructurings and can impact the financing needs of a composition agreement. In the regulatory sphere, the Swiss National Bank since 1996 has been promoting reduction in resource consumption and in 2018 came up with two more indicating factors, i.e. employees and society. Further, Article 964a et seq of the Swiss Code of Obligations provides that certain public companies are subjected to non-financial reporting requirements like reporting on CSR in its entirety, reporting on child labour, payment of dues to government agencies etc. Further, Swiss banks have increasingly resorted to include sustainable investing in its drive for ESG efforts. These sustainable investing strategies are divided into research, transparency, impact assessment, ESG risk management etc. The asset managers are also mandated to consider ESG preferences of their clients. The members of UBS (Union Bank of

[9] *Id.*
[10] *Id.*

Switzerland) and Credit Suisse are also required to commit themselves to reduction in emissions of greenhouse gases in case of their lending. This involves changing their portfolios, reporting on such transitions and the actions taken, setting targets for greenhouse gas emissions etc.[11]

Asia

Coming closer home to Asia, Hongkong has an ESG Guide that provides for disclosure obligations. A company is required to publish an ESG report on an annual basis incorporated in its annual report or as a separate report. In addition, there is an encouragement to disclose ESG issues and Key Performance Indicators (KPI) that have a bearing on the environmental and social impacts of the company as well as influence the decisions of stakeholders.

Japanese regulatory bodies, including the Japan Financial Services Agency (JFSA), have introduced guidelines and frameworks to promote ESG integration in corporate practices. For instance, the JFSA has established codes of conduct for ESG data providers and encouraged voluntary adoption of ESG principles by companies. JFSA has also introduced guidelines to encourage ESG investments and prevent greenwashing by investment trust managers (ITMs). These guidelines outline the scope of ESG Public Funds and establish criteria for disclosures and management practices. This initiative of the JFSA aims to promote transparency and integrity in ESG investments, ensuring that funds marketed as ESG-compliant genuinely adhere to ESG principles.[12] In December of 2022, Japanese regulators completed the code of conduct for providers of ESG data and evaluation. This code is intended for voluntary adoption, operating on a “comply or explain” basis. Essentially, firms can choose not to comply with the code but must then provide an explanation for their decision. This approach indicates that JFSA is providing flexibility for ESG rating and data providers to adapt the code according to their specific circumstances and needs. The landscape of ESG initiatives in Japan is undergoing significant shifts, marked by several key developments which include the following:[13]

(a) **Coal financing restrictions:** Japan’s three major banks have announced their intention to refrain from providing finance to new coal-fired power plants and to exit existing coal finance in the future. This move reflects a growing aversion to coal investments and aims to reduce the number of coal-fired power plants in Japan, aligning with global efforts to combat climate change.

(b) **Government policy:** The Japanese Ministry of Economy, Trade and Industry has announced a policy to significantly reduce old, inefficient coal-fired power plants. This demonstrates a commitment to transitioning towards cleaner energy sources and addressing environmental concerns.

[11] Dr. Roger Bischof (et al),*ESG in Restructuring,* INSOL International, 371, 371-379(2023).

[12] Asian Legal Business, https://www.legalbusinessonline.com/features/japan-moving-forward-esg (lastvisited Feb. 15,2024).

[13] David M. Silk (et al), *Practical Cross Border Insights into ESG Environmental, Social & Governance Law 2022*, International Comparative Legal Guides, (Feb. 15, 2024, 8:30 PM), chrome-extension://efaidnbmnnnibpcajpcglclef indmkaj/https://www.noandt.com/wp-content/uploads/2021/12/iclg_EnvironmentalSocialAndGovernance Law_2022_japan.pdf.

(c) **Investor focus on ESG disclosure:** Investors are increasingly prioritizing ESG disclosures and the commitment of investee companies to ESG principles. Some Japanese investors have revised their policies for exercising shareholder rights to include considerations of ESG performance. This places pressure on companies to prioritize ESG actions to maintain shareholder support and enhance long-term value.

(d) **Human rights due diligence:** Japanese corporations are recognizing the importance of human rights-related due diligence, particularly in response to demands from human rights-conscious customers and investors, as well as stringent human rights regulations in Europe. There is an increasing trend of conducting thorough human rights due diligence in Mergers and Acquisitions deals, investments, and supplier contracts, indicating a growing awareness of human rights considerations in business operations.[14]

Overall, these developments underscore Japan's evolving commitment to ESG principles, reflecting broader global trends towards sustainability, corporate responsibility, and ethical business practices. As companies adapt to these changes, they are likely to prioritize ESG initiatives to remain competitive, attract investment, and meet stakeholder expectations.

India

In India, the Securities and Exchange Board of India (SEBI) has played a pivotal role in promoting ESG disclosures among listed companies. To standardize these disclosures and foster greater transparency and accountability, SEBI introduced the Business Responsibility and Sustainability (BRSR) guidelines.[15]

These guidelines provide a structured framework for listed companies to report their ESG practices and performance. By adhering to the BRSR guidelines, companies are encouraged to integrate ESG considerations into their business strategies, operations, and decision-making processes.

The BRSR guidelines cover a wide range of ESG-related aspects, including environmental impact, social responsibility, governance practices, and stakeholder engagement. They require companies to disclose relevant information on their policies, initiatives, and performance metrics related to ESG factors.[16]

The reporting framework serves as an internal tool for businesses aiming to align themselves with the National Guidelines on Responsible Business Conduct 2016 (NGRBC16). The framework is structured into three sections to facilitate comprehensive reporting:

(a) **Section A is General Disclosures.** This section focuses on gathering basic information about the listed entity, including details about products and services, operations, employees, transparency and disclosure practices, subsidiary companies, holdings, and joint ventures.

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[14] *Id.*

[15] Chaitanya Kalla (et al), *Business Responsibility and Sustainability Reporting The evolution of Sustainability Reporting in India,* EY India (Feb. 15,2024, 9:15 AM), https://www.ey.com/en_in/climate-change-sustainability-services/brsr-reporting-and-the-evolving-esg-landscape-in-india.

[16] *Id.*

(b) **Section B is Management and Process Disclosures.** Here, companies are required to disclose information on policies and processes related to leadership, governance, and stakeholder engagement in line with NGRBC principles. This includes oversight, governance, leadership issues, and management processes, with links to relevant policies provided where applicable.

(c) **Section C is Principle-Wise Performance Disclosures.** This section emphasizes demonstrating the company's commitment to responsible business conduct through actions and outcomes. Companies are expected to report KPIs aligned with the nine principles of responsible business conduct outlined in NGRBC16. Each principle requires reporting on essential indicators, such as environmental data and community initiatives, as well as voluntary leadership indicators, which provide a broader perspective on sustainability efforts, including scope 3 emissions and health and safety assessments of value chain partners.

Overall, the reporting framework aims to enhance transparency, accountability, and sustainability practices within businesses by providing a structured approach to reporting on responsible business conduct in alignment with NGRBC16. By adhering to this framework, companies can showcase their commitment to responsible business practices and contribute to positive societal and environmental outcomes.[17]

CIRP PROCESS FLOW IN INDIA AND ITS PURPOSIVE INTEGRATION WITH ESG

The corporate insolvency resolution process (CIRP) in India, as per the IBC, involves several key steps:

(a) **Initiation of CIRP:** The CIRP begins with the admission of an application for insolvency resolution by the National Company Law Tribunal (NCLT) from a financial creditor (FC), operational creditor, or the corporate debtor (CD) itself.

(b) **Appointment of Interim Resolution Professional (IRP):** Upon admission of the application, the NCLT appoints an IRP within a specific time frame. Regulation 6 of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (CIRP Regulations), indeed stipulates the requirements for making a public announcement upon the appointment of an IRP. The public announcement must be made in a specified form, which typically includes essential details such as the appointment of the IRP, the name of the CD, and other relevant information.[18]

(c) **Formation of committee of creditors (CoC):** The IRP takes control of the CD's management and constitutes a CoC within a stipulated period. The CoC consists of FCs of the company.

(d) **Conducting of CIRP:** The IRP takes over the management of the company's affairs,

[17] Id.

[18] Insolvency and Bankruptcy Board of India, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://ibbi.gov.in/Agenda_2_01122017.pdf (last visited Feb. 15,2024).

works towards determining its financial status, and invites resolution plans from prospective resolution applicants. Regulation 36(1) of the CIRP Regulations mandates the IRP or Resolution Professional (RP) to prepare and submit an information memorandum (IM) in electronic form to each member of the CoC and any potential resolution applicant.[19]

This information memorandum serves as a vital document providing key details about the CD's financial position, assets, liabilities, ongoing resolution process, and other relevant information. Prospective resolution applicants rely on this memorandum to assess the viability of formulating a resolution plan for the distressed company.

The IM plays a crucial role in facilitating transparency and informed decision-making among stakeholders involved in the insolvency resolution process. It enables potential resolution applicants to understand the intricacies of the CD's financial situation and formulate comprehensive resolution plans tailored to address its specific challenges.

Regulation 27 of the CIRP Regulations mandate the RP to appoint two registered valuers to determine the liquidation value and fair value of the CD in accordance with regulation 35 within seven days of his appointment.[20]

(e) **Submission of resolution plans:** Interested resolution applicants submit their resolution plans to the CoC through the IRP within the stipulated time frame.

(f) **Evaluation and approval of resolution plans:** The CoC evaluates the resolution plans received and exercising its commercial wisdom votes on the same. A resolution plan must receive approval from at least 66% of the voting share of the FCs for it to be accepted.

(g) **Approval by the NCLT:** Once a resolution plan is approved by the CoC, it is submitted to the NCLT for final approval. The NCLT assesses the plan for its feasibility and compliance with the provisions of the Code. If found satisfactory, the NCLT approves the plan.

(h) **Implementation of the resolution plan:** Upon approval by the NCLT, the resolution plan is implemented by the resolution applicant. The management and control of the company are transferred to the resolution applicant as per the terms of the approved plan.

(i) **Closure of CIRP:** The CIRP concludes once the resolution plan is successfully implemented, and the CD emerges from insolvency proceedings. If the resolution plan is not approved or fails to be implemented within the specified time frame, the company may be subjected to liquidation proceedings.

These steps outlined in the CIRP process under the Code aims to facilitate the timely and efficient resolution of insolvency cases in India while balancing the interests of creditors and stakeholders involved.[21]

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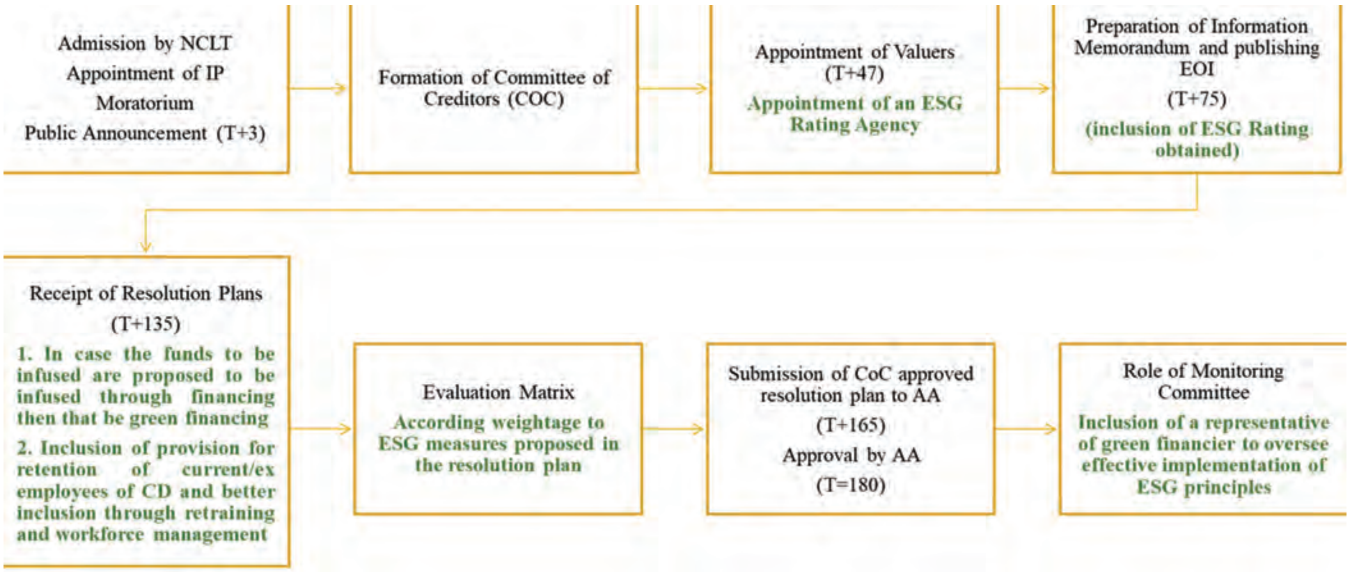
[19] *Id.*
[20] *Id.*
[21] Insolvency and Bankruptcy Code, 2016.

With the above process in mind, following suggestions for integration of ESG are put forth:



1. Suggestions

a) During the CIRP, the CoC holds the authority to appoint a valuer for the comprehensive evaluation of the business of a CD, particularly when the CD maintains the status of a going concern at the initiation of insolvency proceedings. Recognizing the growing importance of ESG factors in business sustainability and risk assessment, the CoC may opt to appoint an ESG Rating Agency for a thorough assessment of the CD's operations. Such an evaluation would encompass not only financial metrics but also consider environmental impact, social responsibility initiatives, and governance practices.

b) During the crucial stage of inviting expressions of interest from potential resolution applicants, the RP plays a pivotal role in facilitating a comprehensive evaluation of the CD's business dynamics. In this context, the RP may actively promote submission of plans that incorporate ESG ratings obtained by the CD. By leveraging the insights provided by ESG ratings, prospective resolution applicants can formulate plans that not only focus on financial viability but also address sustainability, social responsibility, and ethical governance aspects. Emphasizing the revival of the CD as a going concern entity, these plans strive to ensure a holistic restoration of the business while upholding its long-term sustainability objectives. Through this approach, the RP endeavours to foster resolutions that prioritize the interests of stakeholders, contribute positively to the broader ecosystem, and facilitate the enduring revitalization of the CD.

c) In formulating the evaluation matrix, it is prudent for the RP to consult with the CoCs and assign due consideration to ESG factors. Integrating ESG considerations into the evaluation matrix not only reflects a forward-looking approach but also underscores the significance of sustainable business practices in the resolution process. By collaboratively incorporating ESG metrics, the RP and CoC can assess the overall viability and resilience of potential resolution plans in a holistic manner. Environmental impact, social responsibilities, and governance practices are pivotal aspects that can influence the long-term sustainability and ethical standing of the restructured entity. Consequently, assigning some weightage to ESG considerations in the evaluation matrix promotes transparency, accountability, and alignment with international best practices. This inclusive approach not only enhances the quality and robustness of the evaluation process but also fosters stakeholder confidence and trust in the integrity of the insolvency regime. Therefore, giving due weightage to ESG considerations in the evaluation matrix represents a proactive step toward promoting responsible decision-making and advancing sustainable outcomes within the resolution framework.

d) In crafting resolution plans, it is imperative to underscore the integration of ESG factors alongside adoption of green financing mechanisms. Resolution plans that conscientiously incorporate ESG considerations and green financing principles exhibit a forward-looking approach toward sustainable business practices. By embracing ESG factors, resolution plans can address environmental risks, social impacts, and governance frameworks, thus fostering responsible and resilient business models. Concurrently, leveraging green financing mechanisms aligns financial strategies with environmentally sustainable initiatives, facilitating the transition toward low-carbon economies and resource-efficient operations. Embracing ESG factors and green financing not only enhances the resilience of businesses but also amplifies their capacity to generate long-term value for stakeholders while contributing positively to societal and environmental well-being. As such, integration of ESG considerations and green financing principles represents a pivotal step in crafting holistic and impactful resolution plans that drive sustainable growth and resilience in the evolving business landscape.

e) During the post-resolution monitoring phase, when a resolution plan incorporates provisions for green financing, it is advisable to include a representative of the green financier in the monitoring committee as a necessary party to oversee ESG compliance and implementation. The inclusion of such a representative ensures that the ESG objectives outlined in the resolution plan are effectively monitored and executed. Their presence enables a focused oversight mechanism specifically tailored to assess the adherence to green financing commitments, environmental sustainability targets, and social responsibility obligations stipulated in the resolution plan. By actively involving a representative of the green financier in the monitoring committee, the resolution process gains valuable expertise and oversight dedicated to advancing sustainable business practices and fostering accountability in ESG performance post-resolution. This collaboration underscores a commitment to aligning financial strategies with environmental and social considerations, thereby promoting responsible and sustainable corporate behaviour within the insolvency regime.

f) As part of the social obligations under ESG principles, it is advisable that existing employees of a CD be considered for absorption as employees by the successful resolution applicant. This initiative not only reflects a commitment to social responsibility but also acknowledges the importance of maintaining stability and continuity within the workforce. By absorbing existing employees, the resolution applicant can leverage their knowledge, skills, and experience, thereby facilitating a smoother transition and preserving valuable human capital. Furthermore, retaining employees aligns with the principle of social sustainability, as it mitigates the adverse impact of job losses on individuals and their families, fosters employee morale, and contributes to the broader socioeconomic well-being of the community. Integrating existing employees into the post-resolution framework not only supports the principles of fairness and inclusivity but also strengthens the long-term viability and success of the restructured entity, ultimately enhancing its reputation and stakeholder trust in the market. Therefore, prioritizing the absorption of existing employees by successful resolution applicants represents a proactive step towards fulfilling social obligations and promoting sustainable business practices within the insolvency regime.

CONCLUSION

In conclusion, the convergence of ESG principles with corporate restructuring initiatives represents a transformative pathway towards sustainable recovery, resilience, and stakeholder value creation. Through the lens of global best practices and regulatory imperatives, this paper has underscored the imperative for businesses to embrace ESG considerations as an integral component of their strategic decision-making processes.

The discourse surrounding ESG and corporate restructuring transcends traditional paradigms of financial viability and creditor repayment, emphasizing the need for a holistic approach that addresses environmental sustainability, social responsibility, and governance integrity. By aligning financial objectives with broader societal imperatives, businesses can cultivate enduring resilience, mitigate reputational risks, and enhance stakeholder trust in an era characterized by unprecedented challenges and opportunities.

In parallel, regulators and legislators play a pivotal role in shaping the discourse surrounding ESG integration within corporate restructuring. Through proactive engagement, policy advocacy, and regulatory frameworks that incentivize ESG disclosure and compliance, regulators can catalyse a culture of transparency, accountability, and sustainability across diverse industries. Legislative reforms aimed at embedding ESG considerations within the fabric of insolvency laws can further fortify India's commitment to sustainable recovery and stakeholder-centric governance.

Moreover, within the context of India's IBC, there exists a compelling opportunity to integrate ESG principles into the fabric of the restructuring process. By advocating for purposive reforms, stakeholder engagement, and capacity-building initiatives, India can emerge as a trailblazer in leveraging insolvency proceedings as a conduit for sustainable development, inclusive growth, and ethical stewardship.

As businesses navigate the complexities of an ever-evolving regulatory landscape and heightened stakeholder expectations, the imperative to embed ESG considerations within corporate restructuring practices cannot be overstated. Through collaborative efforts, innovative solutions, and a steadfast commitment to ESG integration, stakeholders stand poised to not only navigate financial distress but also catalyse a paradigm shift towards a more sustainable, equitable, and resilient corporate ecosystem.

In essence, the integration of ESG principles within corporate restructuring represents a defining moment for businesses to transcend short-term financial imperatives and embrace a broader mandate of societal relevance, environmental stewardship, and governance excellence. By embracing this transformative ethos, stakeholders can chart a course towards sustainable recovery, prosperity, and enduring value creation in the pursuit of a more sustainable and inclusive future.

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